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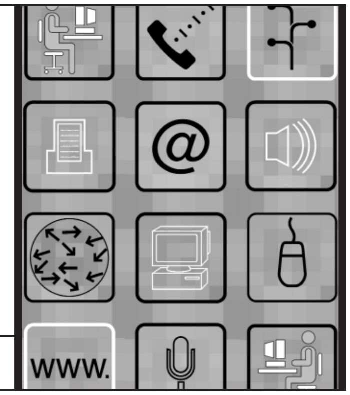
New Voices: **A TELECOMMUNICATIONS PRACTICE FOCUS**

Will Online Calls Kill Access Charges?

The Internet Transforms the Conventional Wisdom on Phone Subsidies



BY DAVID SIERADZKI

According to the conventional wisdom, regulatory changes that could increase consumers' local phone bills never happen during presidential election years. The same conventional wisdom holds that the major local phone companies and the largest long distance carriers never agree on anything about telecommunications regulation, and are always at one another's throats.

But this year, both of these points may be wrong. A powerful force—the Internet revolution—is upending the old conventional wisdom and fundamentally transforming the basic rules of the telecommunications industry.

The Federal Communications Commission is seriously considering, and appears likely to adopt, a plan proposed by a coalition that includes four of the largest local phone companies—Bell Atlantic, Bell South, GTE, and SBC—as well as long distance giants AT&T and Sprint. This group, organized by former FCC Chief of Staff John Nakahata and calling itself the Coalition for Affordable Local and Long Distance Services (CALLS), has united around a proposal to make far-reaching changes to the FCC's access charge rules.

Just what are access charges? They include: (1) the interconnection fees that long distance companies pay local phone companies for originating and terminating interstate long distance calls; and (2) the federally regulated monthly charges that consumers pay to their local phone companies (currently $3.50 per month for most residential users). The CALLS plan would significantly cut the charges paid by long distance carriers, while gradually increasing the charges paid by consumers.

Why have these usual regulatory adversaries come together behind this far-reaching proposal? And why is the FCC likely to adopt such a controversial proposal during this presidential election year? To address these questions, one must first explore how the Internet is undermining the existing access charge regime. This will help explain the plan proposed by the CALLS coalition and the future developments that the Internet may bring about.

The arrival of the Internet is making the present access charge system untenable for three reasons. First, the Internet is accelerating (and taking advantage of) competitive changes in the telecom industry, which make it impossible to maintain the hidden subsidies that are the core of the current access charge system. Second, access charges are based on historical regulatory distinctions—such as local vs. long distance, intrastate vs. interstate, and voice vs. data—but the Internet is rendering these old categories obsolete. Third, the difference between local and long distance service is disappearing as telecom carriers move toward becoming Internet telephony providers.

Undermining Subsidies

First, Internet-driven competition is placing tremendous pressure on the elaborate subsidy mechanism embedded in access charges. That subsidy system, established in the wake of the Bell system breakup in 1984, presumes a competitive long distance marketplace but local phone monopolies. Long distance providers pay the local phone companies access charges that substantially exceed the cost of their interconnections. Those excessive costs were passed along to long distance consumers. At the same time, residential consumers paid below-cost access charges.

The net result was to raise long distance rates to subsidize local phone service in a manner that is almost invisible to consumers. The beneficiaries of this subsidy were local phone subscribers who did not use much long distance service.

In addition, the access subsidy system forced local phone companies to impose access charges that were largely uniform across their service territories, even though the cost of providing service is much higher in rural areas than in urban areas. The result was another hidden subsidy flow—from urban consumers to rural consumers.

Long distance companies like AT&T and Sprint have always chafed under this subsidy system, which forces them to overprice their own services and leads to lower demand for long distance than would be the case if the charges were cost-based. But the problem is getting worse due to the advent of Internet telephony. Increasingly, consumers can avoid high long distance rates from conventional companies by placing calls over the Internet. Consumers pay low monthly rates for local phone service and Internet connections, and can use those connections for long distance calls as well as data communications. Internet telephony is already transforming the international long distance arena, where rates are highest, but in the long term also threatens domestic carriers.

The incumbent local phone companies are also chafing under the existing access charge subsidy system, due to increasing local phone competition, which the Internet is facilitating. (Internet service providers (ISPs) are the most important customers of new local phone competitors that are entering the market.) When local phone service was provided by monopolies, it was relatively easy for regulators to use local phone companies' rates as a mechanism to redistribute dollars between high-volume and low-volume consumers, and between urban and rural areas. But new entrants in the local phone marketplace can undercut the incumbent local phone companies' excessive rates in urban areas, which reduces the customer dollars available to subsidize rural areas. At the same time, the fact that only the incumbent telcos receive subsidies from this system has the effect of preventing competitive entry in rural areas.

