Intercarrier Compensation Reform at Debate: Major Issues of the Missoula Plan

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INTRODUCTION

On July 24, 2006, the National Association of Regulatory Utility Commissioners' Task Force on Intercarrier Compensation (NARUC Task Force) filed a comprehensive intercarrier compensation reform plan, the Missoula Plan (the Plan) with the Federal Communications Commission (FCC). The main objective of the Plan is to unify the now disparate reciprocal compensation and access charges across different carriers, technologies, and types of traffic. The Plan also proposed solutions to deal with the issues of phantom traffic and Voice over Internet Protocol (VoIP) traffic. The FCC sought comments and reply comments on the Missoula Plan from all concerned parties.

By February 1, 2007, sixty-three parties, including twenty state commissions, filed reply comments on the Missoula Plan in CC Docket No. 01-92. This second round of comments provided parties with a forum to develop counterarguments and present their suggestions to modify the Missoula Plan proposal. Commenters continued to debate on issues that remained unresolved during the first comment period, especially those concerning consumer benefits and the competitive impact of the Missoula Plan.

As a further step in a series of papers on the Missoula Plan, this NRRI report synthesizes all the reply comments, and highlights eight major issues of contention that have been the foci of the ongoing debate. These issues include:

- Preemption of state authority
- Impact on consumer benefits
- Flow-through of access rate reductions to end users
- Restructure Mechanism
- Early Adopter Fund and the proposed Benchmark Mechanism
- Cost basis of new intercarrier compensation rates
- Tandem Transit Service and the TELRIC alternative
- Impact of Edge interconnection on CLECs

Whereas those issues are still being discussed and negotiated, this paper intends to inform state commissions, consumer advocacy groups and other concerned parties of key issues of the Plan being debated, and facilitate further dialogue on the process of intercarrier compensation reform.

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Executive Summary

The reply comments cycle on the Missoula Plan (the Plan) provided parties with a forum to develop counterarguments and present their suggestions to modify the Missoula Plan proposal. By February 1, 2007, sixty-three parties, including twenty state commissions, filed reply comments in CC Docket No. 01-92. Commenters continued to debate on issues that remained unresolved during the first comment period, especially those concerning consumer benefits and the competitive impact of the Missoula Plan.

A. Preemption of state authority

Debate: Whether the FCC has adequate jurisdiction over the reform of reciprocal compensation and intrastate access charges.

Supporters:

Section 251(b)(5) and Section 251(c) of the Communications Act (the Act) gives the FCC direct jurisdiction over all intercarrier compensation rules for all types of traffic. Impossibility rules may also apply when it is not technically possible to separate the intrastate and interstate traffic; besides, such separation has become more meaningless nowadays. States may opt not to take the FCC's recommendation on intrastate access charge reduction.

Opponents:

Section 153, 251(c)(2) and Section 252(b)(5) designate intrastate traffic, transit traffic, and reciprocal compensation to the states' jurisdiction. Incremental and state-specific reform is better than an overhaul change. The adoption of the Plan is coercive on states.

B. Impact on consumer benefits

Debate: Whether the Missoula Plan will generate net consumer benefits.

Supporters:

The Plan will reduce toll charges substantially, thus lowering toll rates for consumers. Consumers will also benefit from better bundled services and larger calling areas, once the arbitrary regulatory classification of traffic is removed. Lifeline consumers will not be worse off from the Subscriber Line Charge (SLC) increase. The Plan will facilitate the rollout of broadband by making intercarrier compensation rules more competitively and technologically neutral.

Opponents:

Consumers, especially those who do not make a lot of intrastate toll calls, will have more financial burden from the Restructure Mechanism (RM), the Early Adopter Fund (EAF), increases in the modified federal Universal Service Fund (USF) and in the SLCs. Not all low-income consumers are eligible for the Lifeline program. The Plan does not impose broadband deployment obligations on rural carriers.

