Item 49
8097

State of California **Public Utilities Commission**
San Francisco

M E M O R A N D U M

Date: **November 19, 2008**

To: **The Commission**
(Meeting of November 21, 2008)

From: **Helen Mickiewicz, Asst. Gen'l Counsel**

Subject: **Filing of Comments in Response to FCC's Further Notice of Proposed Rulemaking on IP-Enabled Services, Reform of the Federal Universal Service Program and the Development of a Unified Intercarrier Compensation Regime, WC Docket Nos. 06-122, 05-337, 04-36, 03-109; CC Docket Nos. 01-92, 99-200, 99-68, 96-98, 96-45.**

RECOMMENDATION: The Commission should file limited comments in response to the Federal Communications Commission's (FCC) Further Notice of Proposed Rulemaking (FNPRM) adopted and released November 5, 2008, in which the FCC classifies as "information services" those services that originate calls on IP networks and terminate them on circuit-switched networks, or conversely that originate calls on circuit-switched networks and terminate them on IP networks (collectively "IP/PSTN" services); and proposes major changes to the federal universal service program and the intercarrier compensation regime. Due to the limited time permitted by the FCC to file comments on these proposals, staff is not able to fully analyze the impact to California carriers and customers of many of the proposed changes. Comments are due November 26, 2008. Reply Comments are due December 3, 2008.

BACKGROUND AND THE FNPRM PROPOSALS: The FCC's FNPRM under review here proposes resolutions to various matters that have been the subject of public comments over the last decade.

IP-Enabled Services -- In 2004, the FCC opened a proceeding to examine what regulatory scheme, in any, should apply to IP-Enabled Services defined as services and applications relying on the Internet Protocol family**.** In 2002 and May 2004, the Commission filed comments in this docket urging the FCC to treat VOIP service as a telephony service subject to Title II of the federal Communications Act. Although the FCC has issued several orders in this docket extending certain "Title II" common carrier or telephony requirements to VOIP providers, it has not declared whether IP-enabled services should be treated as information services or telecommunications services.

In this FNPRM the FCC classifies IP/PSTN services as "information services"; i.e., those services that originate calls on IP networks and terminate them on circuit-switched networks, or conversely that originate calls on circuit-switched networks and terminate them on IP networks (collectively "IP/PSTN" services). The FCC states that such traffic today involves a net protocol conversion between end-users, and thus constitutes an "enhanced" or "information service".

Universal Service Fund Reform -- Over the past several years, there has been explosive growth in federal high cost support to carriers at the same time that the funding source -- interstate and international revenues – had declined. There is concern that without action to restrain the growth and/or to change the contribution methodology, the high cost support program may not be sustainable. In addition, the issue of whether to provide universal service support for the deployment and provisioning of broadband facilities and services has been debated in policy circles for some time. On May 1, 2007, the Federal – State Joint Board on Universal Service (Joint Board) sought comment on proposals for addressing the issues related to federal high cost support. The CPUC filed comments with the Joint Board on May 31, 2007. On April 17, 2008, the CPUC filed comments on the Joint Board's *Recommended Decision* issued November 20, 2007, which proposed changes to the high cost support program and also sought comment on expanding the federal universal service program to include support for broadband facilities and services. The CPUC supported some of the Joint Board's recommendations and opposed others. In this FNPRM the FCC does not adopt the Joint Board's *Recommended Decision*. Instead the FCC proposes and seeks comment on these universal service program changes:

- Impose a permanent cap on high cost support at 2008 level. An alternative proposal (OPASTCO/WTA proposal) would not apply the cap to rural rate-of-return incumbent LECs (ROR ILECs) -- all high-cost universal service support mechanisms utilized by rural ROR ILECs would continue to operate as they do today through 2010. This includes high-cost loop support (HCLS), local switching support (LSS), interstate common line support (ICLS), safety net additive support, and safety valve support. Support from these mechanisms would be frozen by study area at 2010 levels.