Old Categories Disappear

Second, the Internet is fundamentally different from the old telecom architecture because it is just as easy to communicate across the ocean as across the street. It is impossible to tell whether a given Internet connection is being used for intrastate or interstate communications. While the Internet was originally used only as a medium for exchanging data, it is increasingly being used for voice communications as well. Thus, the Internet is breaking down the old distinctions between local and long distance, intrastate and interstate, and voice and data. But access charges are premised on these distinctions, particularly on the difference between interstate long distance calls and intrastate local calls.

In this environment, it is increasingly difficult to reconcile the skewed access charge regime for interconnection between local and long distance carriers with the cost-based system for interconnection between incumbent local carriers and competitive local entrants, mandated by the Telecommunications Act of 1996. The two types of interconnection are physically identical; the same zeros and ones that make up a stream of digital bits pass between carriers in either case, and the same network equipment is used. But there is a dramatic inconsistency between the rates for the two types of interconnection. Local interconnection rates are typically in the range of half a cent per minute or less. Access charges for long distance interconnection are significantly higher, typically more than one cent per minute. This creates artificial arbitrage opportunities.

A more significant difference is who receives the charges. In the access charge regime, interconnecting long distance carriers pay the incumbent local telcos for traffic that originates from the telcos' customers and passes to the interconnecting carriers. But under the local interconnection rules, the payments go the opposite direction: The incumbent telcos pay interconnecting carriers for traffic that originates from the telcos' customers and passes to the interconnecting carriers. Also, access charges are supervised by the FCC through tariffs filed at the commission, while local interconnection arrangements are negotiated between carriers, with arbitration by a state public utility commission in the (frequent) case that carriers fail to reach an agreement.

These irreconcilable differences between the access charge rules for local-long distance interconnection and the more economically rational rules for local-local interconnection have generated very difficult questions about the old regulatory categories. When a local telco customer turns on her computer and dials up her Internet service provider that receives service from a competitive local carrier, who should pay whom? Is this call, which gives the customer access to a Web that is "worldwide," really a form of interstate long distance, for which the ISP's carrier must pay access charges to the customer's telco? Or is it a "local" call, for which the customer's telco should pay interconnection fees to the ISP's carrier? This difficult question has led to a tangle of litigation before the FCC, state regulators, and courts, and has generated some conflicting decisions. This difficulty also makes it clear that, in the long term, the distinction between the access charge rules for local-long distance interconnection and the rules for local-local interconnection will have to come to an end.

Distance Becomes Irrelevant

Finally, the distinction between local-local interconnection and local-long distance interconnection is increasingly hard to maintain because the differences between local and long distance service are disappearing—and because all carriers are becoming Internet operators. Long distance carriers are trying to enter the local marketplace and local carriers are trying to enter the long distance marketplace. In the deregulated wireless marketplace, consumers are offered calling options that make no distinctions between the rates for local and long distance calls. Of course, in the world of the Internet, it's just as easy to connect across the world as across the street. Distance is becoming irrelevant. So a regulatory system based on treating "local" and "long distance" interconnection arrangements differently is unsustainable.

Moreover, telecommunications companies are increasingly using Internet protocol technology to deliver ordinary phone calls, and most of them view Internet traffic as their major source of growth over the next few years. As this occurs, it will be hard to maintain the distinction between the interconnection arrangements in the unregulated Internet world and the highly regulated interconnection arrangements between telecom providers. Access charges are not likely to survive in their current form.

The CALLS Plan

All of these developments are placing tremendous stress on the access charge regime. This stress, and the high stakes, led historic enemies—long distance carriers AT&T and Sprint and local phone companies Bell Atlantic, BellSouth, GTE, and SBC—to form the CALLS coalition. These companies have proposed three major changes in the access charge rules.

First, the plan would cut the access charges that local phone companies impose on long distance carriers by more than $2 billion per year, cutting per-minute rates by about half and eliminating most per-line charges. As a result, long distance companies would probably reduce their long distance rates, and AT&T, Sprint, and (in all likelihood) other long distance companies would be able to eliminate some of the monthly surcharges that they now place on consumers' long distance bills.

Second, the CALLS plan would gradually increase the monthly subscriber line charge (paid by end users to local phone companies) from $3.50 up to a maximum of $6.50 for residential consumers' first phone lines. These charges would be keyed to geographic cost differences—they would be lower in urban areas and higher in rural areas, where costs are higher. The proponents claim that most consumers would be better off because the reductions in their long distance bills would more than offset any price increases on their local phone bills, but some consumer groups strongly disagree.

Third, the CALLS plan would create a $650 million fund to subsidize local phone lines in high-cost, rural areas. This fund, the proceeds of which would benefit local phone providers who serve those areas, is intended to ensure that no consumer has to pay more than $6.50 per month in federally regulated charges. All telecommunications providers would pay just under 1 percent of their gross revenues into this fund; the cost would be passed on to consumers through surcharges on phone bills.