C. Flow-through of access rate reduction to end users

Debate: Whether carriers will automatically pass through the benefits of reduced access charges to consumers in the form of lower long distance rates.

Supporters:

The long distance market is competitive enough. No explicit regulatory mandate is necessary.

Opponents:

Market competition is no guarantee for 100 percent flow-through of access charge reductions. Bundled service offerings make flow-through less visible and tangible for consumers. Vertically integrated carriers offering both local and long distance services will have double gains from the Plan.

D. Restructure Mechanism

Debate: Whether the Restructure Mechanism is competitively neutral.

Supporters:

The RM is a legal necessity to offset carriers' access revenue loss and keeps telephone service rates in high-cost areas affordable. It replaces the current implicit subsidies from high access charges. It can be viewed either as an access charge element or a USF mechanism. ILECs may not fully recover their cost because if they lose lines, they will lose the RM support for those lines. In some competitive markets, ILECs may not be able to raise their SLCs to the cap levels proposed in the Plan. The Plan allows all Eligible Telecommunications Carriers to receive the RM.

Opponents:

The RM ensures ILECs' revenue flow and gives them competitive advantages. It is not an access charge element because the mandated rates are not based on actual costs, especially in high-cost areas; nor is it a USF mechanism because all end users contribute to it but only ILECs have access to it. CLECs should also be allowed to recover revenue loss through the RM. Besides, ILECs may deaverage SLC increases across competitive and less competitive areas.

E. Early Adopter Fund and proposed Benchmark Mechanism

Debate: How to properly define the qualification of Early Adopter States and how to compensate carriers in those states.

On January 30, 2007, the Plan supporters and a group of state commissions filed a Missoula Plan Amendment to incorporate a Federal Benchmark Mechanism (FBM). It compares states' local rates to established national residential rate benchmarks and proposes compensation mechanisms in four categories of the funds. In February 2007, the FCC established separate comment and reply comment periods on the FBM.

F. Cost basis of new intercarrier compensation rates

Debate: Whether the three-Track rate structure is cost-based and reasonable.

Supporters:

The proposed three-Track classification and rate design will bring the current disparate intercarrier rates into a more uniform system. Under the Act, the FCC may impose different charges for different classes of communications. Rural ILECs should have preferential rates because of the high-cost nature of their networks and their universal service obligations.

Opponents:

There is no cost analysis to justify the arbitrary three-Track rate design. ILECs and CLECs serving the same areas and performing the same network functions will have different rates under the Plan. The provision creates new opportunities for arbitrage. Some Track 1 ILECs, as well as rural CLECs, want to qualify for lower Tracks to get favorable rates.

G. Tandem Transit Service and the TELRIC alternative

Debate: Whether ILECs have the obligation to provide tandem transit service and whether the Total Element Long Run Incremental Cost (TELRIC) method should be adopted as an alternative to the proposed rates.

Supporters:

The Act requires carriers to stay interconnected, but does not impose an obligation on the ILECs to provide intermediate interconnection service for non-reciprocal traffic. TELRIC is a flawed method and will cause disparities in intercarrier compensation rates nationwide.

Opponents:

Under the FCC's *Local Competition First Report and Order*, ILECs have the obligation to interconnect with requesting carriers at any technically feasible point, on terms and conditions that are just, reasonable, and nondiscriminatory, and at a level of quality equal to that which an ILEC provides to itself in the provision of retail services. Section 252 (d) of the Act also requires the rates to be cost-based. It will be costly for CLECs to build direct network interconnection for low traffic volume. Some commenters propose to use TELRIC rates as the cap rates for tandem transit service because the method is cost-based.

H. Impact of Edge interconnection on CLECs

Debate: Whether the proposed Edge interconnection rules will disadvantage CLECs.

Supporters:

The current interconnection rules allow originating CLECs to choose inefficient interconnection points and cause additional costs to the ILEC networks. Under the Edge Rules, carriers may decide to build their own transport facilities or use an ILEC's network at a reasonable backhaul rate.

