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Inter-Carrier Compensation/ Universal Service Issues

A. <u>The Commission Should Reform Rural Carrier Access and Universal Service Reform.</u>

The Telecommunications Act of 1996 established principles for the preservation and advancement of universal service in a competitive environment. Section 254 of the Act provides that consumers in all regions of the nation, including consumers in rural, insular, and high-cost areas, should have access to telecommunications services at rates that are affordable and reasonably comparable. Section 254 also provides that federal universal service support mechanisms should be specific, predictable, and sufficient to preserve and advance universal service. The Commission has adopted the additional principle that federal support mechanisms should be competitively neutral, neither unfairly advantaging nor disadvantaging particular service providers or technologies.

Since then, the Commission has conducted a series of proceedings to reform its high-cost support mechanisms, as well as its rules for interstate access charges. These proceedings have been completed for the price cap carriers, but are still going on for carriers subject to rate-of-return regulation, which consist primarily of smaller companies serving rural areas. Even though these carriers receive a considerable amount of support via various subsidy mechanisms, the level of their access charges is still several times that of the price cap companies. The Commission should thus complete its proceedings to reform both universal service support and access charges for these carriers. There is widespread agreement on the underlying objectives that should guide these efforts: ensuring affordable rates in the areas served by non-price cap LECs, removing implicit subsidies from access charges, supporting the nationals policy of toll rate averaging, and promoting competition and choice for all Americans.

<u>Access Reform</u>

Most of the reforms adopted for price cap carriers in the 1997 *Access Reform Order* and the 2000 *CALLS Order* should also be adopted for rate-of-return carriers.

- Caps on subscriber line charges (SLCs) should be increased to those in effect under CALLS, namely $6.50 per month for residential and single-line business lines and $9.20 for multi-line business lines. As SLC increases are phased in over the next two years or so, the per-minute carrier common line charge (CCLC) should be reduced to zero.

- Further reductions in per minute switched access rates will be needed to support the national policy of nationwide toll rate averaging. Accordingly, the average traffic sensitive rate (ATS), consisting of switched access revenue per minute, should be reduced to .95 cents per access minute, the same as the target for rural companies participating in the CALLS plan. An additional universal service support fund should be established to offset the decline in revenue from these reductions.

- USF support obligations assessed to the rate-of-return companies should be recovered directly from end users rather than from carrier-paid access charges, as was done in CALLS.

- Certain costs should be reallocated: Costs associated with non-regulated billing and collection functions should be removed from access and recovered in the billing and collection category. Local switching line port costs should be transferred to the common line category and recovered from end-users. Trunk port costs should be recovered from IXCs on a flat-rate basis.

Universal Service Support

In May 2001, the Commission adopted the Rural Task Force ("RTF") recommendations for modifying high cost loop support and otherwise enhanced the universal services subsidies these carriers receive. However, it must now act to make complementary reductions to their access charges. Most importantly, implementation of the RTF principles regarding access reform will result in the removal of all existing subsidies from access rates, as required by a recent Fifth Circuit Court of Appeals decision. The Commission will need to establish an additional support mechanism (or a High-Cost Fund III) to support an ATS rate of 0.95 cents per minute, while the current "long-term support" and local switching support" mechanisms should be retained. All support should be portable and competitively neutral, such that competitive LECs can receive the same amount of support per subscriber line as the incumbent LEC serving that region. The RTF access reforms should be addressed promptly, in advance of the broader proposals in the MAG plan (discussed below), which proposes a system of incentive regulation for the rural ILECs.

Incentive Regulation

The Commission should continue to address the feasibility of replacing rate-of-return regulation with some form of incentive regulation for the non-price cap LECs. However, the MAG (Multi-Association Group) incentive regulation plan recently proposed by several LEC associations is overly generous to the LECs and should not be adopted. An incentive plan that strikes the proper balance between industry and ratepayer interests should contain the following features:

- A productivity factor comparable to the X-factor used in existing price cap regulation is needed to reflect the downward trend in unit costs of providing telecommunications services. AT&T estimates this factor to be 3.3% if the price-cap mechanism is applied to the LECs' interstate revenue per line.

