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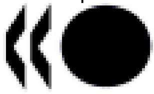

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Working Party No. 2 on Competition and Regulation

ACCESS PRICING (with a focus on telecommunications)

-- United States --

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OVERVIEW OF THE REGULATION OF PRICING FOR ACCESS AND INTERCONNECTION

United States

Introduction

1. This paper discusses regulatory pricing of various access modes available in the United States.[1] Although the legal regime governing access offers new entrants a broad array of options for use of local facilities, the regulations are very complex, with different modes of access and different pricing available depending upon the character of the entity requesting access and the purpose for which the access is to be used.

2. In the United States, the principal types of entities that have a legal right to request access to the local facilities of incumbent local exchange carriers ("ILECs") are: competing local exchange carriers ("CLECs"); interexchange - including international - carriers ("IXCs"); wireless mobile service providers ("CMRSs"); and information service providers, including Internet access providers ("ISPs"). Unfortunately, the extent of each of these access users' rights to use local facilities, and the methods by which such access is priced, are in many cases uncertain because of legal challenges pending before the courts.

3. CLECs are firms that provide local exchange service in competition with the ILECs. Such competition was authorized on a nationwide basis by the Telecommunications Act of 1996[2] ("1996 Act") which precluded the individual states from granting monopoly franchises for telephone service. In addition, the 1996 Act granted CLECs the right to access the networks of the incumbents in order to interconnect for the purpose of exchanging traffic, or to use unbundled network elements ("UNEs") of the ILEC in the provision of their services. The 1996 Act also gave CLECs the ability to resell the local services of the ILEC at a wholesale discount. The terms under which a CLEC obtains the use of ILEC facilities may depend upon whether the CLEC's customers are end users of local service, IXCs, or ISPs. CLECs that provide data services (particularly Internet access services) are often referred to as "DLECs," and the FCC's regulations have special provisions relating to a DLEC's abilities to access an incumbent's distribution facilities, mostly copper loops, in order to provide DSL services.

4. IXCs provide telecommunications between Local Access and Transport Areas ("LATAs"). IXCs have had the right to nondiscriminatory use of the facilities of the local exchange carriers that were formerly affiliated with AT&T since settlement of the government's antitrust case, which resulted in AT&T's divestiture of its local operating companies in 1984. The Bell Operating Companies ("BOCs") implemented the antitrust decree's requirements by the filing of access tariffs with both the Federal Communications Commission ("FCC") and the state public service commissions. These tariffs provide for the provision of both switched access and special access arrangements which permit the IXCs to offer ordinary toll telephone service and private line service, respectively.

5. ISPs use telecommunication services provided by the ILECs in order to provide their customers with enhanced services such as Internet access. The FCC has determined that telecommunication services used by Internet access providers are interstate telecommunications subject to its jurisdiction. Accordingly, the ILECs' primary offerings of access service for use by Internet access providers, such as wholesale DSL, are tariffed at the FCC.

1. Access Available to Competitive Local Exchange Providers

6. Since 1996, CLECs have been able to compete for local exchange services in all of the states. The access they obtain from incumbents includes interconnection for the exchange of traffic, the use of incumbents' network elements, and the resale of incumbents' services. Generally, these seem to fall in the categories of both "one-way" and "two-way" services where the new entrant is directly competing with the incumbent, as described in the Background Note.

A. Interconnection and Reciprocal Compensation

7. Under the 1996 Act, CLECs are entitled to interconnect with incumbent carriers to permit each carriers' customers to call one another[3] and to "establish reciprocal compensation arrangements for the transport and termination of telecommunications."[4] To implement this requirement, the CLECs may obtain transport and termination from the ILEC and are entitled to reciprocal compensation for the termination of the incumbent's local calls. This requirement was implemented by the FCC in its local competition rulemaking.[5] Under these regulations, prices for transport and termination are set by the states that are required to use the FCC's forward-looking cost methodology. In a pending proceeding on intercarrier compensation, the FCC is considering whether an alternative system such as "bill and keep" would be preferable to mutual compensation.[6]

8. After the 1996 Act was passed, interconnection agreements among ILECs and CLECs generally treated Internet-bound calls terminated by CLECs in the same manner as local calls. Because ISPs generate large volumes of traffic that is almost entirely one-way, CLECs have a large incentive to target ISPs as customers to collect the reciprocal compensation.[7] Responding to complaints from the ILECs, the FCC conducted a proceeding to determine whether such an approach was economically sound. Finding that the application of reciprocal compensation to LECs that jointly carry Internet bound traffic had resulted in regulatory arbitrage, the FCC ruled that such traffic is not subject to the reciprocal compensation provisions of the 1996 Act.[8] Exercising its general authority under 47 U.S.C. § 201, the Commission adopted an interim cost recovery rule for local carriers that collaborate in carrying Internet-bound traffic, which, upon the expiration of existing interconnection agreements, would displace the varied regimes that state commissions to date had implemented in the course of arbitrating interconnection disputes. To contain and then reduce the market distortions associated with the application of reciprocal compensation regimes to such traffic, that interim rule requires collaborating local carriers to recover an increasing portion of their pertinent costs from their own subscribers rather than from each other.[9]