Opponents:

The Edge rules will require CLECs to reconfigure their networks at high costs. The Rural Transport Rule requires Track 1 carriers, which include all CLECs, to pay for interconnection transport in both directions between their Edges and the meet points of the Track 3 ILECs.

I. Other issues

- Whether it is appropriate to use telephone numbers as an interim geographic proxy and what impact such an approach will have on numbering resources.
- Whether it is appropriate to rescind the existing Mirroring Rule for dial-up traffic bound for Internet Service Providers (ISPs) and to replace it with the new markets rule.
- Whether the Plan should address the special access issue.
- Commenters generally agree that the FCC should address the phantom traffic and Voice over Internet Protocol (VoIP) issues separately.

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I. Background:
The Missoula Plan on Intercarrier Compensation Reform

On July 24, 2006, the National Association of Regulatory Utility Commissioners' Task Force on Intercarrier Compensation (NARUC Task Force) filed a comprehensive intercarrier compensation reform plan, the Missoula Plan (the Plan) with the Federal Communications Commission (FCC). The main objective of the Missoula Plan is to unify the now disparate reciprocal compensation and access charges across different carriers, technologies, and types of traffic. The Missoula Plan also proposed solutions to deal with the problem of phantom traffic[1] and suggested the creation of a compensation fund for Early Adopter States, which have already taken actions to reduce intrastate access rates. Plan supporters stated that the proposed intercarrier compensation mechanism would be more compatible with the goal of technological and competitive neutrality in a multi-platform competitive era. The FCC sought comments and reply comments on the Missoula Plan in Public Notice DA 06-1510.[2]

The National Regulatory Research Institute (NRRI) has been following closely the debate on intercarrier compensation reform. In August 2006, NRRI published its *Commissioner Briefing Paper: Intercarrier Compensation and the Missoula Plan*.[3] This document provided an overview of the intercarrier compensation problems, the provisions of the Missoula Plan, and potential concerns about the proposed reform.

In November 2006, the NRRI published *A Summary of State Commissions' Comments on the Missoula Plan: Issues of Concern*[4] to synthesize the concerns raised by state public utility

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[1] Phantom traffic refers to phone calls that lack sufficient signaling information to enable intermediate and terminating providers to properly bill the originating provider for intercarrier compensation.

[2] Federal Communications Commission, *Public Notice: Comment Sought on Missoula Intercarrier Compensation Reform Plan (DA 06-1510).* CC Docket No. 01-92, July 25, 2006.

The original comment and reply comments due dates were September 25 and November 9, 2006, respectively. The FCC *Order DA 06-1730 (CC Docket No. 01-92)* extended the comment and reply comments due dates to October 25, 2006 and December 11, 2006, respectively. The FCC approved the extension of the due date for the reply comments period in two occasions, postponing it to January 11, 2007 (*Order DA 06-2339*) and finally to February 1, 2007 (*DA 06-2577*).

[3] Rosenberg, Edwin A., Pérez-Chavolla, Lilia & Liu, Jing. *Commissioner Briefing Paper: Intercarrier Compensation and the Missoula Plan.* Columbus, Ohio: The National Regulatory Research Institute, August 11, 2006.

[4] Liu, Jing & Pérez-Chavolla, Lilia. *Summary of State Commissions' Comments on the Missoula Plan: Issues of Concern.* Columbus, Ohio: The National Regulatory Research Institute, November 10, 2006.

commissions (state commissions) in their comments on the Missoula Plan filed with the FCC by October 25, 2006. Twenty five state public utility commissions filed comments either individually or jointly. Although state commissions applauded the Plan supporters' efforts in facilitating the reform, many state commissions raised questions about the cost basis of the three-Track rate design; the effect of edge interconnection arrangements on competition; compensation for Early Adopter States; and most importantly, potential increases in local exchange rates due to the suggested increase in subscriber line charge (SLC) and any contributions to the proposed cost recovery mechanisms.