- Eliminate the identical support rule;

- Require that all recipients of high cost support commit to deploying broadband in 100% of their service areas in five years or risk losing their support to a winner of a reverse auction. Satellite technology could not be used without a FCC waiver. An alternate proposal (OPASTCO/WTA proposal) would permit rural ROR ILECs to use satellite without a waiver for "very high-cost loops" as defined plus it would provide to rural ROR ILECs who make the five -year commitment supplemental universal service support (see below under ICC Reform for details.)

- Alternatively, implement reverse auctions within one-year in all high cost areas to determine who should receive high cost support and at what level;

- Implement a three-year $900 million pilot program to provide Link-up/Lifeline subsidies to low-income subscribers for Internet Access service;

- Change the universal service contribution methodology for residential customers from the current percentage surcharge on the customers monthly interstate/international billings to a numbers-based methodology of $1.00/month (or alternatively .85 cents/month) on each "assessable number" as defined;

- Change the contribution methodology for businesses to a connections-based methodology in the future, but preserve the surcharge on business interstate/international billings in the interim pending an FCC proceeding to determine how such connections-based methodology would be designed;

- Alternatively, immediately order a change in the contribution methodology for businesses to a system based on dedicated access connections or "assessable connections" as defined.

Intercarrier Compensation Reform -- Following the 1982 Modified Final Judgment divesting AT&T of its local Bell operating companies, the FCC adopted access charge rules that provided for the partial recovery of these incumbent local exchange carriers' (LECs') costs incurred in (or assigned to) the origination and termination of interexchange traffic. These access charges were substantially higher than cost, a situation viewed as an "implicit subsidy" to promote universal service goals by helping to support local carriers, including those in rural areas. . In the 1996 Telecommunications Act, Congress sought to reform the existing universal service system to be consistent with competitive markets. Congress determined that implicit subsidies were neither consistent with, nor sustainable in, a competitive market, and that they should be replaced with explicit support. However Congress also recognized that conversion of the existing web of implicit subsidies to a system of explicit support would be a difficult task that could not be accomplished immediately. Thus the FCC and the states have been lowering these access charges over time to move from a system of implicit subsidies to explicit payments.

The 1996 Act also opened local markets to competition and created a new duty of all telecommunications carriers to connect to one another. 47 U.S.C. 251(a). Section 251(b)(5) of the 1996 Act required all LECs to "establish reciprocal compensation arrangements for the transport and termination of telecommunications." Congress expressed a preference for the carriers to negotiate charges for termination of local traffic through interconnection agreements but provided for state arbitrations in cases where parties could not agree. Section 252(d) established general pricing guidelines for setting of reciprocal compensation rates. The FCC subsequently ordered that states employ a forward-looking, long-run average incremental cost methodology to set these rates, which it called "Total Element Long-Run Incremental Cost" or "TELRIC." The Commission found that TELRIC prices should include a reasonable allocation of forward-looking common costs, including overheads. In 2005 the FCC opened further proceedings in the Intercarrier Compensation (ICC) docket to seek comment on various proposals to provide for comprehensive reform of the existing ICC regime. In 2006, the FCC sought comments on a specific proposal dubbed "the Missoula Plan" which sought to move all terminating access charges and reciprocal compensation charges to one low uniform rate for all providers. The Commission filed comments in these 2005 and 2006 proceedings.

In this FNPRM, the FCC proposes that ICC terminating charges transition over a ten-year period to one low, uniform terminating rate for all carriers in each state. The transition would take place in three stages:

- In Stage 1, all states would have to reduce intrastate access rates to the level of interstate access rates over a two-year time frame.

- In Stage 2, all terminating rates would move, by the end of year four, to a state-wide interim, uniform reciprocal compensation rate adopted by the state.

- In Stage 3, in the six years remaining, all terminating rates would have to move to a final uniform rate, the calculation of which would be based on a methodology mandated by the FCC. Supposedly the methodology would result in low terminating rates of between zero and .0007 per minute of use.