B. Unbundled Network Elements

9. Section 251(c)(3) of the 1996 Act provides new entrants with the right to gain access to the "network elements" of the incumbent. These elements, such as loops, switch ports and interoffice transport, are known as "UNEs." The network elements that may be leased are determined by the FCC and the states pursuant to section 251(d)(2) of the 1996 Act. Unless the new entrant and the incumbent agree upon the charges for these UNEs, the state public utility commission, as an arbitrator, prescribes the rates in accordance with the statutory procedures set forth in section 252. These rates are to be "nondiscriminatory" and "based on the cost (determined without reference to a rate-of-return or other rate-based proceeding)." The states must follow the FCC's pricing rules in establishing such rates.[10] The validity of the pricing rules is the subject of an appeal pending before the U.S. Supreme Court.

10. The FCC promulgated pricing rules for UNEs and for interconnection in 1996.[11] These rules specify the use of "total element long-run incremental cost" ("TELRIC") as the methodology to be used by the state commissions. TELRIC incorporates a "forward-looking" approach to determine rates. A

forward-looking approach attempts to determine what it would cost today to replace the functions of an asset. This is distinguished from the cost of simply duplicating the physical asset. The incumbent telephone companies challenging the TELRIC rules argue that they are not consistent with the statutory language because they believe that the use of the word "cost" implies historical cost. The ILECs also argue that changing from an historical cost methodology to TELRIC will deprive them of an opportunity to recover their investments.[12]

11. Another significant issue regarding the pricing of UNEs arose when the FCC directed the ILECs to make available to data CLECs the use of the high frequency portion of the loop. This arrangement is often referred to as the "line-sharing UNE" because it permits CLECs to offer DSL service to subscribers of the ILECs' voice service, thus sharing the line between the two carriers' services. The pricing of the line-sharing UNE is, of course, dependent upon the allocation of cost between the two uses of the loop. The state commissions are determining rates for this UNE pursuant to FCC regulations that require the incumbent LECs to charge no more to CLECs for access to shared local loops than the amount that they allocate to their own DSL services.[13]

C. Resale of LEC Services

12. The appropriate cost methodology for setting the terms of the required wholesale offering of local service has been the subject of protracted legal challenges. Section 251(c)(4) of the 1996 Act requires incumbents to make available at a wholesale discount telecommunications services they provide at retail to users that are not common carriers. The FCC interpreted this language to mean that ILECs should charge wholesale rates that exclude costs that would be avoidable if the ILEC were not in the retail business. The U.S. Court of Appeals for the Eighth Circuit, however, overturned this decision and ruled that excludable costs should only include those that were actually avoided when a reseller provided the service.[14] This decision may substantially limit the discount that is available to resellers.

13. In addition to the disputes over the proper way to set the wholesale discount, there have been legal disputes as to what services the resale requirement should apply. The FCC has interpreted the "at retail" provision in the resale requirement to mean that the ILECs' exchange access services and DSL services provided to Internet service providers are not subject to the discounted resale requirement because they are not designed for end users. The rationale, in part, is that such services would not include the retail billing and customer care costs that were intended to be excluded by the wholesale discount.[15]

2. Access Provided To Interexchange and International Carriers

14. The use of local telephone facilities by IXCs falls into the category described in the Background Note as a "one-way" service where the firm in an adjacent market is not necessarily a direct competitor of the firm supplying the input. IXCs typically purchase access service from the LECs for both originating and terminating calls and the LECs are not required to purchase services from the IXCs.