By February 1, 2007, sixty-three parties, including twenty state commissions,[5] had filed reply comments on the Missoula Plan proposal. This second round of comments continued the debate on issues mentioned above and provided parties a forum to present more in-depth counterarguments. During the reply comments period, the disagreement among supporters and opponents to the Plan focused on several key issues and their arguments became sharper.

At the center of the debate is the economic analysis of costs and benefits of the Missoula Plan. The AT&T-sponsored Clarke and Makarewicz's (2006) study[6] supported that the Missoula Plan would generate great social welfare benefit. Based on their estimate, intercarrier compensation reform could lead to over $21 billion cumulative benefits over the eight years following initial implementation of the plan for wireline consumer, and over $19 for wireless consumers. Clarke and Makarewicz calculated that the combined economic benefits of the proposed Plan, including toll rate reduction and demand surge, modification to the federal Universal Service Fund (USF) and the multiplier effect of the increased telecommunications expenditure on the entire economy, could amount to $54.19 billion. However, their model and results were challenged by Selwyn's (2006)[7] study, which was sponsored by the National Cable & Telecommunications Association (NCTA) and a group of Competitive Local Exchange Carriers (CLECs). In contrast to the AT&T sponsored study, Selwyn calculated that the implementation of the plan would result in an economic loss estimated in the $39 to $44 billion range. Both studies were frequently cited in reply comments of various parties as evidence to support their positions.

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[5] The reply comments can be searched at the FCC Electronic Comment Filing System http://gullfoss2.fcc.gov/prod/ecfs/comsrch_v2.cgi, under CC Docket 01-92. They are also available at the NRRI Intercarrier Compensation page, http://www.nrri.ohio-state.edu/Telecom/hot-topics-links/intercarrier-compensation/stakeholder-docs/comments/

Joint comments are counted as one submission. The count does not include the submission of the Missoula Plan Amendment on Federal Benchmark Mechanism.

[6] Clarke, N. Richard & Makarewicz, J. Thomas, AT&T. *Economic Benefits from the Missoula Plan Reform of Intercarrier Compensation*, July 18, 2006.

[7] Selwyn, L. Lee. *The True Economic Impact of the "Missoula Plan" for Intercarrier Compensation: An Assessment Based on Reality*. Economics and Technology, Inc., November, 2006.

Furthermore, individual industry players evaluated the costs they would bear and the benefits they would receive should the Missoula Plan be adopted. Their stands during the reply comment period were drastically different, depending on the affiliation of the commenter, that is, on whether it was an incumbent local exchange carrier (ILEC) or a CLEC, a rural or urban local exchange carrier (LEC), a small or large carrier, a wireline or wireless provider, a traditional telephone provider or cable telephony provider, etc. State commissions, commissions' associations, and consumer advocacy groups also presented an array of opinions. Potential financial losers from the implementation of the Plan (e.g., CLECs, rural LECs, and Early Adopter States) continued to argue about the fairness of the new intercarrier compensation structure and the appropriate compensation for their revenue loss.

The synthesis of reply comments in this report intends to help commissions, consumer advocacy groups, as well as other concerned parties, better understand the Missoula Plan. It intends to present both sides of the arguments as objectively as possible. This paper focuses on eight major issues of contention that emerge from the reply comments. Although some issues are intricately related with one another, the author developed the categorization below for illustrative purposes. Whereas those issues are still being discussed and negotiated, the author hopes that this paper can inform readers of the key issues of the Plan being debated and facilitate further dialogue on the process of intercarrier compensation reform.