An ILEC would be permitted to recovery revenues lost due to the reductions in interstate and intrastate access rates by increasing its federal end user Subscriber Line Charge (SLC). Such recovery however would only be permitted if the LEC's state retail rates and any intrastate SLC are set at the maximum level permitted under state regulation. To the extent that a carrier's state retail rates have been deregulated, that carrier would not be permitted to increase its SLCs to recover any net loss in intrastate intercarrier compensation revenues.

Specifically, the FCC proposes to increase the SLC cap for residential and single-line business lines from $6.50 to $8.00, the non-primary residential line SLC cap from $7.00 to $8.50, and the multi-line business SLC cap from $9.20 to $11.50.

The FCC would also refer to the Separations Joint Board certain specific issues regarding possible increases in interstate end-user charges: (i) whether SLC caps should be increased by a fixed amount to recover any net loss in intercarrier compensation revenues; (ii) whether a "flexible" SLC cap should be used in conjunction with an overall benchmark or threshold; or (iii) some combination of those options.

The FCC proposes two alternatives for further recovery of losses for those carriers who cannot make up the losses through SLC and rate increases.

Alternative One -- Certain carriers may recover these losses through payments from the universal service fund.

As a precondition for receiving new universal service support, any carrier—whether price cap or rate-of-return—must show that its federal SLC, state SLC (if any), and state retail local service rates are at the maximum levels permitted under existing applicable law. If this precondition is met, then carriers may apply for universal service funds.

As discussed below, there are additional requirements to qualify for universal funding that vary depending on whether a carrier is subject to price cap or rate-of-return regulation. In either case, the ILEC bears the burden of demonstrating that it is entitled to such funding based on the following criteria.

Rate-of-Return ILECs. For ILECs subject to rate-of-return regulation, a carrier may qualify for universal service funding if it can demonstrate that it will not have a reasonable opportunity to earn its authorized rate of return as a result of its net loss of revenues caused by the changes in intercarrier compensation rates resulting from this order, even after having increased its interstate SLC, state SLC (if any), and state retail local rates to the maximum permitted by applicable law.

Price Cap ILECs. For ILECs subject to price cap regulation, a carrier may qualify for universal service funding if it can demonstrate that, as a result of reduced and reformed intercarrier charges, and after accounting for increased end-user charges, it is still unable to earn a "normal profit" defined as the "total revenue required to cover all the costs of a firm, including its opportunity costs." The FCC would consider all of the company's costs and revenues—both regulated and non-regulated—before providing new universal service support.

Alternative Two (OPASTCO/WTA proposal):

Rural Rate of Return Carriers automatically would be permitted to recover lost revenues through supplemental Interstate Common Line Support (ICLS). [ICLS is one of the five elements of federal high cost support and is available only to ROR ILECs and competitive ETCs providing service in the areas of these companies.]

The proposed supplemental ICLS would consist of two components. The first component compensates rural ROR ILECs for all of the revenues lost as a result of the mandated reductions in intercarrier compensation rates that are not otherwise recoverable through increases in SLCs.

The second component is available only to those rural ROR ILECs that have

> committed to the five-year broadband build-out requirement. This component is intended to ensure that those ILECs continue to have an opportunity to earn their authorized interstate rate of return, subject to a cap. This component will provide compensation for unrecoverable revenue losses attributable to losses in access lines and interstate and intrastate minutes of use, using 2008 as a base year. The second component remains in effect for the first five years of the transition and is capped at $100 million in year one, $200 million in year two, $300 million in year three, $400 million in year four, and $500 million in year five. Prior to year five, the FCC shall conduct a proceeding to determine if modifications are required.

Phantom Traffic: -- The FCC acts to eliminate the phantom traffic problem as follows. CPN is a critical component of call signaling information. When CPN is populated in the SS7 stream by an originating service provider and passed, unaltered, along a call path to a terminating service provider, the terminating provider can use the CPN information to help determine the applicable intercarrier compensation. The FCC proposes to modify its rules to prohibit stripping or altering information in the SS7 call signaling stream. The FCC also expands the scope of its existing rule regarding passing CPN, which currently applies only to service providers using SS7 and only to interstate traffic. It extends these requirements to all traffic originating or terminating on the PSTN, including jurisdictionally intrastate traffic. The FCC also amends its rules to require service providers using MF signaling to pass CPN information, or the charge number (CN) if it differs from the CPN, in the Multi Frequency Automatic Number Identification (MF ANI) field.

