Key Regulatory Developments For Enterprise Customers

Jim Blaszak and Colleen Boothby

The FCC moves slowly—here's what to expect from decisions it has made and those that are pending

Smart enterprise customers stay informed about significant developments in telecommunications regulation because regulation can affect the price, quality and availability of both basic and state-of-the-art services. Savvy customers also know that what happens to carriers at the FCC, in the courts, and before Congress spills over to affect the marketplace. Customers who adjust their procurement strategies to account for regulatory changes are better prepared to weather the marketplace consequences of those regulatory changes.

What follows, therefore, is a high-level summary of the key decisions made by the FCC and the federal courts in 2004 that will affect the interests of enterprise customers. Overall, enterprise customers are likely to face heavy weather—in the form of fewer choices, higher prices and lower service quality—as a result of those decisions. This is not because of direct rulings against customers, but because of rulings that are likely to further undermine the development of competition in the telecommunications industry.

Jim Blaszak and Colleen Boothby are partners at Levine, Blaszak, Block & Boothby, LLP. They represent enterprise customers in the acquisition of telecommunications and technology products, in the resolution of disputes with providers, and on regulatory and public policy matters before the FCC and the federal courts.

Competitors Under Siege In Local Markets

The Bell Operating Companies (BOCs) won major victories in 2004 that dim the already bleak prospects for competition in local exchange markets. At the root of these victories lies the lengthy and complex August 2003 order by the FCC known as the "Triennial Review Order" or the "TRO." In that order, the FCC cut back—though it did not completely eliminate—the requirement that incumbent local exchange carriers like the BOCs allow would-be competitors to buy unbundled network functionalities to fill out the geographic scope of their nascent networks while they construct their own facilities.

In March 2004, a federal appeals court rejected significant parts of the FCC's TRO decision and articulated new unbundling standards that will make it easier for BOCs to withhold network functionalities from their competitors in the future. In compliance with the court's order, the FCC added yet another phase to the complex TRO proceeding to replace its vacated rules.

As of this writing, the FCC has not published the new unbundling rules. But the commission has indicated informally that the new rules will impose much tighter constraints on competitor access to incumbent networks. Most observers expect an FCC order that will seal the fate of many would-be competitors, absent either a revolution in network technology that reduces network deployment costs, or unlimited patience in the capital markets while competitors build out their networks—neither of which seems likely.

Given these developments—coupled with an FCC and a judiciary that prefer facility-based competitors who do not need access to incumbent networks—AT&T announced that it would exit the local services market and would stop marketing long distance service to the residential market. Although MCI and Sprint did not make similar announcements, they have indicated that they will also abandon active marketing of long distance service to smaller customers.

Those responses make business sense—long distance carriers can't compete effectively in today's consumer market if they are prevented from including cost-competitive local service in their service bundles. But this development strengthens the position of incumbent local carriers like the BOCs, who can be expected to use the higher revenues and the benefits of scope and scale that result from their dominance in the residential market to fund more aggressive efforts to win enterprise customers away from traditional long distance carriers.

In the relatively short term, some BOCs may offer more aggressive prices and better contractual terms and conditions than traditional long distance providers. But the BOCs tend to vary significantly in the responsiveness and flexibility they are willing to exhibit in order to obtain enterprise customer business. Until they improve substantially on both fronts, customers should expect an uneven experience with the BOCs.

Nevertheless, and regardless of whether one or more of the BOCs acquires one or more of the long distance carriers, enterprise customers would be well advised to respond to the past year's regulatory developments by including the BOCs when they seek service provider bids. If the BOCs win some enterprise procurements, the market will likely become more competitive and enterprise customers would benefit. If the BOCs initially lose procurements, they will figure out what they need to do to win, again benefiting customers.

In the long term, however, the BOCs' efforts in the enterprise market are likely to lead to market concentration—an adverse outcome for enterprise customers because less competition invariably means less responsive service providers and reduced price competition.

IP Services In The Spotlight

Services based on IP technologies attracted considerable industry and regulatory attention in 2004, and will draw even more interest in 2005. Voice over IP (VOIP) attracted most of the press coverage, of course. As an application that enterprise customers can run on their private networks, VOIP promises better service features and cost management. But as a technology that enables cable television networks and new providers, such as Vonage, to compete with the incumbent telcos for local and long distance calling services, VOIP also promises to be the source for what little competition there may be, particularly for residential customers.