- A lower formula adjustment, whereby companies can obtain relief if their earnings fall below a certain threshold, is acceptable if there is also a mechanism that requires companies to share any excess earnings with ratepayers.

- An "all or nothing rule" should apply such that a company electing incentive regulation must do so for all of its study areas.

- Incentive regulation should be mandatory for the largest rate-of-return companies.

B. <u>The Commission Should Complete Reform of the USF Contribution Mechanism by Moving to a Current, Per-Line Assessment Passed Through to the End User.</u>

There are three key problems that plague the universal service system today. *First*, the variation in carriers' line-item recovery amounts creates customer confusion about their telecommunications bills. This undesirable variation is the inevitable result of the fact that: (a) carriers bear the risk of non-recovery, *i.e.*, they must contribute to the USF based on their billed revenues irrespective of whether or not they are able to collect their service charges and universal contributions from their end user customers, and (b) they are assessed USF contribution amounts based on historical revenues. *Second*, the USF system is not competitively neutral because the assessment is made against historical revenues and requires carriers with declining revenues to have a higher line-item recovery amount on the customer bill than the FCC assessment rate. *Third*, basing the assessment on interstate telecommunications revenues is increasingly difficult and undermines the stability of the universal service fund, given bundled offers that combine multiple services, increasing wireless long distance usage that is difficult to jurisdictionalize, and multiple exceptions that allow various carriers to escape contributions (*e.g.*, the "international" and "*de minimis*" exceptions).

As explained in AT&T's June 25, 2001 and July 9, 2001 comments and reply in CC Docket 96-45, to solve all of these problems and sustain the viability of the universal service program, the Commission should move to a broader, competitively neutral basis for USF funding with a *current* assessment (based on customer lines) and pass through to the end user of the assessed amount, and absolve carriers of the risk of non-recovery of their USF obligations. Specifically, the Commission should implement the following changes. (1) The Commission should require all carriers to pass through a prescribed universal service contribution amount and relieve individual carriers of the risk of non-recovery by spreading that risk evenly throughout the industry in a way that prevents varying line-item amounts on the customer bill and thus promotes transparency, predictability and competitive neutrality. (2) The Commission should eliminate, once and for all, the lag between accrual and assessment of universal service obligations. (3) The Commission should transition from its existing revenue-based assessment method to a flat-rated assessment method. This mechanism can be implemented immediately for residential, wireless and switched voice business customers. Further investigation is required for business customers that use special access. If due to the complexities of business services, a flat-rate mechanism cannot be implemented immediately, then the Commission should maintain the current, revenue-based method for *all* business customers on an interim basis until the issues concerning a transition to flat-rated charges, and the impacts on the market, can be more thoroughly explored. Together, the first two modifications will make the system competitively neutral and will avoid the customer confusion created by carriers' varying line-item recovery amounts. Instead, carriers will recover the amount set by the Commission for a given class of customer. The third modification will stabilize the universal service program and ensure the necessary broad contribution base in that it will assess each customer line (wireline and wireless) without having to make difficult service or jurisdictional inquiries, and eliminate the existing unwarranted exceptions from contributions.

To comply with requirements of Section 254(d) of the Act that carrier contributions to the support of universal service be both "equitable" and "nondiscriminatory," the Commission must eliminate, in its entirety, the "lag" that exists under the existing USF assessment methodology that assesses carriers for the current period based on their historical revenues. On March 14, 2001, the Commission took its first step towards addressing the problem by reducing the interval (or "lag") between the accrual of revenues and the assessment of universal service contributions based on those revenues, from one year to six months. Nonetheless, even with the shortened lag, the Commission's assessment mechanism is anticompetitive and does not comply with the Act's directives of equitable and nondiscriminatory contributions because it systematically disadvantages carriers, such as IXCs, whose interstate revenues are declining and advantages carriers, such as the ILECs (most notably the BOCs as they gain in-region entry).