II. Major Issues of Contention

A. Preemption of state authority

A number of components in the proposed reform triggered debate over the FCC's legal authority over those matters. At the core of the argument is whether the FCC has adequate jurisdiction over intercarrier compensation reform, especially in terms of reciprocal compensation and intrastate access charges. Many state commissions[8] held that the Plan would severely undermine the states' ratemaking authority over reciprocal compensation, tandem transit, and intrastate access charges. Section 251(c) (2) and Section 252(b) (5) of the Communications Act of 1934, as amended (the Act), provides states' legal authority over transit traffic and reciprocal compensation, respectively. The Act also clearly designates the regulation of intrastate traffic to state commissions.[9] State commissions further argued that compared to the one-size-fit-all solution proposed by the Plan, states are in a better position to tailor intercarrier

[8] This issue was reiterated in the Reply Comments of several state commissions, including the Arizona Corporation Commission, the Massachusetts Department of Telecommunications and Energy, the Michigan Public Service Commission, the North Carolina Utilities Commission, and the Texas Office of Public Utility Counsel, among others.

[9] Under Section 153 of the Communications Act of 1934, the term "State commission" is defined as the commission, board, or official that has regulatory jurisdiction with respect to intrastate operations of carriers.

compensation mechanisms within their individual jurisdictions. State commissions can target problems unique to the state without shifting revenues across states. They state that incremental policy changes will be less disruptive than an overhaul of the existing intercarrier compensation system. In fact, a number of states have successfully reduced rate disparities by mandating intrastate rate decreases, increasing local rates, establishing a state USF mechanism, or a combination of these approaches.

Supporters of the Plan argued that the FCC has direct jurisdiction over intercarrier compensation rules with respect to all traffic, both interstate and intrastate, falling within the scope of the following categories: [10]

(1) Section 251(b)(5) – the duty to establish reciprocal compensation arrangements for the transport and termination of telecommunication; and
(2) Section 251(c) – the duty to provide, for the facilities and equipment of any requesting telecommunications carrier, interconnection with the local exchange carrier's network, with the possible exception of originating intrastate access charges.

In addition, AT&T stated that the FCC has preemptive authority in implementing nationwide intercarrier compensation reform. Based on the "impossibility" exception set forth in the *Louisiana Public Service Commission vs. FCC*[11] and the *Vonage Order*,[12] the FCC may preempt state regulation when it is impossible to separate the interstate and intrastate components of the asserted FCC regulation. Supporters of the Plan further argued that even if it is technically possible to distinguish between interstate and intrastate traffic for intercarrier compensation purposes, the FCC can still assert jurisdiction over this matter in order to achieve a valid federal regulatory objective. Moreover, distinctions between traffic types (e.g., local vs. long distance; voice vs. data traffic) are becoming less meaningful as the wireless and Internet technologies become more prominent. However, opponents of the Plan did not think that these two prerequisites for the FCC preemption are present with respect to intrastate access charges.

Supporters of the Plan also stated that the FCC may still recommend originating access charge reform, and states have the option of not adopting it. However, the Missouri Public Service Commission stated that given the heavy penalties of opting out the intrastate access

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[10] Reply Comments of AT&T Inc., p.35.

[11] *Louisiana Public Service Commission v. FCC) ("Louisiana PSC"),* 476 U.S. 355 (1986). The case deals with the separation of federal and state jurisdiction over mixed interstate and intrastate components of telephone services.

[12] *Memorandum Opinion and Order, Vonage Holdings Corporation, Petition for Declaratory Ruling Concerning an Order of the Minnesota Public Utilities Commission ("Vonage Order"),* 19 FCC Rcd 22404 (2004). The Order preempts the Minnesota Public Utilities Commission's order applying its traditional telephone regulation to Vonage's DigitalVoice service.

charge reform, the Plan makes its adoption almost coercive.[13] Besides, by mandating (or coercing) intrastate access charge reductions, the Plan will shift intrastate revenue to federal mechanisms such as the SLC, the Restructure Mechanism (RM), and the Early Adopter Fund (EAF).[14] Subsequently, it will negatively impact those state USFs that use intrastate revenue to ensure affordable local rates.

