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FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of	)	
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Access Charge Reform	)	CC Docket No. 96-262
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
Transport Rate Structure and Pricing	)	CC Docket No. 91-213
	)	
Usage of the Public Switched Network by Information Service and Internet Access Providers	)	CC Docket No. 96-263
	)	

NOTICE OF PROPOSED RULEMAKING, THIRD REPORT AND ORDER, AND NOTICE OF INQUIRY

Adopted: December 23, 1996 **Released:** December 24, 1996

NPRM Comment Date: January 27, 1997
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By the Commission:

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I. INTRODUCTION

A. Overview

1. In passing the Telecommunications Act of 1996 (1996 Act),[1] Congress sought to establish "a pro-competitive, de-regulatory national policy framework" for the United States telecommunications industry.[2] With this Notice, we commence the third in a trilogy of actions that collectively are intended to foster and accelerate the introduction of efficient competition in all telecommunications markets, pursuant to the mandate of the 1996 Act. In August 1996, as required by the 1996 Act, we adopted rules to implement Sections 251 and 252 of the Act, which establish the basic obligations of carriers, especially in the local exchange and exchange access markets.[3] In November 1996, pursuant to Section 254 of the Act, the Federal-State Universal Service Joint Board issued its recommendations to the Commission for reforming our system of universal service so that universal service is preserved and advanced, but in a manner that permits the local exchange and exchange access

[1] Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56, *to be codified at* 47 U.S.C. §§ 151 *et. seq* (1996 Act). Hereinafter, all citations to the 1996 Act will be to the 1996 Act as codified in the United States Code.

[2] S. Conf. Rep. No. 104-230, 104th Cong., 2d Sess. 1 (1996) (*Joint Explanatory Statement*).

[3] Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98, First Report and Order, 11 FCC Rcd 15499 (1996) (*Local Competition Order*), Order on Reconsideration, CC Docket No. 96-98, 11 FCC Rcd 13042 (1996) (*Local Competition Reconsideration Order*), *petition for review pending and partial stay granted, sub nom.* Iowa Utilities Board et. al v. FCC, No. 96-3321 and consolidated cases (8th Cir., Oct. 15, 1996), *partial stay lifted in part*, Iowa Utilities Board et. al v. FCC, No. 96-3321 and consolidated cases (8th Cir. Nov. 1, 1996).

markets to move from monopoly to competition.[4] In this proceeding, we seek to reform our system of interstate access charges to make it compatible with the competitive paradigm established by the 1996 Act and with state actions to open local networks to competition.[5]

2. The 1996 Act seeks to develop efficient competition by opening all telecommunications markets through a pro-competitive, deregulatory national policy framework. To that end, the 1996 Act eliminates state and local legal and regulatory barriers to entry, and bans state and local governmental actions that have the effect of prohibiting any entity from offering any telecommunications service.[6] The Act also requires all telecommunications carriers to interconnect directly or indirectly with other telecommunications carriers in order to facilitate the creation of a "network of networks."[7] In addition, the 1996 Act requires all local exchange carriers (LECs) to establish reciprocal compensation arrangements for the transport and termination of calls,[8] and prohibits incumbent LECs from charging more than the additional cost incurred to transport and terminate a call.[9] The Act further directs all LECs to provide number portability and dialing parity.[10] The 1996 Act confers three fundamental rights on potential competitors to incumbent LECs: the right to interconnect at rates based on cost, including a reasonable profit; the right to obtain unbundled network elements at cost-based rates; and the right to obtain an incumbent LEC's retail services at wholesale discounts in order to resell those services.[11]

3. The Act also directs the Commission, after receiving the recommendations of a Federal-State Joint Board, to define the services to be supported by federal universal service mechanisms, to support such services in a manner that is "explicit and sufficient," and to ensure that "every telecommunications carrier that provides interstate telecommunications

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[4] Federal-State Joint Board on Universal Service, CC Docket No. 96-45, Recommended Decision, FCC 96J-3 (rel. Nov. 8, 1996) (*Joint Board Recommended Decision*).

[5] In providing interstate long-distance service, interexchange carriers use local telephone companies' facilities to originate and terminate calls. The use of local telephone company facilities to originate and terminate long-distance calls is referred to as access service. Local exchange carriers receive access charges for providing interexchange carriers with access to the local exchange carrier's customers.

[6] 47 U.S.C. § 253.

[7] *See* 47 U.S.C. § 251(a).

[8] 47 U.S.C. §§ 251(b)(5), (c)(2), and (c)(3).

[9] 47 U.S.C. § 252(d)(2).

[10] 47 U.S.C. §§ 251(b)(2) and (b)(3).

[11] 47 U.S.C. § 251(c)(4).

services shall contribute, on an equitable and non-discriminatory basis, to the specific, predictable and sufficient mechanisms . . . to preserve and advance universal service."[12] The Act further provides that multiple carriers may seek and obtain designation as carriers eligible to receive universal service funds for service within a particular geographic area.[13] As a whole, these provisions of the 1996 Act, when fully implemented, should greatly reduce the legal, regulatory, economic, and operational barriers to entry in the local exchange and exchange access market.

4. The 1996 Act also ends the prohibition against provision of interLATA services[14] by Bell Operating Companies (BOCs) that was imposed by the Modification of Final Judgment.[15] BOCs were permitted immediately upon enactment of the 1996 Act to begin to provide certain interLATA services, including out-of-region and incidental interLATA services. In order to provide interLATA services originating in-region, however, a BOC is first required to obtain Commission approval. In order to approve such an application, the Commission must find that the BOC has met the requirements of the "competitive checklist," that the BOC will comply with the Act's separate affiliate requirements, and that grant of the application is consistent with the public interest, convenience and necessity.[16]

5. These fundamental changes in the structure and dynamics of the telecommunications industry wrought by the 1996 Act now necessitate that the Commission review its existing access charge regulations to ensure that they are compatible with the 1996 Act's far-reaching changes. We also seek to eliminate, either now or as soon as changes in the marketplace permit, any unnecessary regulatory requirements on incumbent LEC exchange access services. While a broad range of telecommunications industry participants, including both interexchange carriers (IXCs) and incumbent LECs, have long advocated for the Commission to commence a comprehensive review of access charges, the Act accelerates and intensifies the need for such a review. We commence this review of the Commission's Part 69 interstate access charge rules, together with its Part 61 price cap rules, to determine the

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[12] 47 U.S.C. § 254.

