HIGH-LEVEL SUMMARY OF THE FCC’S USF/ICC REFORM ORDER AND WHAT IT MEANS FOR STATES
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Overview

1. USF Reform Elements of the FCC’s Order.............1
   1.1 Context for Reform..................................1
   1.2 FCC’s Reforms......................................2
2. ICC Reform Elements of the FCC’s Order............ 4
   2.1 Context for Reform..................................4
   2.2 FCC’s Reforms......................................4
3. What the FCC’s Order Means for States.............. 6
   3.1 Impact on Regulatory Federalism..................6
   3.2 Open Issues.........................................8

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The following provides only a high-level summary of core elements of the FCC’s recent USF/ICC reform order. All quoted text refers the final FCC order. Questions and comments should be directed to:

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1. **USF Reform Elements of the FCC’s Order**

1.1 **Context for Reform**

- The main goal was to restructure this $8 billion fund so that it can support broadband deployment going forward.

- According to the FCC, despite the best efforts of industry – including hundreds of billions of dollars in infrastructure investment over the last decade – about 5% of households in the U.S. – equal to 18 million people – continue to lack access to terrestrial (i.e., non-satellite) broadband.

- This situation needed to be addressed because, in the view of the FCC – and a vast majority of stakeholders – “networks that provide only voice service...are no longer adequate for the country’s communications needs.”

- The problems with the USF were clear to nearly everyone:
  
  - The size of the high-cost fund – the mechanism through which LECs received subsidies to provide POTS in rural areas – had nearly doubled between 2001 and 2011, increasing from $2.6 billion to $4.5 billion.

  - The fund increased in size because there were no costs controls and little incentive for those that received funds to streamline their operations. Moreover, the fund was poorly managed, which led to the waste of vast sums of taxpayer dollars in support of an outdated service.

  - And perhaps most perversely of all was the creation of a “rural-rural” divide: some rural areas have access to broadband, but many do not because, as the FCC observes, “the existing [USF] fails to direct money to all parts of rural America where it is needed.”

- The solution? A massive overhaul of how the USF is structured, what it supports, and how funding is allocated. These changes will be phased in over the next six years.
1.2 FCC’s Reforms

- The $4.5 billion high-cost fund will become the Connect America Fund and will support broadband deployment to unserved parts of the country.
  - A companion fund – the Mobility Fund – will provide upwards of $500 million in funding each year to support the deployment of wireless broadband networks to unserved areas.

- The goal of these efforts over the long-term is to ensure that every household in the U.S. has access to a terrestrial broadband connection. The FCC predicts that Internet service will be available to 7 million unserved Americans over the next six years as a result of these efforts.

- In an effort to ensure that these new funds are properly managed – and that funding recipients are held accountable – the FCC has adopted a number of performance goals for service providers receiving funds. (The FCC is seeking additional comments on how to structure new public interest obligations for funding recipients.)

- Equally as important is the fact that the FCC has capped the high-cost fund and will implement a strict budget. The goal is to ensure that the fund does not exceed its current level ($4.5 billion).

- With regard to the mechanics of implementing these changes:
  - Price cap carriers (83% of the 18+ million unserved live in areas served by price cap carriers) that elect to receive CAF funds for broadband will be subject to immediate reforms in how they receive USF funding. These will be implemented in two phases:
    - (I) Over the next year, price cap carriers will have the chance to opt for additional funding to support broadband deployment. Those that elect to receive funds will be required to deploy networks capable of speeds of 4Mbps down/1Mbps up.
    - (II) The next phase will begin after the Commission develops a “forward-looking broadband cost model and competitive bidding” process to support broadband networks for five years (2013-2017 in theory). Ideally, this new model will be used to “establish the efficient amount of support required to extend and sustain robust, scalable broadband in high-cost areas.”
  - New regulations impacting rate-of-return (ROR) carriers will be delayed until the FCC can design a framework to meet the unique needs and business models of these providers.
• ROR carriers “operate in many of the country’s most difficult and expensive areas to service.” In the near-term, ROR carriers “receiving legacy USF support, or CAF support to offset lost ICC revenues, must offer broadband service...with actual speeds of at least 4Mbps down/1Mbps up, upon their customers’ reasonable request.”

• Absent such a request, ROR carriers will not be required to extend broadband service to customers. The FCC, via its FNPRM, will attempt to design a “predictable path forward for ROR carriers to extend broadband.”
  
  o The Mobility Fund will also be deployed in two phases:

  • (I) $300 million in funding will be made available to immediately accelerate mobile voice and broadband services in unserved areas. These funds will be allocated via nationwide reverse auctions. Winners will be required to deploy 4G service in three years, and 3G service in two years.