B. Impact on consumer benefits

In the first round of comments, almost all state commissions that filed with the FCC pointed out the financial burden that the Plan's proposed revenue adjustment mechanisms would impose on end-users.[15] Such disapproval of rate increases for local telephone service customers was also strong in the reply comments. Concerned commenters pointed out that, by preserving the revenue of ILECs to a large extent, the Plan would shift the financial burden from carriers to consumers, who would have to pay for the increased federal Subscriber Line Charge (SLC) and federal USF, as well as for the newly introduced RM and EAF.[16] Vonage, for instance, argued that the RM and the modified federal USF serve as "revenue insurance plans" for ILECs, whereas end users will bear all the costs.[17]

Under the Plan, the federal SLC will increase to recover part of the LECs' revenue loss resulting from reduced intercarrier compensation rates. For example, Track 1 carriers are allowed to raise nationwide SLC caps up to $10.00 at the end of the four-step transition and will be able to raise the SLC cap with inflation every year after. Track 2 and 3 carriers may raise the primary residential and single-line business SLC cap by $2.25 over three years up to an $8.75 level. Some commenters argued that because the LECs' costs inflate a rate lower than inflation in the whole economy, the FCC should not allow local charges to float with inflation.[18] Other commenters were also worried that ILECs may deaverage SLC increases, keeping the SLC low in competitive service areas and high in less competitive markets.[19]

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[13] Comments of the Missouri Public Service Commission.

[14] For example, reply Comments of the North Carolina Utilities Commission and the Illinois Commerce Commission.

[15] Liu and Pérez-Chavolla, 2006.

[16] See, for example, the Reply Comments of the New Mexico Public Regulation Commission, the Massachusetts Department of Telecommunications and Energy, the National Association of State Utility Consumer Advocates (NASUCA), and the Utah Public Service Commission.

[17] Reply Comments of Vonage.

[18] See, for example, Reply Comments of the Ad Hoc Telecommunications Users Committee.

[19] Reply Comments of Texas Office of Public Utility Counsel.

In addition to the SLC increase, the Plan will modify the High Cost Loop support mechanism and Safety Valve support mechanism. Such modifications will increase the current total federal USF by 32 percent, that is, by about $2.225 billion, as estimated by the Delaware Public Service Commission. States that are net contributors to the federal USF are particularly concerned about the effects of such costs on consumers in their states.[20]

The initial estimates of the RM, the EAF, and the federal USF adjustment in the proposed Plan were $1.5 billion, $0.2 billion, and $0.3 billion, respectively. However, the sizes of these funds would grow rapidly if other factors are taken into consideration. The National Association of State Utility Consumer Advocates (NASUCA) pointed out that making the RM available to CLECs would add about $428 million to the Plan; the EAF has grown to $806 million by allowing states that have rebalanced their intrastate access rates by means other than an explicit state USF to receive compensation through the EAF; rebasing the High Cost Loop cap would add a total of $324 million. Adding all figures together, NASUCA estimated that the Missoula Plan would have a cumulative impact of $2.778 billion on the existing USF, making it even less sustainable. [21]

Although the Plan did not specify the contribution and distribution mechanisms of the RM and the EAF, it is almost certain that end-users would bear the costs eventually. Combined with increases in the SLC and the federal USF, these two revenue recovery mechanisms may make basic local telephone service less affordable for many consumers. For instance, the North Carolina Commission estimated that the Plan will result in a net cost of $50 to $138 million per year on North Carolina customers; overall, the Plan would cost at least $6.9 billion nationwide in order to reduce end-user rates of only $6 billion.[22]

The economic benefits of the Plan, as estimated by the Plan Supporters, mainly come from reductions in long distance charges for consumers and stimulated demand for long distance services that the Supporters estimate such rate decrease will bring about. AT&T argued that "current regulatory schemes err enormously on the side of excessive reliance on usage-sensitive cost-recovery mechanisms, most notably in the form of often inflated intrastate access charges."[23] Under the Plan, the reduced toll charges would outweigh the combined raise of the SLC charge, the USF adjustment, and the new RM and EAF. Both AT&T and Verizon argued that increases in SLC caps will be both "gradual and modest."[24] Besides, the federal Low-

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[20] See, for example, the Reply Comments of the Michigan Public Service Commission and the North Carolina Utilities Commission.