[13] 47 U.S.C. § 214(e). We note that, while section 214(e) requires a state commission to designate additional eligible telecommunications carriers upon request and consistent with the public interest, in the case of an area served by a rural telephone company, section 214(e) permits a state commission to designate additional eligible telecommunications carriers only if the state commission finds that the designation is in the public interest. 47 U.S.C. § 214(e)(2).

[14] Section 3(21) of the 1996 Act defines interLATA services as "telecommunications between a point located in a local access and transport area and a point located outside such area." 47 U.S.C. § 153(21).

[15] United States v. AT&T, 552 F.Supp. 131 (D.D.C. 1982) (*MFJ*).

[16] 47 U.S.C. § 271.

extent to which we must revise these rules to take account of the local competition and Bell entry provisions of the 1996 Act and state actions to open local networks to competition; to reflect the effects of potential and actual competition on incumbent LECs' pricing for interstate access; to implement the Act's direction to end implicit universal service subsidies in favor of a system of explicit subsidies; and to establish fair rules of competition for both the local exchange and interexchange markets, especially as carriers begin to offer service packages that bundle local and interexchange offerings.

6. We adopted our Part 69 rules at approximately the same time that AT&T divested its local exchange operations and established the seven regional Bell companies pursuant to the *MFJ*. The rules were designed to promote competition in the interstate, interexchange market by ensuring that all IXCs would be able to originate and terminate their traffic over incumbent LEC networks at just, reasonable, and non-discriminatory rates. While our Part 69 rules expressly contemplated competition in the interexchange market, they were not designed to address the potential effects of competition in the local exchange and exchange access market. Indeed, these rules reflected the reality of the telecommunications marketplace in 1983 -- and what was mandated in some states prior to the 1996 Act -- that the incumbent LEC was the monopoly provider of local exchange and exchange access services. In adopting the Part 69 rules, the Commission did not seek to eliminate implicit support flows, but in fact incorporated such flows into the Part 69 rate structure. Our Part 69 rules are designed to be consistent with our jurisdictional separations rules that govern the allocation of incumbent LECs' expenses and investment between the interstate and state jurisdictions.[17] Consequently, the Part 69 access charge system likely reflects any jurisdictional cost misallocations mandated by our current separations rules. As such, the Part 69 rules are fundamentally inconsistent with the competitive market conditions that the 1996 Act attempts to create. We will soon begin a related proceeding to examine our jurisdictional separations rules in light of the 1996 Act.

7. Competition isolates and highlights the inefficiencies and distortions present in the current Part 69 access charge rules. Our present interstate access charge regime, for example, requires incumbent LECs to maintain rate structures that have been widely criticized as economically inefficient. In particular, even though the costs of the local loop do not vary with the amount of traffic carried by the loop, our current rules require incumbent LECs to recover a portion of those costs through traffic-sensitive carrier common line (CCL) charges imposed on IXCs. While Part 69 mandates per-minute charges for local switching, the portion of local switching costs that is associated with ports appears to be driven by the number of lines connected to the switch, not by the number of minutes of traffic routed by the switch. The transport interconnection charge (TIC) is a non-facilities-based, per-minute charge imposed on all switched access customers regardless of whether they use the incumbent LEC's transport facilities. Rather than fostering efficient pricing and competition,

[17] Part 36 of the Commission's Rules; 47 C.F.R. §§ 36.1 *et seq.*

these mandatory rate structures inflate usage charges and reduce charges for connection to the network, in essence overcharging high-volume end users in order to reduce rates for low-volume end users.

8. Although these inefficient rate structures might have been sustainable in a local monopoly environment, the introduction of competition from providers operating their own network facilities or leasing network facilities as unbundled network elements may undermine these access rate structures. A competing provider of exchange access services entering a market can use its own facilities or lease unbundled network elements to target selectively the incumbent LEC's high-volume end users with efficiently priced access service offerings. This places the incumbent LEC at a regulatorily-imposed disadvantage in competing for high-volume end users, and jeopardizes the source of revenue that permits the incumbent LEC to cover its costs of providing service to low-volume end users. At the same time, these inefficient rate structures and implicit support flows also create artificial impediments to any new entrants that might seek to serve the subsidized end users, because they must attempt to do so without the benefit of a subsidy. As a result, these access rate structures may inhibit the development of competition for service to low-volume end users.

9. Competition also allows entrants to arbitrage between different pricing systems. For example, if transport and termination rates are lower than access charge rates, a competitor would have an incentive to funnel interexchange terminating access traffic through transport and termination arrangements where possible. Whether traffic originates locally or from a distant exchange, transport and termination of traffic by a particular LEC involves the same network functions. Ultimately, the rates that local carriers impose for the transport and termination of local traffic and for the transport and termination of long distance should converge. As a legal matter, however, transport and termination of local traffic by an incumbent LEC are different services from access service provided by that incumbent LEC for long-distance telecommunications. Transport and termination of local traffic are governed by 251(b)(5) and 252(d)(2), while access charges for interstate long-distance traffic are governed by sections 201 and 202 of the Act.

10. This Commission has previously examined the impact of state-led reforms in New York and Illinois on the existing access charge rate structures, and has concluded that some interim modifications to the incumbent LECs' rate structures were warranted where states had implemented market-opening measures similar to those mandated by the 1996 Act. The Commission concluded that competitive developments in the New York City, Chicago, and Grand Rapids LATAs justified granting NYNEX and Ameritech limited waivers of our access charge rules to allow them to recover the TIC on a geographically deaveraged basis and to

bulk bill some of their common line costs rather than recovering them through the per-minute CCL charge.[18]

11. In addition to their criticisms of the access charge rate structures, IXCs, in particular, have insisted that the rate levels of access charges are excessive and must be reduced. AT&T asserts, for instance, that the current average per-minute access rates of the BOCs are nearly seven times the forward-looking economic cost of providing that service, and that total interstate access charges collected today from interexchange carriers exceed forward-looking economic cost by $11 billion, or 70 percent of the total.[19] IXCs argue that, if access prices are allowed to remain at current levels, they will face an anticompetitive disadvantage both in the local exchange market and in the interexchange market whenever an incumbent LEC also provides interexchange services.[20]

12. In this item, we first adopt two initial steps toward reforming our system of access charges. In the sections that comprise the Third Report and Order in the Price Cap Performance Review for Local Exchange Carriers, we eliminate the lower service band indices, which unnecessarily restrict the ability of price cap LECs to lower their access prices. Under our existing rules a price cap LEC must specifically justify a proposal to lower its access charges below the pricing floors established by the indices. Thus, our rules currently discourage price cap LECs from lowering prices even when it would be economically efficient to do so. These rules also hamper a price cap LEC in responding to lower-priced access service offerings by competing access service providers. To encourage the development and prompt deployment of new switched access services, we also streamline the process for price cap LECs to offer such services.