In sum, the CALLS plan would cut in half the access charges paid by long distance carriers, to a level that is closer to actual cost, and would eliminate hidden subsidies in the local and long distance rate structure. The plan includes protections for low-volume and rural consumers, but a significant amount of these subsidies would be collected and distributed in a more competitively neutral manner.

Missing the Forest for the Trees

The FCC appears to be poised to adopt this plan, or some variant of it. As of last week, the CALLS advocates, consumer representatives, and FCC commissioners and staff appeared to be locked in dispute over the extent of rate changes, particularly the increase in the subscriber line charge.

The agency's focus on the minor details of the CALLS plan, however, misses the larger issues raised by the plan. Because of political sensitivities over increasing the subscriber line charge during an election year, the coalition's plan does not go nearly far enough. Instead of just reducing the disparity between local-long distance access charges and local-local interconnection charges, the FCC should eliminate that disparity entirely.

Arguably, the Telecommunications Act of 1996 itself appears to contemplate a single set of interconnection rates between carriers. But the FCC, when implementing the statute, recognized the probability that long distance carriers would stop paying inflated access charges to the incumbent local phone companies, and instead would try to utilize the cost-based interconnection rates contemplated by the statute. At the time, the commission feared that such a radical change could sharply reduce local phone companies' overall revenues and lead to major increases in local rates. So the FCC adopted a number of rules in 1996 that erected legal distinctions between access charges and local-local interconnection. The commission's notion was that this would lead to a gradual reduction in access charges rather than a sudden change.

But today, four years later, it's time for the FCC to consider getting rid of some of these distinctions altogether. Indeed, the agency, in a proposed rule making in early 1999, took a small step that might have started the process of eliminating these distinctions.

The FCC was asked to resolve a battle between incumbent local phone companies and competitive local carriers over calls to Internet service providers. The incumbents claimed that the FCC had jurisdiction over the calls from customers of the incumbents to the competitive carriers serving ISPs—and consequently, that the competitive carriers should pay access charges to the incumbents. The competitors argued that these calls were local, and therefore that incumbents should pay local-local interconnection charges to the competitive carriers.

The FCC "split the baby" in a very interesting way. On the one hand, the FCC pleased the incumbents by holding that the calls were indeed subject to federal jurisdiction and, as a legal matter, should not be subject to the existing local-local interconnection regime. (A subsequent remand by the U.S. Court of Appeals for the D.C. Circuit throws doubt on this decision.)

On the other hand, the FCC feared that imposing access charges on these calls would lead to the unthinkable—per-minute surcharges on Internet access customers. To avoid this outcome, the agency proposed to delegate to the state commissions authority for regulating these interstate calls—and to price these calls as if they were subject to the local-local interconnection rules. This proposal remains pending more than a year later.

The End of Access Charges?

Assuming that ISP calls are interstate, the FCC proposal for handling these calls opens a possible path toward a more radical overhaul of the access charge regime than the CALLS plan. If the FCC can delegate to the states authority for regulating this interstate traffic, and can require that the calls be priced as if they were subject to the local-local interconnection rules, then it could treat all interstate calls the same way.

This could mean the end of access charges and would have a number of interesting consequences. State commissions could oversee the negotiation of agreements (or could arbitrate such agreements) between local and long-distance carriers. These agreements would treat all traffic the same, whether local or long distance. The statutory rules requiring cost-based interconnection rates would apply to all forms of interconnection, whether local-local or local-long distance. State commissions, which would oversee these agreements, ultimately would be forced to eliminate the economically distortive, implicit subsidies to low-volume and rural consumers that are now hidden in state-regulated rates, and either allow those customers to pay the full cost of local service, or develop competitively neutral subsidy mechanisms.

Ultimately, such a development could lead to the total elimination of both local-long distance and local-local interconnection charges. As the regulatory distinctions fall by the wayside, the major telecom carriers might have incentives to negotiate agreements that parallel the interconnection agreements in the Internet world. These "peering" agreements typically provide for traffic to be exchanged freely among providers, and for providers to compensate one another "in kind" for carrying each other's traffic. This is consistent with the Telecommunications Act of 1996, which already permits carriers to negotiate local-local arrangements "that afford the mutual recovery of costs through the offsetting of reciprocal obligations, including arrangements that waive mutual recovery (such as bill-and-keep arrangements)." 47 U.S.C. §252(d)(2)(B)(i).

Thus, the Internet revolution may not only transform the FCC's interconnection rules, it may lead to the end of interconnection charges altogether. In the future, telecom companies may stop trying to profit from imposing access or interconnection charges on one another. Instead, they would have to focus more on competing to provide top-notch service to consumers at reasonable—but unregulated—prices.

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