DISCUSSION:

Staff is unable to make recommendations on many of the aspects of this FNPRM due to lack of time to make a full analysis. There are also indications that this FNPRM will not be considered at the FCC's December 18, 2008 Open Meeting as currently proposed by FCC Chairman Kevin Martin, although its final status is not known at this time. In the event that the FCC does proceed to a vote on these proposals, however, it would seem desirable that the CPUC does comment, as the proposals would amount to the most significant changes in universal service and intercarrier compensation in a decade. , staff deems it prudent to obtain Commission authorization to proceed if necessary Comments are due on November 26, 2008 (the day before Thanksgiving). Staff makes the following recommendations for CPUC comments.

IP-Enabled Services -- The Commission should seek clarification of the rationale and the consequences of the FCC's declaration that IP/PSTN traffic is an "information service". The FCC states that such traffic today involves a net protocol conversion between end-users, and thus constitutes an "enhanced" or "information service". This logic can be applied to analog to digital exchanges and wireless to wireline exchanges as well.

The Commission also should ask the FCC to clarify the role of the states as it relates to IP/PSTN traffic, should it adopt this determination. For example, it is unclear how this classification would affect state authority to collect universal service monies and it also raises questions about the interconnection rights of such services.

Universal Service Fund Reform --

The FCC's proposals contain a number of changes to the structure and operations of the existing universal fund:

- A permanent cap on high cost support -- In past filings, the CPUC has opposed a permanent across the board cap on high cost support prior to reform. Capping all five major support mechanisms across the board may not be the appropriate way to structure a cap, even a temporary one. The staff recommends the CPUC continue to oppose this proposal and suggest a detailed proceeding on this matter is needed as recommended by the Joint Board. However staff recommends that the CPUC should urge the FCC, should it adopt a permanent cap, to support the OPASTCO/WTA proposal that a cap not to apply rural ROR ILECs until 2011 -- all high-cost universal service support mechanisms utilized by rural ROR ILECs would continue to operate as they do today through 2010.

- Elimination of the identical support rule **--** Staff recommends that the CPUC refrain from commenting on this issue at this time, as a similar issue is pending before the CPUC in the California High Cost Fund-B (CHCF-B) proceeding (R.06-06-028).

- Requirement That All Recipients Of High Cost Support Commit To Deploying Broadband In 100% Of Their Service Areas In Five Years Or Risk Losing Their Support To A Winner Of A Reverse Auction -- Staff recommends the CPUC oppose the proposal to require the five-year broadband roll-out due to the negative financial impact that such a requirement could have on our rural ROR carriers. Staff has not had time to evaluate whether the alternative proposal that would provide rural ROR ILECs who make the five year commitment with supplemental universal service support would be adequate to assuage our concerns. However, staff recommends the CPUC urge the FCC to provide some type of federal support to rural RORs should the FCC adopt this federal mandate.

- Reverse Auction Proposals -- Staff recommends that the CPUC file limited comments, stating that the CPUC's goal in the pending second phase of the CHCF-B proceeding (R.06-06-028) is to institute a market-driven reverse auction process to determine high cost support levels. Staff further recommends that the CPUC refrain from making any policy recommendations on the specifics of a reverse auction process, because similar issues are still pending in the R.06-06-028 proceeding.

- Three-Year $900 Million Pilot Program To Provide Link-Up/Lifeline Subsidies To Low-Income Subscribers For Internet Access Service – Staff recommends that the CPUC oppose this proposal. In past filings the CPUC has opposed adding "broadband Internet access" to the statutory definition of "universal service," due to the resulting substantial increase in the draw on the federal universal service programs. However, should the FCC adopt such a program, the CPUC should recommend that it require all broadband service providers contribute to the fund.