13. In the Notice of Proposed Rulemaking portion of this item, we initiate a comprehensive review of our interstate access charge regime. We propose a series of reforms to the existing access charge rate structure rules that are designed to eliminate the inefficiencies summarized above. Our goal is to end up with access charge rate structures that a competitive market for access services would produce.

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[18] The NYNEX Telephone Companies Petition for Waiver, Transition Plan to Preserve Universal Service in a Competitive Environment, Memorandum Opinion and Order, 10 FCC Rcd 7445 (1995); Ameritech Operating Companies, Petition for a Declaratory Ruling and Related Waivers to Establish a New Regulatory Model for the Ameritech Region, Order, FCC 96-58 (rel. Feb. 15, 1996).

[19] Letter from Bruce K. Cox, Government Affairs Director, AT&T, to William F. Caton, Acting Secretary, FCC, October 9, 1996, filed in CC Docket No. 96-45; Letter from R. Gerard Salemme, Vice President, Government Affairs, AT&T, to Regina Keeney, Chief, Common Carrier Bureau, Nov. 22, 1996 (*AT&T November 22 Letter*).

[20] *See, e.g., AT&T November 22 Letter.*

14. We also outline in this item two possible approaches for addressing claims that existing access charge levels are excessive, for establishing a transition to access charges that more closely reflect economic costs, and for deregulating incumbent LEC exchange access services as competition develops in the local exchange and exchange access market. The first is a market-based approach under which we would rely on potential and actual competition from new facilities-based providers and entrants purchasing unbundled elements to drive prices for interstate access services toward economic cost. Under this approach, we would gradually relax and ultimately remove existing Part 69 rate structure requirements and Part 61 restrictions on rate level changes as marketplace forces provide the discipline on incumbent LEC access prices that our rules are currently needed to apply. The second is a more prescriptive approach to access reform under which this Commission would specify the nature and timing of the changes to the existing rate levels. These approaches could be employed singly or in combination. We emphasize, however, that under either approach, our ultimate goal is the same -- adoption of revisions to our access charge rules that will foster competition for these services and enable marketplace forces to eliminate the need for price regulation of these services.

15. Under the market-based approach to access reform, we propose two intermediate phases, each of which would require an incumbent LEC to demonstrate that certain circumstances exist in order to obtain greater pricing flexibility than the current rules permit. We also propose that an incumbent LEC's access services be deregulated, that is, removed from price cap and tariff regulation, once they are subject to substantial competition. At the first phase, an incumbent LEC would have to show that its local market has been opened to competition and potential rivals are able to enter through any of the three avenues mandated by the 1996 Act -- interconnection, unbundled network elements, and resale. We ask whether an incumbent LEC making such a showing should be permitted to deaverage geographically its rates for interstate access services, to offer volume and term discounts, and to offer contract-based tariff offerings for interstate access. We also ask whether new services should be deregulated at that phase. At the second phase in our market-based approach, an incumbent LEC would have to show that it faces actual competition in the local exchange marketplace. We ask whether, at that phase, we should eliminate service categories within baskets, permit incumbent LECs to engage in differential pricing of access to residential, single-line business, and multi-line business customers, and eliminate mandatory rate structures for local switching and transport. We also seek comment on combining the trunking and traffic-sensitive baskets at that stage.

16. A second option for access reform is a more prescriptive approach. Marketplace forces alone may not be sufficient to drive access rates to forward-looking economic costs. Under this approach, we ask whether we should require incumbent LECs to move prices for interstate access in their service areas to more economically-efficient levels pursuant to rules adopted in this proceeding. As with a market-based approach, we also propose under this

prescriptive approach that we remove incumbent LEC access services subject to substantial competition from price cap and tariff regulation.

17. In Section II, below, we seek comment on issues affecting the scope of this proceeding. In Section III, we propose changes to our existing interstate access charge rate structures to make them more conducive to economic efficiency. We also discuss in Section III the reassignment of certain network facilities costs that under current rules are allocated to the Transport Interconnection Charge for recovery. In Section IV, we summarize our two basic approaches to access reform and propose eliminating price cap and tariff regulation for services subject to substantial competition. We also there seek comment on whether and when one approach or the other is preferable, or if a combination of these approaches should be used, and also, how such a combined approach should be structured. In Section V, we discuss in detail a market-based approach to access reform. In Section VI, we outline a more prescriptive approach to access reform.

18. In Section VII, we first discuss adjustments to the current interstate access charge regime that may be required due to actions taken in the Federal-State Universal Service Joint Board proceeding. We also raise in that section the issue of whether there is a significant difference between embedded incumbent LEC costs currently allocated to the interstate jurisdiction and recovered through access charges, and the forward-looking economic costs of interstate access. To the extent that implementation of access charge reform is expected to cause a significant reduction in incumbent LEC access revenues from current levels, we seek comment on whether such LECs are entitled or should be permitted to recover some or all of that difference through a temporary special recovery mechanism.

19. In Section VIII, we seek comment on possible additional changes to our access charge rules that may be necessary to make them compatible with the competitive market envisioned by the 1996 Act, including whether there is any special need for regulating terminating interstate access service and "open-end" services, whether provided by incumbent LECs or new entrants. We also discuss possible changes to our existing treatment of the use by interstate information service providers, such as Internet service providers, of incumbent LEC switched access networks to originate interstate traffic. In Section IX, we issue a Report and Order implementing the changes to the LEC price cap rules discussed above that were proposed in the *Price Cap Second FNPRM*.[21]

[21] Second Further Notice of Proposed Rulemaking in CC Docket No. 94-1, Further Notice of Proposed Rulemaking in CC Docket No. 93-124, and Second Further Notice of Proposed Rulemaking in CC Docket No. 93-197, 11 FCC Rcd 858 (1995) (soliciting comments on proposed and other possible changes to the price cap plan to reflect emerging competition in telecommunications services) (*Price Cap Second FNPRM*).