Where VOIP is available, particularly over alternative networks such as cable television, the incumbent telcos can no longer be secure as *de facto* monopolists with respect to residential and small business services and highly profitable custom calling features (e.g., call waiting, three-way calling, Caller ID, etc.). But the loss of monopoly status means that any remaining "social engineering" of residential rates—by, e.g., subsidizing residential rates with revenues from toll, high-margin features, and inflated access service charges—is in jeopardy. Accordingly, state regulatory authorities and local exchange companies have been increasingly concerned about the effect of VOIP on intrastate telecommunications regulatory models and on residential telephone rates.

The FCC and federal district courts in various rulings last year rebuffed the efforts of several state regulators to subject particular VOIP services to intrastate telecommunications regulation. The FCC concluded that services like pulver.com's Free World Dialup service ("FWD") constitute interstate "information services," under the Communications Act. As such, they cannot be regulated at the state or federal level.

The FCC also held that services like Vonage's VOIP offering escape state regulation whether or not they constitute information services, because their use of the public Internet makes them inherently interstate services, and thus subject exclusively to the FCC's jurisdiction. In contrast, the FCC ruled that AT&T's phone-to-phone IP service, which uses IP as the transmission protocol only within AT&T's network, is a regulated telecommunications service.

As a consequence, services like FWD and Vonage that qualify as "true" VOIP will be free to develop without the hindrance of disparate or conflicting state regulatory regimes, including market entry limitations that might otherwise protect the incumbent telcos' market positions. "True" VOIP services will also escape the imposition of intrastate access charges that could otherwise reduce the economics of deploying VOIP.

Where VOIP services are available, telcos are no longer secure as monopolists

Enterprise customers should benefit from these regulatory safe harbors for VOIP, assuming that a more predictable regulatory environment stimulates additional competitive offerings from "true" VOIP providers. More competitors should translate into better service and lower prices.

Unfortunately, substantial regulatory uncertainty still over-hangs VOIP on the interstate front. So far, the FCC has only considered certain individual flavors of VOIP. It has not made a generic ruling, but it did initiate a rulemaking in 2004 to examine important questions about the extent to which it should regulate "IP-enabled services," which includes VOIP.

One of the most significant issues in the proceeding is the extent to which IP-enabled services constitute regulated telecommunications rather than unregulated information services. Even if the FCC concludes that a particular VOIP offering constitutes an information service, however, the FCC could impose other regulatory obligations. These could include the provision of 911 and enhanced 911 services (which require networks to transmit information about a caller's geographic location), compliance with the Communications Assistance for Law Enforcement Act (CALEA, which requires carriers to incorporate surveillance capabilities in their networks), access for persons with disabilities and various additional consumer protection measures.

Decision-makers at the FCC seem disinclined to impose traditional regulatory obligations on

Enterprises should keep rate flexibility, because access charges are poised to fall

most IP-enabled services as a matter of national policy. They want to encourage the development of new technologies and services that compete at a facilities level with the incumbent service providers. They have suggested that imposition of significant regulatory burdens on IP-enabled services would impede the development of IP-enabled services.

Nevertheless, enterprise customers should take regulatory uncertainty into account when they contract for IP-enabled services. How to do that is a topic we will explore in a future article.

Access Charge Rules Under Fire

The FCC did nothing in 2004 to fundamentally reform its 20-year-old regime for access charges. These are the charges that long distance carriers pay to local carriers to originate and terminate long distance traffic over local "last mile" networks. Nor did the FCC move on its proceeding to re-vamp "inter-carrier compensation," the charges local carriers pay each other when a local call is bound for a location on another local carrier's network (also see this issue, pp. 16–17).

Access charges and inter-carrier compensation are significant cost drivers for enterprise customer rates, constituting as much as 35–40 percent of some switched access services (e.g., toll-free service at the originating end) and a sizeable (although highly variable) portion of special access services (such as leased line, frame relay, VPN and other data services). FCC action to push these charges down, which would allow long distance charges to drop, is long overdue.

After more than a year of closed-door negotiations, a group known as the Inter-Carrier Compensation Forum (ICF, consisting of the major long distance carriers, some second tier long distance carriers, and SBC), proposed an inter-carrier compensation regime to replace both access charges and reciprocal compensation. The ICF proposal includes higher line charges for end users, bigger universal service payments to rural local exchange carriers, and some transitional inter-carrier payment mechanisms. Switched access charges would decline dramatically, moving from the current average rate of about 0.6 to 0.65 cents per minute, down to .0175 cents per minute in four steps, eventually hitting zero.