  • (II) After phase I ends, upwards of $500 million in funding will be available for ongoing support of mobile broadband build-out. Support will extend to “communities in which service would be unavailable absent federal support.” The FCC has asked for comments (in its FNPRM) on additional details regarding the distribution mechanism going forward.

  o The FCC also adopted a framework that will phase down and eventually eliminate the identical support rule.

  o An additional $100 million per year will also be allocated to ensure that those living in the most remote parts of the country “can obtain affordable access through alternative technology platforms, including satellite and unlicensed wireless services.”
2. **ICC Reform Elements of the FCC’s Order**

2.1 **Context for Reform**

- As the FCC astutely observed in its order, the original ICC system was “designed for an era of separate long-distance companies and high per-minute charges, and established long before competition emerged among telephone companies, cable companies, and wireless providers.”

- Over the last several years, this system became increasingly ineffective for several reasons.

  - First, the implicit cross-subsidies proved inefficient and unnecessary in many instances since competitive offerings had emerged organically. As a result, millions of consumers paid more on their wireless and long-distance bills than they should have.

  - Second, bad actors had figured out how to game the system via arbitrage schemes like traffic pumping. “Traffic pumping” occurs when LECs artificially increase the amount of traffic that must be terminated. In many cases, LECs would partner with 3rd-parties to provide customers with “free” calling services (which are, in fact, paid for by the carrier of the calling party). Since rural LECs could charge relatively high (above-cost) termination fees, bad actors were able to game the system. By one estimate, the total cost of traffic pumping to the industry was $2.3 billion over the past five years.

  - Third, by “focusing on minutes instead of megabytes,” the ICC framework created little incentive for rural carriers to invest in broadband networks.

2.2 **FCC’s Reforms**

- The FCC’s order addressed many of these issues and included:

  - Immediate reforms aimed at curbing arbitrage schemes, phantom traffic, and other such schemes.

  - A multiyear “glide path” toward comprehensive reform of the ICC payment framework. The ultimate goal is bill-and-keep, a system where “carriers look first to their subscribers to cover the costs of the networks, then to explicit universal service support where necessary.” Bill-and-keep has proven successful in the wireless space and will eliminate “competitive distortions” between voice providers.
• The FCC reasons that “A bill-and-keep methodology will ensure that consumers pay only for services that they choose and receive, eliminating the existing opaque implicit subsidy system under which consumers pay to support other carriers’ network costs.”

• States will be responsible for “determining the scope of each carrier’s financial responsibility for purposes of bill-and-keep.”

  o In the interim, though, the FCC will phase in bill-and-keep by:

    • First – capping most ICC rates and requiring carriers to bring intrastate and interstate terminating rates to parity in two steps by July 2013.

    • Second – price cap carriers will be required to transition termination rates to bill-and-keep within 6 years; ROR carriers will have 9 years.

    • Carriers are free to negotiate rates among themselves.

    • The FCC’s FNPRM seeks comment on the “appropriate transition and recovery for the remaining originating and transport rate elements.”

  o Carriers will be able to offset lost ICC revenues via per line Access Recovery Charges, which will be capped and closely monitored by the FCC.

  o VoIP-to-PSTN traffic will also eventually be brought into the bill-and-keep system. In the short-term, the default rate for VoIP-PSTN traffic will be the interstate access rate.

    • The FCC has decided to not subject VoIP to the preexisting ICC framework.

    • In addition, the FCC’s order does not address the issue of whether VoIP should be classified as either a telecom service or an information service. [A docket on this issue was first opened in 2004.]
3. **WHAT THE FCC’S ORDER MEANS FOR STATES**

3.1 **Impact on Regulatory Federalism**

- In the abstract, the reforms outlined in the FCC’s order, if properly implemented, could yield enormous consumer welfare gains for consumers in every state.
  
  - Millions of additional residents across the country will be able to access terrestrial broadband for the first time. At a time when broadband is becoming an integral part of modern life, these households will finally be able to join the broadband revolution.
  
  - In addition, updating the ICC framework will reduce arbitrage opportunities and deliver tangible gains to consumers, who will no longer be forced to overpay for voice service.

- In practice, though, these reforms will recalibrate the federal-state balance vis-à-vis telecom reform.
  
  - Some regulators and policymakers worry that such a recalibration will undermine states’ rights. However, it should be noted that the FCC order does not preempt states entirely on these issues. Indeed, the order identifies many areas for collaboration and joint oversight of carriers making the transition to the new framework. In addition, states retain authority over ETC designation and COLR regulation.
  
  - But the FCC does call for a national approach to ICC reform, one that transitions terminating rates to bill-and-keep in a uniform way. The rationale put forward by the Commission is persuasive: in the absence of a uniform move to bill-and-keep, bad actors will find a way to create arbitrage opportunities that take advantage of variable terminating rates in different jurisdictions.
  
  - To some, this rationale – though compelling from a consumer rights standpoint – will be inadequate from a pure states’ rights perspective. Though understandable from a theoretical understanding of states’ rights, federalism in telecom regulation has always been a bit different and subject to revision in light of innovation and changes in consumer demand.
  
  - Indeed, one need only look at how wireless regulation has evolved over the last three decades to see how a national framework can maximize consumer welfare.
• Prior to 1993, states were free to impose a wide array of rules and regulations on wireless service providers. Most of these rules mirrored those that were devised for POTS under the assumption that only the type of service (voice) mattered from a regulatory vantage, not how those services are delivered.