20. Finally, in Section X, we issue a Notice of Inquiry to examine fundamental issues about the implications of usage of the public switched network by information service and Internet access providers.

B. Background

1. Regulation of Interstate Exchange Access Service

21. For much of this century, most telephone subscribers obtained both local and long distance services from the same company, the pre-divestiture, integrated Bell System, owned and operated by AT&T. Although some telephone subscribers received local telephone service from non-Bell independent companies, AT&T still provided long distance service to these customers. AT&T compensated its Bell Operating Company subsidiaries for originating and terminating interstate calls through revenue division arrangements and compensated the independent companies for access pursuant to settlement agreements. In the 1970s, MCI and other IXCs (then called "other common carriers," or OCCs) began to provide switched long distance services in competition with AT&T Long Lines by attaching their own switches to local business lines purchased from the incumbent LECs and reselling AT&T services.[22] In 1979, AT&T and the OCCs, under Commission supervision, entered into a comprehensive interim agreement, known as Exchange Network Facilities for Interstate Access (ENFIA), to replace the local business rates with a different set of rates AT&T would charge OCCs for originating and terminating interstate traffic over the facilities of its local exchange affiliates.[23] AT&T Long Lines continued to compensate its local exchange affiliates and the independent exchange carriers for the use of their facilities pursuant to their division of revenues and settlements arrangements. Following a lengthy proceeding, the Commission in 1983 adopted uniform access charge rules that govern the provision of interstate access services by all incumbent LECs, BOCs as well as independents.[24]

22. The costs that incumbent LECs recover through interstate access charges are determined by a multi-step process. Incumbent LECs first record all their booked expenses and their cost of investment in the accounts prescribed by the Commission's Part 32 Uniform

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[22] *See* MCI Telecommunications Corporation, Docket No. 20640, Decision, 60 FCC 2d 25 (1976); MCI v. FCC, 561 F.2d 365 (D.C. Cir. 1977), *cert. denied*, 434 U.S. 1040 (1978); MCI v. FCC, 580 F.2d 590 (D.C. Cir. 1978), *cert. denied*, 439 U.S. 980 (1978).

[23] For additional background on the ENFIA agreement, *see, e.g.*, Investigation of Access and Divestiture-Related Tariffs, CC Docket No. 83-1145, Phase I and Phase II, Part 1, FCC 85-100, 57 Rad.Reg.2d 1229, 1241 (rel. March 8, 1985).

[24] MTS and WATS Market Structure, Third Report and Order, CC Docket No. 78-72, Phase 1, 93 FCC 2d 241 (*Access Charge Order*), *recon.*, 97 FCC 2d 682 (1983), *second recon.*, 97 FCC 2d 834 (1984).

System of Accounts (USOA).[25] They next divide the recorded investment and expenses between regulated and nonregulated services, pursuant to Part 64 of our Rules. Incumbent LECs then divide regulated expenses and investment between state and interstate jurisdictions pursuant to the separations procedures contained in Part 36 of the Commission's rules.[26] Incumbent LECs then apportion their regulated interstate costs among the interstate access and interexchange service categories. Finally, to recover their access costs, incumbent LECs charge IXCs and end users for access services in accordance with the Part 69 access charge rules and, for incumbent LECs under price cap regulation, with the provisions of the Part 61 price cap rules.

23. Commentators have pointed out that, because each of these divisions of costs occurs pursuant to regulation rather than through operation of a competitive marketplace, these divisions are subject to distortions.[27] In particular, commentators have focused on the separations process, which apportions costs between the intrastate and interstate jurisdictions. These commentators suggest that separations allocation, in particular allocation of common plant, reflects not only economic considerations, but also public policy considerations related to universal service and the desirability of low local rates.[28] To the extent these allocation decisions have resulted in greater allocations to interstate services than would be economically justified, these distortions flow through Parts 69 and 61 into access charges.

24. Part 69 establishes two basic categories of access services: special access services and switched access services. Special access services do not use the local switch; they use dedicated facilities that run directly between the end user and the IXC's point of presence (POP).[29] By contrast, switched access services use the local exchange switch to route originating and terminating interstate toll calls. The special access category includes a wide

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[25] *See* 47 C.F.R. Part 32.

[26] *See* 47 C.F.R. Part 36. The fundamental principles of jurisdictional separations were described by the Supreme Court in Smith v. Illinois Bell Telephone Co., 282 U.S. 133 (1930). Our Part 36 rules address this jurisdictional distinction.

[27] *See, e.g.*, Proposal for Universal Service and Access Reform: Post 96-98 Interconnection Order, NYNEX, Nov. 5, 1996 (*NYNEX November 5 Proposal*), at 13.

[28] *See* Halprin, Albert, "Separations' Legacy of Subsidy", Exhibit 7 to the The NYNEX Telephone Companies Petition for Waiver, Transition Plan to Preserve Universal Service in a Competitive Environment, Dec. 15, 1993; *AT&T November 22 Letter* at 12.