The FCC probably will not adopt the Inter-Carrier Compensation Forum proposal as presented. The proposal is significant, however, because it reflects broad, if not universal, agreement that the current access charge and reciprocal compensation systems are under tremendous pressure and, at least in their present form, probably cannot survive technological and marketplace changes like the introduction of VOIP and the migration of customer demand to wireless service.

On the other hand, rural local exchange carriers, consumer advocates and some competitive local exchange carriers oppose the Inter-Carrier Compensation Forum proposal, though for different reasons. The rural carriers believe that they would lose money under the proposal, while the consumer advocates oppose any proposal that would increase subscriber line charges or any other recurring charge that is unrelated to usage.

What conclusions should an enterprise customer draw, and what should enterprise customers do, in response to the Inter-Carrier Compensation Forum proposal and the opposition it has generated? Expect access charges to decline and rates for traditional voice service to drop even further.

The timeline and degree of change are far from certain, but actual rate changes for access service will probably not occur in 2005. Nevertheless, enterprise customers should avoid being financially or operationally tethered to a particular carrier and should avoid long-term contracts with limited rate flexibility because very significant switched access charge reductions will come. Enterprise customers should preserve in their contracts and purchasing practices some ability to negotiate new deals for uncommitted traffic or amendments to existing deals that reflect those reductions. Without good rate review provisions or the buying power to move traffic to alternative vendors, enterprise customers will find themselves at above-market rates.

Special Access Pricing Also Under Attack

"Special access" is the FCC's term for all access services other than "plain vanilla" switched access, and includes dedicated private lines, OCn's, T1s, DS3s, SONET, etc. In other words, special access refers to the services provided by incumbent local carriers like the BOCs that enterprise customers use the most.

The BOCs' excessively high special access prices have been a sore point for enterprise customers and long distance carriers for the past several years, prompting challenges in several procedural settings before the FCC. The prices came under renewed attack from two parties in 2004.

The Ad Hoc Telecommunications Users Committee (a group of enterprise customers represented by the authors' law firm) filed a White Paper in a number of FCC rulemaking proceedings which demonstrates that the BOCs have used the special access pricing flexibility granted to them by the FCC in 2001 to raise their rates for services that they claimed were competitive. According to Ad Hoc, the BOCs earned on average a whopping 43.7 percent fully-loaded rate of return (that's *after* interest, taxes, depreciation and amortization, *not* EBITDA) on special access in 2003, costing businesses more than $15 million a day.

Ad Hoc determined that incumbent local exchange carriers remain the sole source of connectivity for enterprise customers at roughly 98 percent of all business premises nationwide. The FCC, in Ad Hoc's view, should give the BOCs regulatory flexibility to cut prices where competition emerges, but should also protect customers where competition does not emerge. At a minimum, Ad Hoc urged the FCC to order the BOCs to reduce their overpriced special access rates so that their fully-loaded rate of return drops closer to the authorized level of 11.25 percent.

FCC inaction regarding excessive BOC special access prices also caught the attention of the U.S. Court of Appeals for the District of Columbia Circuit. The court called the FCC in to explain why the commission had been sitting on an AT&T petition seeking re-regulation of BOC special access prices because of the price gouging described above. AT&T's petition proposes the same solution as that advocated by Ad Hoc—an immediate reduction in overpriced special access rates and regulation where competition has not yet emerged. At oral argument, the FCC's lawyer told the court that an order dealing with AT&T's petition was before the FCC Commissioners for action. To give the FCC an opportunity to act on AT&T's petition, the Court has deferred action until early December 2004. At press time, this action had not occurred.

The FCC's forthcoming order could have a significant impact on prices for business services. Enterprise customers should prepare for the worst if the FCC declines to revisit its virtual deregulation of BOC special access pricing. If, on the other hand, the FCC starts such a proceeding, the BOCs may restrain additional special access rate increases pending conclusion of the proceeding. As a result of the efforts of AT&T and the Ad Hoc Telecommunications Users Committee in 2004, there is a chance that BOC special access price increases may abate in 2005.

Universal Service Surcharge On The Edge

The universal service surcharge that most enterprise customers see on their interstate bills was relatively static in 2004—8.7 percent of interstate and international billings in the first two quarters rising to 8.9 percent in the second two quarters. But the surcharge truly is the tip of an ominous iceberg, rising or falling with increases in the size of the funds for which the surcharge is collected.

Policy-makers have a newfound interest in the size of those funds because expansion in one of those funds threatens to push the Universal Service Fund (USF) surcharge above 10 percent, a threshold considered too politically sensitive to cross. In the face of projections that the surcharge would actually hit 12 percent by the end of this year, the USF system came under heightened scrutiny at the FCC and in Congress in 2004.