The Commission's May 8, 2001 Notice of Proposed Rulemaking (NPRM) is designed to re-examine the methodology the Commission uses to assess carrier contributions to the universal service fund and the manner in which carriers recover those costs from their customers. As the NPRM recognizes, competitive developments in telecommunications markets have completely undermined the Commission's existing assessment method, in which each carrier contributes a percentage of its interstate retail telecommunications service revenues. For example, the Commission has noted significant variations in collection rates imposed by carriers due to differences in uncollectible expense and the six-month lag between accrual and assessment of universal service obligations. In addition, carriers are increasingly bundling interstate telecommunications services with both intrastate and non-telecommunications services in flat-rated packages, which makes it difficult, if not impossible, to identify the interstate revenue portion of an end user's revenue. To address these developments, the Commission should replace the existing system with a flat per-line USF funding mechanism based on current data and prescribe a pass-through to the end user of the assessed surcharge, and absolve carriers of the risk of non-recovery of the USF obligations.

C. The Commission Must Vigilantly Monitor and Remedy the ILECs' Deteriorating Performance in the Provisioning of Access Services, Especially Special Access.

AT&T and other IXCs continue to experience deteriorating performance levels in the provisioning of access services, and especially in the area of special access, by the incumbent Local Exchange Companies. Carriers like AT&T purchase special access service to provide all forms of telecommunications services to end user customers, including local service. Poor service quality performance results in severe adverse business consequences, up to and including loss of customers. The ILECs still have a virtual monopoly in provision of special access facilities and therefore, there are no market forces to correct these performance deficiencies.

According to the self-reported RBOC data compiled by the ARMIS 43-05 report, RBOC service quality for residence consumers and business customers has deteriorated severely in the past several years. State complaint rates, the percentage of dissatisfied customers, local service repair intervals and percent repeat troubles are all increasing dramatically. Additionally, according to the ARMIS 43-05 report, Table I, overall RBOC Service Quality in terms of installation commitments met for service to IXCs has dramatically decreased from 1993 through 2000 with percentage dropping from approximately 97% to about 87%.

As ILECs obtain increased pricing flexibility and 271 relief, they will compete on a more comprehensive basis with both CLECs and IXCs, providing all telecommunications services to customers. These increased freedoms provide both the incentive and the opportunity for the incumbents to discriminate against its competitors by providing preferential service to itself (already a significant problem), and will only serve to increase as competition for customers increases.

Currently, there is no comprehensive process to address special access performance issues. The performance measures and enforcement mechanisms for UNEs, based on the Telecom Act's "parity" principles, do not cover the performance of special access services and facilities and are beyond the scope of existing state performance penalty plans (where those plans exist) because the circuits at issue are interstate. The existing FCC measures are inadequate and do not include substantial, self-executing remedies like those included in local performance plans adopted in a number of states and approved by the FCC in 271 proceedings. These problems are further exaggerated by the difficulty in getting access to information the LEC maintains and getting customers to speak "on the record" about these problems. Despite the promising dockets in New York and Massachusetts addressing special access performance, there continues to be a void in carriers' ability to enforce reasonable performance metrics and address apparent discriminatory treatment by LECs in providing facilities to its own customers before providing those facilities to other carriers. In particular, the present regulatory scheme provides no incentive for LECs to improve performance, and in fact, allows valid complaints to languish in the gap between state and federal regulation.

The Adoption of a comprehensive set of performance measures, reporting provisions and self-executing remedies by the FCC is the best solution to this problem. AT&T suggests a plan similar to those adopted for UNE performance. The LECs would have to report performance on ordering, provisioning, maintenance and repair of special access services by carrier. Carriers would no longer be faced with inadequate information and would no longer carry the burden of proof. Standards established by the FCC would provide a baseline for special access performance, ensuring that ILECs will both sustain and take steps to improve special access performance.