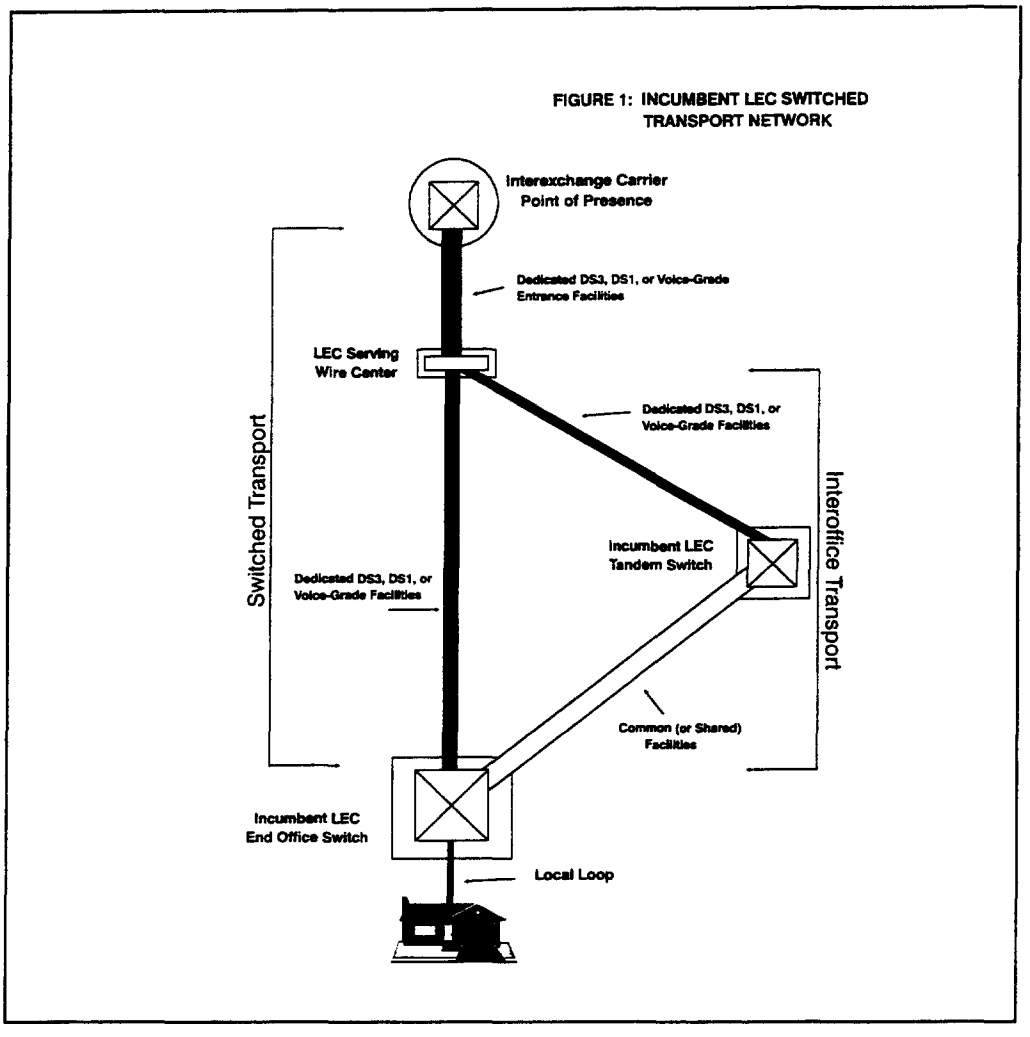
[29] Dedicated facilities or "circuits" come in varying degrees of capacity, from a single voice-grade circuit, with sufficient bandwidth to carry a single voice conversation, to fiber optic circuits capable of carrying thousands of conversations simultaneously.

variety of services and facilities, such as wideband data, video, and program audio services.[30] The Commission does not prescribe specific rate elements for special access services in Part 69.[31] Part 69 does, however, establish specific switched access elements and a mandatory switched access rate structure for each element tailored to the nature of each service in order to promote competition in the interexchange services market and eliminate discrimination within or among services. In general, we have attempted to move toward rate structures that create incentives for the most efficient utilization of all telecommunications facilities.[32] These elements generally correspond to the components of switched access service, as shown in Figure 1.

[30] *See* Investigation of Access and Divestiture Related Tariffs, CC Docket No. 83-1145, Phase I and Phase II, Part 1, FCC 85-70, 57 Rad.Reg.2d 1459, 1465 (Com. Car. Bur. 1985).

[31] *See Access Charge Order*, 93 FCC 2d at 315; *see also* 47 C.F.R. § 69.114.

[32] *See Access Charge Order*, 93 FCC 2d at 253, 268. Part 69 also prescribes cost allocations for each switched access service element. Under the price cap rules discussed below, however, the cost allocation sections of Part 69 no longer play a role in setting the actual price levels for the access element charges of price cap carriers.



25. Interoffice transmission services, known as transport services, carry interstate switched access traffic between an IXC's POP and the end office that serves the end user customer. Incumbent LEC transmission facilities that carry interstate traffic between an IXC's POP and the incumbent LEC end office serving the POP (called the serving wire center or SWC) are known as entrance facilities. Part 69 requires incumbent LECs to impose flat-rate charges on IXCs to recover the costs of entrance facilities. Incumbent LECs currently offer two types of interstate switched transport service between a SWC and an end user's end office. Under the first service, direct-trunked transport, calls are transported between the SWC and the end office by means of a direct trunk that does not pass through an intervening switch. To recover the costs of direct-trunked transport facilities, Part 69 requires incumbent

LECs to impose a flat-rate charge on IXCs.[33] The second service, tandem-switched transport, routes calls from the SWC to the end office through a tandem switch located between the SWC and the end office. Traffic travels over a dedicated circuit from the SWC to the tandem switch, and then, over a shared circuit that carries the calls of many different IXCs, from the tandem switch to the incumbent LEC end office.[34] For tandem-switched transport, Part 69 prescribes a per-minute tandem-switching charge and a per-minute transmission charge assessed on IXCs.[35]

26. Incumbent LEC end offices serving end users switch interstate traffic between the transport trunks carrying traffic to and from the IXC POPs and the end users' local loops. Our Part 69 rules require incumbent LECs to recover the costs of the local switch through a per-minute local switching charge assessed on IXCs.[36] Part 69 also requires incumbent LECs to impose a per-minute TIC on interstate switched access traffic.[37] We note that an incumbent LEC's provision of transport and local switching for terminating interstate traffic is functionally the same as its provision of transport and termination service under the 1996 Act.

27. Finally, incumbent LECs assess end users a flat end user common line charge (EUCL), also known as the subscriber line charge (SLC), to recoup part or all of the local loop costs allocated to the interstate jurisdiction. The SLC currently may not exceed the lesser of the actual interstate loop cost, or $6 per month for multi-line business customers and $3.50 for residential and single-line business customers.[38] In addition, IXCs are assessed a per-minute CCL charge to recover the remaining interstate allocation of loop costs that is not recovered through SLCs.[39] IXCs with at least .05 percent of the total common lines presubscribed to IXCs in all study areas are also assessed Universal Service Fund and Lifeline

[33] *See* 47 C.F.R. §§ 69.110, 69.112.

[34] Such shared circuits, as well as tandem switches, may also be used to carry intrastate toll and local calls.

[35] *See* 47 C.F.R. § 69.111.