15. When competition was introduced into the long distance or interexchange market, numerous legal disputes occurred regarding the obligation of the local exchange carriers to provide access to their facilities for the purpose of originating or terminating long distance calls. Pursuant to the divestiture provisions of the AT&T consent decree, the FCC[16] and the states implemented interexchange tariffs setting rates for the use of exchange carriers facilities for both switched access and for special access. These rate levels were set based on traditional rate of return procedures using historical costs. The rate structure for switched access included a variety of usage-based and flat-rate charges which were intended to permit the local companies to recover some portion of the cost of providing the subscribers' local loop from the

interexchange carriers. The FCC believes that in order to maintain low rates for telephone service, access charges have generally exceeded the forward-looking costs.[17]

16. Subsequently, the FCC undertook several proceedings to reform access charges. In the Price Cap proceeding, the Commission replaced the traditional rate of return system with an approach that established ranges of prices that could be charged for baskets of services. These prices would be adjusted periodically based on a prescribed factor that would adjust prices to account for changes in productivity.[18] Following passage of the 1996 Act, the FCC also began proceedings to reform the rate structure of switched access charges.[19] There were two main purposes of this proceeding: to consider ways to reduce the subsidies that were inherent in the existing access charge rate structure that recovered fixed costs through usage based charges and to permit the exchange carriers more pricing flexibility in light of increased competition.

17. As part of its program to implement the competitive policies of the 1996 Act, the FCC also initiated a proceeding to examine the rate levels of access charges. In May 1997, the FCC decided that, in the first instance, it would allow market forces to drive interstate access charges to economic cost. As a back-stop, however, the Commission ordered price-cap ILECs to file forward-looking economic cost studies on or before February 8, 2001.[20]

18. The FCC has recently also adopted policies to govern the charges that new CLECs could levy upon the interexchange carriers for originating and terminating their calls.[21] This proceeding was partly in response to complaints that CLECs were imposing terminating access charges on interexchange carriers that exceeded the rates charged by the incumbent LECs.

19. Finally, the FCC has requested comment on proposals to develop a regime for unifying all regulated forms of intercarrier compensation. A principal focus of these proposals would be to substitute "bill and keep" arrangements for other forms of intercarrier compensation where ever such a regime would be economically justified.[22]

3. Access Provided to Enhanced Service Providers Including Internet Service Providers

20. The use of local telephone facilities by ISPs is similar to that of IXCs and would seem to fall in the category described in the Background Note as a "one-way" service where the firm in an adjacent market is not necessarily a direct competitor of the firm supplying the input and the local exchange carrier is not required to purchase inputs from the ISP.

21. Internet service providers ("ISPs") provide end users with access to the Internet either through dial-up connections using LEC or CLEC circuit-switched networks, or over broadband connections using cable modem or DSL technology. With dial-up access, the customer of the ISP makes a local phone call to connect to the ISP server, which provides computer processing, information storage, and protocol conversion to connect the end user with distant Internet sites.[23]

22. The FCC regulates access services provided by ILECs that are used by other communications providers to carry messages to other states pursuant to section 201 of the 1996 Act.[24] For conventional communications, the Commission has imposed a combination of flat charges and usage charges for such service upon the connecting IXC.[25] Although the FCC regards ISPs as using interstate access services, it has exempted enhanced service providers from the usage-based charges paid by IXCs. ISPs are instead permitted to pay for their access lines at rates contained in local exchange tariffs.[26]

23. The availability of non-usage-sensitive local lines for dial-up Internet access has made this form of narrowband access very popular. The ILECs, however, have generally also deployed wholesale DSL service that ISPs may use to provide Internet access. This service uses DSL technology and a separate

packet-switched network to provide a broadband connection to the Internet over the same loop that is used to provide the customer with analog voice service. These services offered to ISPs are regarded as wholesale in nature and are not offered to CLECs at a discount. They are, however, subject to regulation by the FCC under section 201 of the 1996 Act.

4. Access Provided to Mobile Services Carriers

24. Since CMRS providers have their own wireless networks, generally the access they require from the incumbent LECs is interconnection for the exchange of traffic and reciprocal compensation arrangements for the transport and termination of other carriers' calls on their network. This, of course, is a form of "two-way" access as discussed in the Background Note.

25. In 1994, the FCC had directed incumbent LECs to interconnect with CMRS providers on a nondiscriminatory basis.[27] After passage of the 1996 Act, the FCC decided to have mobile-to-ILEC interconnection and reciprocal compensation determined pursuant to procedures found in sections 251 and 252.[28] However, a CMRS industry group has petitioned the FCC to end the current system of reciprocal compensation and impose instead a "bill and keep" regime.[29] The FCC has requested comments on this request as part of the Intercarrier Compensation proceeding.

Conclusion

26. Although there is a wide variety of legal means by which access to incumbent LEC facilities and services may be obtained, there is not a fully consistent basis for determining the prices of such facilities which reflects the costs of providing them. The FCC is engaged in a series of proceedings that are expected to simplify and make more uniform various forms of intercarrier compensation.

NOTES

1. This discussion refers to the categories of "one-way" and "two-way" access described in the Working Party No. 2 Background Note, *see generally* Organization for Economic Co-operation and Development, Working Party No. 2 on Competition and Regulation, *Access Pricing: Theory and Application To Telecommunications* (2001), but such distinctions do not correspond precisely to conditions in the United States.

2. Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996) (codified as amended in scattered sections of 47 U.S.C.).

3. 47 U.S.C. §§ 251(a)(1) & (c)(2).

4. *Id.* § 251(b)(5).

5. *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, 11 FCC Rcd 15,499 (1996) ("*Local Competition Order"*), *aff'd in part and rev'd in part, Iowa Utilities Bd., et al. v. FCC*, 120 F.3d 753 (8th Cir. 1997), *rev'd in part and aff'd in part, AT&T Corp. v. Iowa Utilities Bd*, 525 U.S. 366, *on remand (1999) ("Iowa Utils. Bd. I")*, *Iowa Utilities Bd. v. FCC*, 219 F.3d 744 (8th Cir. 2000), *cert granted sub nom. Verizon Communications, Inc. v. FCC*, -- U.S. --, 121 S. Ct. 877 (Jan. 22, 2001) (No. 00-511).

6. *In re: Developing a Unified Intercarrier Compensation Regime*, Notice of Proposed Rulemaking, FCC CC Docket 01-92, 2001 WL 455872 (rel. Apr. 27, 2001) ("Intercarrier NPRM"), ¶ 8.

7. The Commission notes that the unbalanced traffic generated about $2 billion in annual payments, 90% of which was from ISP-bound traffic. *In re: Implementation of the Local Competition Provisions of the Telecommunications Act of 1996; Intercarrier Compensation for ISP-Bound Traffic,* Order on Remand and Report and Order, 16 FCC Rcd 9151 (2001) ("*ISP Order*"), *appealed sub nom. WorldCom v. FCC*, No. 01-1218 (D.C. Cir.) (filed May 17, 2001), ¶¶ 2, 70.

8. 47 U.S.C. § 251(b)(5).

9. *ISP Order* ¶ 7**.**

10. *See Iowa Utils. Bd. I,* 525 U.S. at 383-85.

11. *Local Competition Order*, ¶¶ 674-703.

12. Brief for Verizon Communications, Inc., *Iowa Utilities Bd. v. FCC*, 219 F.3d 744 (8th Cir. 2000), *cert. granted sub nom. Verizon Communications, Inc. v. FCC*, -- U.S. --, 121 S. Ct. 877 (Jan. 22, 2001) (No. 00-511).

13. *In re: Deployment of Wireline Services Offering Advanced Telecommunications Capability*, Third Report and Order, 14 FCC Rcd 20,912 (1999), ¶¶ 131-41.

[14.] *Iowa Utilities Bd. v. FCC*, 219 F.3d 744 (8th Cir. 2000), *cert granted sub nom. Verizon Communications, Inc. v. FCC*, -- U.S. --, 121 S. Ct. 877 (Jan. 22, 2001) (No. 00-511).

[15.] *Association of Communications Enterprises v. FCC*, 253 F.3d 29 (D.C. Cir. 2001).

[16.] The FCC regulates interstate access charges pursuant to Section 201 of the Communications Act. *See generally* 47 C.F.R. Part 69.

[17.] Intercarrier NPRM ¶ 7. *See In re: Federal-State Joint Board on Universal Service*, Report and Order, 12 FCC Rcd 8776 (1997) ("*Universal Service Orde*r").

[18.] *See In re: Price Cap Performance Review for Local Exchange Carriers,* Fourth Report and Order, 12 FCC Rcd 16,642 (1997), *rev'd in part*, *United States Tel. Ass'n. v. FCC*, 188 F.3d 521 (D.C. Cir. 1999).

[19.] *In re: Access Charge Reform*, First Report and Order, 12 FCC Rcd 15,982 (1997) ("*Access Charge Reform*"*)*; s*ee also* Intercarrier NPRM ¶ 7 n.6.

[20.] *See Access Charge Refor*m ¶ 48; s*ee generally In re: Access Charge Reform*, Sixth Report and Order, 15 FCC Rcd 12,962 (2000).

[21.] *See generally In re: Access Charge Reform; Reform of Access Charges Imposed by Competitive Local Exchange Carriers*, Seventh Report and Order, 16 FCC Rcd 9923 (2001).

[22.] *See* Intercarrier NPRM.

[23.] The FCC does not regulate the terms by which the Internet backbone providers exchange traffic. Intercarrier NPRM ¶ 2.

[24.] 47 U.S.C. § 201.

[25.] *See* 47 C.F.R. Part 69.

[26.] *ISP Order* at 55.

[27.] Intercarrier NPRM ¶ 79.

[28.] *Id.* ¶ 81.

[29.] *Id.* ¶ 79.