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Regulation and Competitive Markets

A. **Rate Averaging Requirements Should be Relaxed to Allow Competitive Marketplace Responses That Are Not Hamstrung by Regulation.**

The rate averaging requirements of Section 254(g) of the Act are an artifact of the pre-1996 Act world and should be changed. Since that time, long distance rates for most customers have dropped substantially, to the point that residential customers with even moderate usage can now pay less for their service than many large business customers did a few years ago. Many types of firms compete to carry a customer's long distance minutes: nationwide LD carriers; prepaid card companies; BOCs and other ILECs who offer LD only in a limited portion of the country; and wireless carriers who commonly offer many buckets of "included" long distance minutes in their price plans. Of these types of firms, only one group – the nationwide long distance carriers – is hamstrung by antiquated nationwide rate averaging rules from reducing prices or introducing special offers to respond to competition in particular locations. This regulatory artifact hurts competition and impedes healthy, undistorted head-to-head competition.

Given the recent drop in average long distance rates, all customers across the country have received significant benefits from the ever-increasing competition for toll calls. However, in order to provide such low average rates, carriers have had to reduce their margins significantly. If nationwide carriers were required to lower their rates throughout the country to compete with regional carriers that have lower average costs -- especially RBOCs who have received section 271 relief in five states -- they will not be able to compete effectively against those carriers.

A prime example of such a circumstance is SBC's operations in Texas. SBC only offers long distance service to Texas consumers if they are SBC local customers, and thus are located in SBC's own franchised serving territory. As a result, SBC obtains a double benefit. First, it only has to absorb its internal costs of originating access, even though its access rates, especially its intrastate rates, are well in excess of those costs. Moreover, SBC does not have to absorb the significantly higher access rates charged by independent LECs. As a result, SBC can afford to provide "averaged" long distance rates that are lower than nationwide carriers can afford to offer in Texas if those rates must also be made available to all their customers across the country.

As a result of these dramatic changes, the Commission should begin to exercise forbearance with respect to the rate averaging requirements. At a minimum, the Commission should permit carriers to offer rates that are *lower* than their nationwide rates in all areas where the incumbent is allowed to provide both local and long distance service. This will not impair consumers generally, because the market has already driven average long distance rates to historic lows. Moreover, it will serve the public interest, because it will provide a way for national carriers to compete effectively for key customers in targeted areas who they would otherwise lose if they were not able to offer such lower rates. If carriers lost such customers, they would face even lower average revenues and higher averaged costs for all their customers. Finally, it will avoid the need for nationwide carriers to consider withdrawing service to customers in high cost areas in order to avoid the economic anomalies resulting from strict adherence to the rate averaging rules.

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International Issues

A. **International Settlement Rates.**

Settlement rates are fees paid by US carriers to terminate traffic in foreign countries. Historically, these rates have been far above cost, resulting in huge outpayments to foreign carriers, higher costs for US carriers, and higher prices for consumers. Recently, increased competition in foreign countries, technology advances, and global routing options have worked together to begin to lower settlement rates around the world. Also, the FCC's "benchmarks" order has been a key catalyst in driving down these rates. Benchmarks are maximum rates, albeit well above cost, US carriers can pay foreign carriers for handling international traffic and, depending on the economic development of a specific country, vary by date and rate. Despite these factors, however, US carriers still paid $4.8B to foreign carriers in 1999, and at least $3.5B of this amount is above-cost subsidy.

WorldCom-Telmex Settlement Rate Agreement

Mexico is by far the largest recipient of US carriers' outpayments. In 1999 alone, Mexico carriers received $663M, and from 1990-99, they received over $7B. Furthermore, Mexico has in place rules that insure only Telmex, the incumbent local and long-distance provider in Mexico and the prime beneficiary of these huge cash flows, negotiates accounting rates with US carriers, which prevents competitive forces from lowering these rates to cost-based levels.