[36] *See* 47 C.F.R. § 69.106.

[37] *See* 47 C.F.R. § 69.124. We note that our rules do not constrain an incumbent LEC's downward pricing flexibility for the TIC. 47 C.F.R. § 61.47(g)(3).

[38] *See* 47 C.F.R. § 69.104.

[39] *See* 47 C.F.R. § 69.105.

service charges based on each IXC's share of presubscribed access lines.[40] In addition, Part 69 identifies several other charges, including those for signalling and database queries.[41]

28. The specific access charges currently assessed on interexchange carriers and end users under our rules vary among incumbent LECs because their embedded costs, on which access charges (even for price cap incumbent LECs) are based, vary from state to state. Significant differences in factors that affect a carrier's cost of providing service, such as the topography and population density of its service area, are reflected in different prices for access service.

29. The total regulated revenues of Class A incumbent LECs by service rate elements are shown in Table 1, below.[42] As indicated there, more than 25 percent of the incumbent LECs' total regulated revenues are derived from interstate access services. In addition, of the $11.9 billion in interstate switched access revenues that incumbent LECs recover from IXCs, approximately 90 percent ($10.8 billion) is recovered through per-minute charges (*i.e.*, CCL, TIC, and local switching).

[40] *See* 47 C.F.R. §§ 69.116, 69.117.

[41] *See generally* 47 C.F.R. §§ 69.101-129.

[42] Class A companies are those having annual revenues from regulated telecommunications operations of $100 million or more. 47 C.F.R. § 32.11(a)(1). In 1996, the Class A companies included all price cap LECs.

Table 1

Class A Incumbent Local Exchange Carriers' 1995 Total Regulated Revenues
(in Billions)[43]

Interstate Revenues		
Subscriber Line Charge	$ 7.1	
Per-Minute Switched Access Charges		
Carrier Common Line	$ 3.7	
Transport Interconnection Charge[44]	$ 2.9	
Local Switching (and other T-S)	$ 4.2	
Total Per-Minute Switched Access Charges	$10.8	
Transport (Facilities)	$ 1.1	
Special Access	$ 3.1	
Information	$ 0.3	
Miscellaneous[45]	$ 1.0	
TOTAL INTERSTATE ACCESS REVENUES[46]		$23.4
Intrastate Revenues		
Basic Local Exchange Service	$32.0	
Intrastate Access	$ 7.3	
Other Intrastate Services[47]	$28.0	
TOTAL INTRASTATE REVENUES		$67.4
TOTAL REGULATED REVENUES		$90.8

[43] Source: ARMIS Data compiled by Industry Analysis Division, Common Carrier Bureau. Totals reflect rounding to the nearest hundred million.

[44] ARMIS does not identify TIC revenues. The TIC revenue is derived by using the ratio of TIC to total transport revenue (73 percent) reported in the annual access tariff filings.

[45] Miscellaneous includes billing and collection, and interexchange services.

[46] Totals do not reflect incumbent LECs' revenues derived from Lifeline ($.2 billion) or Universal Service Fund ($0.3 billion).

[47] "Other Intrastate Services" include toll, private line, vertical features, payphones, etc.

30. The Part 61 price cap rules give incumbent LECs that are subject to price cap regulation -- generally the largest incumbent LECs[48] -- a degree of flexibility in establishing the actual levels of their access rates. Incumbent LEC price cap regulation is designed to promote economic efficiency by easing restrictions on overall profits while setting price ceilings at reasonable levels.[49] The incumbent LEC price cap plan is designed to simulate some of the efficiency incentives found in competitive markets and to act as a transitional regulatory scheme until the advent of actual competition makes price cap regulation unnecessary.[50] Price cap regulation encourages incumbent LECs to improve their efficiency by harnessing profit-making incentives to reduce costs, invest efficiently in new plant and facilities, and develop and deploy innovative service offerings.

31. The price cap rules split interstate access services into three discrete groups, called baskets.[51] Two baskets are further grouped into narrower service categories and subcategories. Price cap incumbent LECs have some ability to raise and lower the charges for elements or services that are included in the same basket as long as the actual price index (API) for the basket does not exceed the price cap index (PCI) for that basket. This pricing flexibility is limited by banding rules that establish separate upper and lower pricing bands for each service category or subcategory within a basket. The price cap for each basket and the pricing bands for each service category and subcategory are adjusted annually based on defined formulas.[52] The price cap rules place services subject to different competitive pressures into different baskets, service categories, and service subcategories. These measures limit the incumbent LECs' ability to offset reductions in service prices that are subject to competition with increases in service prices that are not subject to competition.

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[48] The Commission required price cap regulation for the BOCs and GTE, and permitted other LECs to adopt price cap regulation voluntarily, provided that all their affiliates also convert to price cap regulation, and that they withdraw from the NECA pools. Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, CC Docket No. 87-313, 5 FCC Rcd 6786, 6818-20 (1990) (*LEC Price Cap Order*). Currently, the price cap LECs serve more than 92 percent of the total access lines, based on LECs' 1995 and 1996 Annual Access Tariffs filed with the Commission, and account for almost 91 percent of the total interstate revenues for access services, *see* Universal Service Fund Data Collection, CC Docket No. 80-286, Universal Service Fund 1996 Submission of 1995 Study Results by NECA, Oct. 1, 1996.

[49] *See, e.g.*, Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, First Report and Order, 10 FCC Rcd 8961 (1995).

[50] *Price Cap Second FNPRM*, 11 FCC Rcd at 862.

[51] The price cap rules create a fourth basket for interexchange services.

[52] 47 C.F.R. §§ 61.45, 61.47.

2. The 1996 Telecommunications Act

32. The 1996 Act seeks to open for all carriers the local and long distance telecommunications markets to competition by removing economic, regulatory, and operational impediments that have protected monopolies in the local exchange market. The 1996 Act requires incumbent LECs to open their networks to competition, and permits the BOCs, upon meeting certain conditions, to enter the interLATA market within their respective service areas.[53] The 1996 Act also requires the Commission to forbear from applying any regulation or any provision of the Communications Act to telecommunications carriers or telecommunications services, or classes thereof, if the Commission determines that certain specified conditions are satisfied.[54]

a. Local Competition

33. The local competition provisions of the 1996 Act added new sections 251, 252, and 253 to the Communications Act. Section 251 establishes general interconnection obligations for all telecommunications carriers,[55] delineates further obligations for LECs,[56] and prescribes additional requirements for incumbent LECs.[57] Sections 251(c)(2) and (c)(3) require that incumbent LECs' "rates, terms, and conditions" for interconnection, unbundled network elements be "just, reasonable, and nondiscriminatory in accordance with . . . the requirements of sections 251 and 252."[58] Section 252 generally sets forth the procedures that state commissions, incumbent LECs, and new entrants must follow to implement the requirements of section 251 and establish specific interconnection arrangements. Finally,

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[53] *See* 47 U.S.C. § 271.