- Changing the universal service contribution methodology to a numbers-based (residential) and connection-based system -- Although the CPUC has supported a adoption of a number-based methodology to determine universal service fund contributions, Staff has no recommendation at this time on this particular proposal because staff has not had time to analyze its impact, including how the new category of numbers and connections would affect California subscribers.

Intercarrier Compensation Reform – Staff recommends that the CPUC restate its support for a transition to a unified terminating rate. Staff recommends that the CPUC oppose the FCC's transition plan unless rural ROR carriers are made whole for their net losses in access revenue. Staff has not had time to analyze the impact of the alternative proposal (OPASTCO/WTA proposal) to provide recovery to rural ROR carriers through supplemental Interstate Common Line Support (ICLS) and how this proposal would relate to the proposal to cap the high cost support fund. We cannot make a recommendation on the alternative proposal at this time. Staff is also concerned about the impact of this transition plan on mid-size price cap carriers and this matter needs more analysis also.

Terminating Rate – the FCC asks whether the terminating rate for all § 251(b)(5) [recip comp] traffic should be set as: (i) a single, statewide rate; or (ii) a single rate per operating company?

In past filings, the CPUC has stated that an approach to meet a unified rate that uses different transition tracks for carriers based on economic differences, similar to the three track approach in the Missoula Plan, is a better approach than forcing all carriers to follow the same transition plan. If this is the question being asked, then Staff recommends that the CPUC support state flexibility to determine how the transition plan would proceed. The matter should be left to the state to decide. If the FCC is asking if the end unified rate should be uniform throughout the state, then Staff recommends that the CPUC support a single, statewide rate.

TELRIC or incremental cost – The FCC asks whether the additional cost standard utilized under § 252(d)(2) of the Act be: (i) the existing TELRIC standard; or (ii) the incremental cost standard described in the draft order? Below are brief descriptions of the two methodologies.

Staff has not had time to properly analyze the new suggested methodology. Today, states use TELRIC when setting UNE and Reciprocal Compensation rates. The FCC suggests that the new methodology would result in terminating rates of between zero and .0007 per minutes of use which is where the FCC is proposing terminating rates should be at the end of the ten-year transition.

Description of TELRIC Methodology: Calculated by estimating the forward-looking cost of individual network elements, which the FCC defined as "physical facilities of the network, together with the features, functions, and capabilities associated with those facilities."

The FCC determined that forward-looking costs should be "based on the least cost, most efficient network . . .technology," – assuming current wire center locations. It further determined that the relevant increment should "be the entire quantity of the network element provided." The FCC concluded that "forward-looking common costs shall be allocated among elements and services in a reasonable manner"

- Assumes circuit switching and fiber optic transport technology
- Includes an allocation for commons costs and overhead

Cost Method Proposed in the FNPRM:
First - evaluate a forward-looking economic cost analysis of a stand-alone network that performs all functions of a modern telecommunications network, including transport and termination of other carriers' traffic.

Second -evaluate a forward looking economic cost analysis of a stand-alone network that performs all the same functions except for the transport and termination of other carriers' traffic.

Third, states must compare the costs of these two networks. The difference between the costs of the two networks is the additional costs of termination of traffic subject to the "additional costs" standard.

- Assume the least cost, most efficient network technology. The FCC states that the least cost, most efficient switch today is a softswitch, and the least cost, most efficient technology for transport is fiber optic cable.

- The cost studies must exclude all common costs, including overhead costs.

- All nontraffic-sensitive costs must be excluded from the cost studies.

Preemption Issue: The FCC's proposed ICC reform plan raises questions about the FCC's ability to mandate changes to intrastate access rates. The FCC proposal requires states to lower intrastate access rates to the interstate rate level in the first two years. The FCC then mandates a certain methodology be used to determine the final uniform rate in a state that would be put in place at the end of the ten-year transition. The Staff has not had time to analyze this preemption issue thoroughly and recommends no comment on this issue at this time.

Phantom Traffic Solution -- Although the CPUC has encouraged the FCC to develop polices that address the phantom traffic problem, Staff has not had time to analyze the FCC's proposed solution in this FNPRM.

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