Recently, WorldCom and Telmex announced an agreement that would lower the current settlement rate of $.19/minute to $.155/minute in 2001, $.135/minute in 2002, and $.10/minute in 2003

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WorldCom's proposed rates are far above cost-based levels, which are under 4 cents, and are also far above the rates Mexican carriers pay Telmex today for the facilities and services required to terminate calls from the United States, which are under 4.5 cents. Because of the substantial margins by which WorldCom's proposed rates exceed cost-based levels, approval of this agreement would force U.S. consumers to pay almost $800 million in above-cost subsidies to Mexican carriers over the next three years.

AT&T and its global affiliate, Concert, have therefore asked the Commission to reject the agreement, just as the Commission has twice before rejected recent U.S. carrier agreements with Telmex for providing insufficient reductions on this critical route. There is no justification for this massive, above-cost outpayment to a neighboring country that supposedly opened its telecommunications market to competition more than four years ago, or for such blatant discrimination against U.S. carriers. The only reason why international calls to Mexico are not terminated at the 3-4 cent rates now paid to Canada -- producing U.S. consumer rates for calls to Canada as low as 7 cents per minute -- is the government-imposed Telmex monopoly over settlement rate negotiations in Mexico and the intransigence Telmex has consistently shown in these negotiations.

Denial of the proposed agreement is particularly necessary to safeguard against whipsawing. Concert has informed both Telmex and the Mexican government that it seeks cost-based rates, and is now paying cost-based interim rates to Telmex pending the adoption of a new agreement. But Telmex refused to negotiate with Concert while it negotiated higher rates with WorldCom, and now takes the position that it will not negotiate further with Concert and demands that Concert should sign the same agreement as WorldCom. Such conduct by Telmex, "isolating a U.S. carrier in an effort to negotiate a favorable accounting rate agreement," is a whipsaw in violation of the Commission's International Settlements Policy (ISP), as the International Bureau found in 1998.

This is the *third* successive settlement rate negotiation in which Telmex has sought to whipsaw the U.S. carriers that sought the largest settlement rate reductions by agreeing smaller reductions with their U.S. competitors. On each of those two prior occasions, the International Bureau rejected the proposed agreements that would have made the greater reductions sought by other U.S. carriers impossible to obtain. And on each of those two prior occasions, U.S. carriers subsequently negotiated lower rates with Telmex than those proposed by the agreements rejected by the Bureau.

The proposed deal also includes an agreement to negotiate competitive market-based rates to take effect on January 1, 2004. WorldCom and Telmex also agree to request the US and Mexican governments to eliminate existing regulations that prevent the negotiation of any such competitive market-based rates. However, the deal provides no certainty regarding the results of such further negotiations, and no assurance that Mexico's anticompetitive and WTO-inconsistent regulations will be removed. Thus far, the Mexican government has resisted taking any such action.

Any approval of this deal would hinder other US carriers' efforts to negotiate lower rates with Telmex, and would allow continued subsidization of an intransigent foreign monopolist at the expense of US businesses and consumers. Therefore, the Commission should reject this agreement.

Benchmark Enforcement

As noted above, the FCC's benchmarks have been very successful in lowering settlement rates worldwide. Today, in fact, 86% of all US outbound traffic is terminated in countries that are benchmark compliant. Furthermore, many of these countries have rates that are well below the benchmarks rates. However, continued and consistent enforcement of the benchmark order specifically, and the Commission's International Settlements Policy (ISP) in general, are required to insure this positive trend continues.