• But as wireless became more popular, it quickly became clear that regulatory obstacles at the state level – i.e., the patchwork of rules that had developed – were impeding the development of more robust networks that could offer national coverage. Indeed, up until the early 1990s, wireless was mostly a regional service dominated by one or two large carriers.

• Congress stepped in and adopted a national regulatory framework in 1993 that, among other things, rationalized the patchwork system that had developed. After 1993, states were unable to regulate pricing and market entry. However, states did retain the authority to regulate “other terms and conditions” of service, as well as the siting of wireless towers and rights-of-way management (which impact the construction of the physical infrastructure supporting mobile networks).

• In other words, regulatory federalism in this instance was recalibrated to reflect the borderless nature of the underlying technology. The results of this approach have been staggering: the emergence of national carriers; the deployment of 3G and 4G wireless broadband networks; the development of a wireless ecosystem (networks, devices, content) that has produced enormous consumer welfare gains.

• It should be noted that some states had implemented similar reforms before 1993. But without the buy-in of all 50 states, the patchwork remained. This created an opening for federal action.

  o This same dynamic is evident in the voice space, where a patchwork approach to access charges created a payment system that was vulnerable to arbitrage and that succeeded in supporting failed business models.

  o But this isn’t to say that the FCC’s USF/ICC reform order is the end of telecom reform. That is very far from the truth. Chances are that parts of the order will be challenged in court. Moreover, the FCC is still investigating a range of important issues via the companion FNPRM that was released with the order. And the FCC left untouched an array of issues that could benefit from robust reform at the state-level.
3.2 Open Issues

- The FCC’s USF/ICC reform order failed to address – or only partially addressed – an array of issues, including:
  
  o Originating access (OA)

  - The FCC’s order does address one aspect of OA: it caps interstate originating access rates (and some intrastate OA rates – i.e., those for price cap carriers and CLECs that benchmark rates to price cap carriers) at their current level. However, in its FNPRM, it seeks comment on how to transition OA to bill and keep.

  - The FCC’s rationale for not fully addressing OA in this order: “Although we conclude that the originating access regime should be reformed, at this time we establish a transition to bill-and-keep only with respect to terminating access charge rates. The concerns we have with respect to network inefficiencies, arbitrage, and costly litigation are less pressing with respect to originating access, primarily because many carriers now have wholesale partners or have integrated local and long distance operations.”

  - In the absence of reform, arbitrage opportunities might still exist given the variance in rates across jurisdictions. This also means that carriers will continue to pay an array of different access charges to originate a call. Although interstate rates are capped, some intrastate rates remain uncapped (i.e., those for ROR carriers and CLECs that benchmark rates to ROR carriers).

  - States could begin the process of capping intrastate OA rates and creating more uniformity, much like they were doing with terminating access. The FCC notes in its order that “states remain free to [reform OA], provided states support any recovery that may be necessary, and such a result would promote the goals of comprehensive reform adopted today.”

  - Indeed, it appears as though the FCC is hoping that states will begin to address this issue *sua sponte*: “Although the Commission can exercise its authority to implement a transition, as it does in the Order today, the Commission could also defer to the states to create a transition to bill-and-keep for originating access. Since originating intrastate access rates are not capped for rate of return carriers, we ask whether we should initially defer the transition to bill-and-keep for originating access to the states to implement.”
• The FCC could seize on reform momentum at the state level and formalize it via an order hopefully in the near future.

  o **Rural transport**

    • In its attempt to mitigate adverse impacts on LECs from the move to bill-and-keep, the order establishes an interim rule limiting ROR LECs’ responsibility for the costs of transport involving non-access traffic exchanged with CMRS providers. Specifically, a wireless provider is responsible for the remaining transport to an interconnection point when that interconnection point is outside the LEC’s service area.

    • While the order stresses that this is an interim rule, it does not indicate which allocation rule will ultimately apply. Moreover, it appears that the application of this interim rule will increase wireless providers’ transport costs by imposing payment obligations on wireless providers for both the transfer and termination of traffic. In the handful of states in which there is only one interconnection point, this rule creates arbitrage incentives to increase traffic to the primary interconnection point and shift costs to wireless providers.

  o **PSTN retirement**

    • The FCC’s Technical Advisory Committee previously recommended that the PSTN be retired by 2018

    • Trends indicate that only 6% of the population will use the PSTN by 2019. In the absence of FCC guidance, states will likely take a variety of different approaches to retiring the PSTN. This could create inefficiencies that ultimately detract from broadband investment and deployment.

  o **Classification of IP-enabled services (e.g., VoIP)**

    • FCC docket on this issue has been open since 2004

    • In the absence of FCC guidance, regulatory uncertainty will prevail as some state PUCs have attempted to impose legacy rules on VoIP providers.
**Role of state PUCs going forward**

- State PUCs retain some authority per the Telecom Act, but their role in a world dominated by borderless communications technologies remains uncertain. The FCC’s order identifies several roles for PUCs in implementing a variety of provisions, but expected legal challenges to the preemptive elements of the order could create tension between federal and state regulatory entities.