[54] 47 U.S.C. § 160. The Commission must forbear if the Commission determines: (1) that enforcement of the regulation or provision is not necessary to ensure that the charges, practices, classifications, or regulations by, for, or in connection with that telecommunications carrier or service are just and reasonable and are not unjustly or unreasonably discriminatory; (2) that enforcement is not necessary for the protection of consumers; and (3) that forbearance consistent with the public interest. 47 U.S.C. § 160(a). The forbearance authority applies to all provisions of the Communications Act, except the provisions added by the 1996 Act relating to interconnection and BOC entry into long-distance services. 47 U.S.C. § 160(d).

[55] 47 U.S.C. § 251(a).

[56] 47 U.S.C. § 251(b).

[57] 47 U.S.C. § 251(c).

[58] 47 U.S.C. §§ 251(c)(2) and (c)(3).

Section 253 bars state and local regulations that prohibit or have the effect of prohibiting entities from offering telecommunications services.[59]

34. The terms and conditions under which such facilities and services are made available by incumbent LECs may be the subject of negotiated agreements between an incumbent LEC and a requesting carrier.[60] If an incumbent LEC and requesting carrier are unable to reach a negotiated agreement, either party may ask a state to arbitrate the disputed issues.

35. As required by the 1996 Act, incumbent LECs must provide interconnection and nondiscriminatory access to network elements on an unbundled basis. In implementing the Act, we identified the following minimum set of network elements that incumbent LECs must provide to requesting telecommunications carriers, many of which are analogous to interstate access rate elements: network interface devices; local loops; local and tandem switches (including all software features provided by such switches); interoffice transmission facilities; signalling and call-related database facilities; operations support systems and information; and operator and directory assistance facilities.[61] States may require unbundling of additional elements.

b. Universal Service

36. Section 254, added by the 1996 Act, for the first time codifies the role of universal service in federal telecommunications regulation.[62] Section 254 directs the Commission to commence a proceeding to implement sections 254 and 214(e) of the Act, and to refer such proceeding to a Federal-State Joint Board. The Joint Board was given nine months to make recommendations to the Commission, including a definition of the services to be supported by federal universal service support mechanisms and a timetable for the implementation of such recommendations. We initiated the Joint Board proceeding in March 1996,[63] and the Joint Board issued its *Recommended Decision* in November 1996.

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[59] 47 U.S.C. § 253(a). Section 253 also authorizes the Commission to preempt any law or regulation that is violative of this section. 47 U.S.C. § 253(d).

[60] 47 U.S.C. § 252(a)(1).

[61] *Local Competition Order* at para. 366.

[62] 47 U.S.C. § 254.

[63] Federal-State Joint Board on Universal Service, Notice of Proposed Rulemaking and Order Establishing Joint Board, CC Docket No. 96-45, FCC 96-93 (rel. Mar. 8, 1996) (*Universal Service NPRM*).

37. The 1996 Act established several requirements for federal universal service support mechanisms. The Commission, after receiving the recommendations of the Joint Board, is to designate specific services for federal universal service support.[64] Such support is to be available for the provision, maintenance and upgrading of facilities and services for which the support is intended, and not for other purposes.[65] Such support is to be available to all eligible telecommunications carriers.[66] Such support is to be explicit,[67] and, as the Conference Report makes clear, shall not be implicit.[68] Such support is also to be funded on an equitable and non-discriminatory basis by all telecommunications carriers that provide interstate telecommunications services.[69]

38. In its *Recommended Decision*, the Federal-State Joint Board concluded that several universal service mechanisms currently implemented through the jurisdictional separations and access charge structures must be replaced or modified in order to meet the Act's requirements that support mechanisms be explicit, specific, predictable and sufficient to preserve and advance universal service. Accordingly, the Joint Board recommended that changes be made to the high cost assistance fund,[70] and that the Dial Equipment Minutes (DEM) weighting program[71] and Long Term Support (LTS)[72] be phased out, eliminated, and replaced by a new explicit universal service mechanism.[73] If the Commission adopts the Joint Board's recommendations, our access charge rules must be adjusted to reflect these changes, to prevent incumbent LECs from recovering the same costs twice, and to provide the same

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[64] 47 U.S.C. § 254(c).

[65] 47 U.S.C. § 254(e), (k).

[66] 47 U.S.C. §§ 254(e), 214(e); *see also Joint Board Recommended Decision* at paras. 155-62; *Joint Explanatory Statement* at 131 (1996) ("The conferees intend that only eligible telecommunications carriers should receive support from specific Federal universal service support mechanisms . . . .").

[67] 47 U.S.C. 254(e).

[68] *Joint Explanatory Statement* at 131 ("In keeping with the conferees' intent that universal service support should be clearly identified, [section 254(e)] states that such support should be made explicit . . . .").

[69] 47 U.S.C. § 254(d).

[70] 47 C.F.R. §§ 36.601 *et seq.*

[71] 47 C.F.R. § 36.125(b).

[72] 47 C.F.R. §§ 69.105, 69.502, 69.603(e), 69.612.

[73] *Joint Board Recommended Decision* at paras. 268-82.

subsidies to non-incumbent LECs as are provided to incumbent LECs for serving high-cost or low-income subscribers.[74]

39. At the same time, we must also examine other features of our access charge system to determine whether they contain implicit universal service support, in contravention of the Act's requirement that all universal service support be explicit and its requirements as to funding of federal universal service support. In our *Universal Service NPRM*, we asked whether the CCL charge is an implicit universal service support mechanism.[75] While the Joint Board did not reach this question, it suggested that it would be desirable for the CCL charge to be restructured to be collected on a flat-rate rather than a per-minute basis because per-minute collection is economically inefficient.[76]

40. We continue to recognize that, because of the role that access charges have played in funding and maintaining universal service, it is important to implement changes in the access charge system together with complementary changes in the universal service system. In Sections III.B., below, we discuss whether the CCL charge must be restructured to comply with the Act's universal service requirements.