- *Whipsaw*

US carriers are currently negotiating for benchmark deals with many countries required to achieve benchmarks in 2002 and 2003. These lesser-developed countries usually have monopoly international carriers who have the ability and incentive to leverage their position by playing one US carrier against another. These actions include disabling a carrier's circuits, providing different quality of service levels, or decreasing return traffic to a specific US carrier. This possibility of "whipsaw" is exactly the reason the ISP was established, and was a driver for the benchmarks order. Recent examples of such acts have occurred in Kuwait and Guyana, and more are expected as US carriers negotiate for benchmark-compliant deals predominantly with countries with monopoly carriers. The FCC must be vigilant in taking quick action against whipsawing, including requiring US carries to stop all payments until the whipsaw or retaliation is stopped.

- *India*

The second largest recipient of US outpayments in the world is India. While US carriers in the past have had great difficulty negotiating with India's monopoly carrier VSNL, India's settlement rates are on a "glidepath" that should meet India's benchmark requirement of $.23/minute by 1/1/02.

US carriers have recently agreed to a new deal with VSNL. This deal reduces the current settlement rate of $.425/minute to $.34/minute. Because VSNL's fiscal year runs from April to April, VSNL demanded the one-year deal run from 4/1/01-3/31/02. However, India's benchmark is a $.23/minute settlement rate on or before 1/1/02.

The FCC should "truncate" this deal. Specifically, the FCC should allow the new rate to be in effect only from 4/1/01 through 12/31/01, but require US carriers to negotiate a new benchmark compliant rate effective 1/1/02. This allows the reduction to come into effect, while at the same time enforcing the benchmark order. The FCC has in the past taken similar action on four different countries (Oman, Brunei, Singapore, Taiwan) and two similar orders are pending (Morocco and Suriname). This step would also send a strong reminder to countries not yet at benchmark that the FCC's policy will be uniformly applied and enforced.

B. <u>Submarine Cable Notice of Proposed Rulemaking.</u>

On June 22, 2000, the FCC released its "Review of Commission Consideration of Applications under the Cable Landing License Act" Notice of Proposed Rulemaking. The NPRM proposed a mechanism under which a submarine cable applicant could qualify for streamlined processing, and also proposed some specific streamlining methods.

Formal industry reaction to the NPRM has been strongly against the proposals. In general, while the industry supported the need for streamlining that reflects pro-competitive policies, the proposed mechanisms in the NPRM are complex, uncertain, and highly regulatory. Ironically, under the proposals, only carriers that fit favored profiles would be granted streamlining, and the process for determining if an applicant was worthy of such expedited treatment would require significant regulatory review.

Global Crossing was the lone commenter supporting the proposals that would, in effect, provide preferred regulatory treatment for private (closed investment) cables over consortium (open investment) cables. However, Global Crossing's underlying theories are not borne out by the current state of the undersea cable and international telecommunications markets. Specifically, Global Crossing claims that open cable investment limits submarine capacity, thus foreclosing closed cables from the market. However, undersea cable capacity at year-end 2000 is over three times capacity at year-end 1999, and similar increases are expected for 2001 and 2002. Furthermore, private cable investment represents the vast majority of new capacity, and in 2002, 100% of new forecasted capacity will be private. Clearly, no market foreclosure of closed investment cables has occurred.

Global Crossing also asserts that closed investment cables are foreclosed from the market because US carriers must "cluster" on open investment cables to obtain necessary foreign-end arrangements and IMTS proportionate return. However, 95% of circuits on new cables are used for private lines, which do not earn return traffic, and may be terminated with any facilities-based carrier on the foreign end.

While the broad procedures included in the NPRM are inconsistent with today's sub-cable marketplace, some targeted streamlining steps would be beneficial. Specifically, the FCC should adopt an approach successfully used today for Section 214 applications. All cable landing licenses should be presumed to be pro-competitive and should qualify for expedited treatment, i.e., approval in 14 days upon public notice. The Commission should refuse to entertain any petitions to deny, but any application that raises extraordinary concerns could be removed from streamlining.