The USF is paid out to four different fund groups: high-cost rural telephone companies; schools and libraries; rural telemedicine projects; and low-income subscribers. The size of each of these funds is determined by how much the recipients claim to need, with the exception of the E-rate, which is capped at $2.25 billion per year. The fund for high-cost rural telephone companies is the source of the surcharge increases on enterprise customer bills, thanks to virtually unbridled growth in the size of that fund. The fund has grown over many years, outstripping the projections used to justify the FCC rules creating it.

In 1999, high-cost support subsidies were just over $1.72 billion. In 2004, high-cost support will approximate $3.5 billion. Verizon has predicted that high-cost subsidies will top $3.75 billion per year in 2005. With influential elected officials proclaiming the need for virtually ubiquitous availability of broadband service, particularly in rural areas, the high-cost component of the Universal Service Fund probably will continue to grow at an alarming rate.

The FCC's solution to this problem for the past three calendar quarters has been to shift undistributed funds in the schools and libraries component of the USF to the high-cost fund. But this is only a band-aid, since there is nothing in the FCC's rules, or the rural telcos' spending habits, that will put the brakes on high-cost fund growth.

In 2004, the FCC asked interested persons to comment on a proposal to limit universal service high-cost subsidies to "primary" lines. The practical effect of the proposal would be to limit the universal service subsidies paid to qualifying wireless service providers who receive the same level of subsidization for each activated handset as rural telcos receive for each subscriber line.

The FCC's inquiry, however, only nibbles at the edges of the universal service surcharge problem. A trade association representing wireless service providers (CTIA) pointed out that between 2000 and 2003, the high-cost support received by wireless providers increased by about $124.5 million, while the wireline support grew by $900 million—over seven times as fast.

Western Wireless, in a separate petition for rulemaking, asked the FCC to change the standard that it uses to determine the level of high-cost subsidies received by local exchange carriers serving rural areas. According to Western Wireless and other parties, the current standard creates an incentive for rural telcos to misallocate costs, invest in plant not needed for services eligible for universal service subsidies, and at the very least, encourages tremendous inefficiency. The FCC reached no decision in 2004 on what to do about the astounding growth in the high-cost component of the USF.

At least the FCC started a process that may lead to corrective action. Neither the FCC nor state regulators have sufficient resources to scrutinize the accounting and cost allocations of a meaningful percentage of the more than 1,000 rural telephone companies. Since 1998, the FCC has performed just seven audits. The quasi-governmental company charged with overseeing the USF—the Universal Service Administrative Company—plans to use its own personnel and outside

Proceedings before the FCC could force the BOCs to lower special access rates

Customers should expect less competition, leading to higher prices and poorer service quality

auditors to perform more than 250 audits of high-cost subsidy recipients.

If the audits are rigorous, they may help control the growth in the universal service surcharge. Like so many of the 2004 developments, however, the real consequences will not be seen until 2005, or perhaps even 2006.

The next biggest component of the Universal Service Fund is the schools and libraries fund (the so-called E-Fund). Generally, the E-Fund subsidizes telecommunications and Internet connectivity for schools at which a very high percentage of the students qualify for the federal school lunch program. Congress held hearings on alleged fraud and waste in the E-Fund and the FCC launched its own investigation and amended its E-Fund rules. Despite the publicity given these investigations, neither the FCC's action nor the congressional investigations reduced the size of the E-Fund, which is capped at $2.25 billion per year.

Further reform of the universal service system is related to reform of the current access charge system. If the FCC adopts the Inter-Carrier Compensation Forum proposal or one similar to it, some telcos claim that the universal service surcharge would soar to unacceptable levels in order to compensate rural carriers for lower switched access revenues. Other proposals would change the USF contribution methodology from assessments based on interstate revenues to charges applied per working telephone number and/or unit of capacity connected to the public switched network.

Because USF surcharges can impose significant increases on enterprise customer bills, and because enterprise customers have historically been the favorite target for state and federal regulators trying to subsidize the USF charges paid by residential customers, enterprise customers must be alert to the possibility of significant increases in the amounts they would be required to pay, and they should budget accordingly.

Conclusion

In all the areas reviewed above—local markets, IP services, access charges and universal service—federal regulators and the courts struggled for the past year to reconcile their deregulatory policy preferences with the brute reality that robust competition is not emerging in today's telecommunications marketplace. If competitive forces remain too weak to protect customers from overpricing and poor service quality, then enterprise customers will need regulatory protections, and regulatory savvy, to keep their prices low and their service quality high□