3. Need for Access Reform

41. There is a consensus among virtually all participants in the telecommunications industry on the need to reform our interstate access charge rules. IXCs and incumbent LECs, for example, agree that current per-minute interstate access charges exceed economically efficient levels and that, consequently, per-minute interstate access charges must be reduced.[77] They differ, however, as to the reasons why current charges exceed forward-looking economic cost, the aggregate amount by which current charges exceed economic cost, and the effects of particular factors (*e.g.*, alleged excessively-long prescribed depreciation schedules, separations distortions, strategic investments, and operational inefficiency). They also disagree on what portion, if any, of the difference between forward-looking economic cost and the portion of embedded costs allocated to the interstate jurisdiction incumbent LECs should be permitted to recover.

42. Current access charges distort competition in the markets for local exchange access. Our access charge rules create incentives for IXCs to bypass the LEC switched access

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[74] *See* Section VII.A, *infra*.

[75] *Universal Service NPRM* at paras. 113-14.

[76] *Joint Board Recommended Decision* at paras. 775-76.

[77] *See generally, e.g.*, *AT&T November 22 Letter* at 1-4; *NYNEX November 5 Proposal* at 16-17.

network for reasons that have nothing to do with the economics of operating an access network. This uneconomic bypass may occur for a variety of reasons; rates may be too high, or our access charge rules may require rates for a LEC access service to be too high in relation to the rates for an alternative LEC service or for a comparable service offered by an alternative supplier. Inefficient entry may occur if the price for a package of jointly-provided services is above economic cost, even if the LEC would actually be the most efficient provider of the service. Conversely, if a package of jointly-provided services, including access, is priced too low because of regulatory requirements, efficient entry by an otherwise efficient provider may be precluded. In either case, the total cost of telecommunications service will not be as low as it could be if all services were priced at economic levels, thereby providing accurate price signals to all market participants. High access charges may also keep long-distance rates higher than they would otherwise be, which restricts demand for service and harms long-distance consumers. We describe more fully some of the causes of uneconomic bypass below.

43. Inefficient, mandatory rate structures are one reason that per-minute interstate access charges exceed the economic cost of providing service to certain customers. One example is the recovery through a per-minute CCL charge of part of the allocated interstate costs for incumbent LECs to provide local loops to end users. Recovering on a per-minute basis the cost of the local loop, which is a fixed cost that does not vary with usage, results in high-volume toll users paying charges to their IXCs that exceed the cost of serving those customers, while some low-volume toll users may pay rates that are below cost. Mandatory per-minute charges for local switching, which probably has significant fixed costs, also results in IXCs paying access charges for high-volume toll users that exceed the cost of serving those customers. Finally, the requirement that most rates be averaged on a "study area" basis (*i.e.* generally, state-wide) precludes incumbent LECs from setting rates to reflect cost differences in high-density and low-density areas, leaving incumbents vulnerable to niche entry in high-density areas, and precluding entry by firms that might otherwise seek to serve low-density areas.

44. Assignment of costs to the wrong elements may also contribute to high per-minute interstate access rates. As discussed in Section III.E. below, the TIC currently recovers some costs that may be appropriately included in the rates for services in the trunking basket. This also results in higher-volume switched access toll users paying rates that exceed cost.

45. Incumbent LECs, and to a lesser degree others such as AT&T, argue that another reason current interstate access charges exceed forward-looking economic cost is the over-allocation of costs to the interstate jurisdiction in the separations process, which allocates costs between the interstate and intrastate jurisdictions.[78] According to these parties, the revenues now recovered through interstate switched access rate elements in the traffic-sensitive basket

[78] *See generally, e.g., AT&T November 22 Letter* at 2; *NYNEX November 5 Proposal* at 8.

exceed the cost of providing interstate switched access services, while intrastate rates do not recover enough to cover the economic cost of providing intrastate exchange and exchange access services.

46. A major focus of the IXCs, on the other hand, is the contention that current interstate access charges exceed economic cost levels because the incumbent LECs are inefficient.[79] As a result, they argue, the incumbent LECs' unseparated rate base is higher than it should be, and all prices in both the interstate and intrastate jurisdictions exceed economic cost-based levels that an efficient provider would charge.

47. Several parties, including AT&T and MCI, argue that, to the extent access services are not available to IXCs at their forward-looking economic cost, incumbent LECs and their long-distance affiliates will have an unfair competitive advantage in the market for long-distance services.[80] According to these IXCs, this is because the incumbent LEC's affiliate's effective cost of obtaining "in region" access service is the incremental cost that its affiliated LEC incurs in providing access. If an incumbent LEC that also provides long-distance service can charge unaffiliated IXCs access prices that are significantly higher than forward-looking economic cost, the IXCs argue that the incumbent LEC may be able to create a "price squeeze" by raising rivals' costs. Under these circumstances, the incumbent LEC affiliate could lower its retail price to reflect its cost advantage, and competing unaffiliated IXCs would be forced either to match the price reduction and absorb profit margin reductions or maintain their prices at existing levels and accept reductions in their market shares.

48. Additionally, to the extent that unbundled network elements become available from incumbent LECs at economically efficient prices, IXCs will have the ability to avoid paying access charges by purchasing such elements to provide both local exchange and exchange access service to end-user customers. IXCs may also take access service from a competitive LEC that either provides its own facilities or takes unbundled elements from the incumbent LEC. The availability of unbundled network elements at their forward-looking economic cost would appear to reduce the danger of a price squeeze insofar as IXCs can use those elements to provide their own access to customers for whom they are the local service provider. There may, however, be limits on the extent to which access charges can be replaced by unbundled elements in either the short or long-term, because an IXC may have to take access service for those end-user customers for which it does not provide local service.[81]

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[79] *See, e.g., AT&T November 22 Letter* at 2.

[80] *See e.g., AT&T November 22 Letter* at 3.

[81] *See Local Competition Reconsideration Order* at para. 13 (stating that a requesting carrier that purchases an unbundled local switching element for an end user may not use that switching element to provide interexchange service to end users for whom that requesting carrier does not also provide local exchange service).