[21] Reply Comments of the National Association of State Utility Consumer Advocates (NASUCA).

[22] Reply Comments of North Carolina Commission, p.5; Reply Comments of the NASUCA, p.16.

[23] Reply Comments of AT&T Inc., p.10; Reply Comments of Verizon, p.3.

[24] *Id.*, p.11. Also see Reply Comments of Sprint Nextel Corporation, p.3.

Income subsidy program would cover any fee increase on a dollar-to-dollar basis for Lifeline recipients, making them no worse off than the current situation. Moreover, the Plan would remove the rate distinction based on arbitrary regulatory classification (types of carriers and traffic, etc.) and make it easier for carriers to offer flat-rate bundled services and larger calling areas.

However, other commenters, especially state commissions, doubt that all consumers would receive a huge benefit under the Plan. Heavy users of wireline long distance phone service may receive offsetting benefits through the lower toll rates or a bundled plan with more toll minutes. However, customers that make few or no wireline long distance phone calls would be worse off financially, and those customers are more likely to be part of low and middle income population. Rosenberg, Pérez-Chavolla, and Liu (2006) pointed out that even when "[i]gnoring the increases in universal service charges resulting from the Restructure Mechanism, if the SLC increases by $3.50 per line, per month, and long-distance rates decrease by 1.433 cents per minute, only customers using in excess of 244 minutes (over four fours) of total wireline long distance per month would see any net decrease in their total bill."[25]

Lifeline recipients are the only consumer group shielded from any potential financial harm resulting from SLC increases. The federal Lifeline program will cover the total amount of SLC, and meanwhile, those consumers may benefit from the reduced toll rates. But as many commenters recognized, the income threshold for qualifying for the Lifeline subsidy is very low, which makes many low-income households ineligible.

Plan supporters, such as AT&T, emphasized that the new intercarrier compensation regime will facilitate the rollout of information infrastructure in rural areas because it is more competitively and technologically neutral than the existing system. However, the Massachusetts Department of Telecommunications and Energy argued that the Plan did not, in any place, require rural carriers to use the increased USF to expand offerings of advanced services; therefore, consumer benefits are, at best, uncertain in this respect.

C. Flow-through of access rate reductions to end users

Many commenters expressed concerns about the Plan's lack of detail on the mechanism for passing the benefits of reduced access rates to long-distance carriers' end users. Without a flow-through mechanism, the Plan would generate substantial benefits for long distance carriers, especially for those affiliated with the ILECs. As the Arizona Corporation Commission stated, "[c]reating a new subsidy program of this magnitude which is ultimately to be borne by end-users requires at a minimum a demonstration of need and that carriers be held accountable for the monies they receive."[26]

Selwyn (2006) challenged Clarke and Makarewicz's analysis of the economic benefits of the Missoula Plan. He emphasized that Clarke and Makarewicz's estimate is critically based on

[25] Rosenberg, Pérez-Chavolla and Liu, 2006, p.65.

[26] Reply Comments of the Arizona Corporation Commission, p.6.

the assumption of 100 percent flow-through of the access charge reductions in the form of lower long distance prices. Selwyn argued that market competition does not provide sufficient incentives for incumbent wireline long distance carriers to pass through the entire access rate savings. Not all long distance carriers may realize as many benefits as the Plan claims because (1) CLECs and cable telephony providers that offer local and long distance service bundles would have zero net benefits from the reduced access charges; (2) wireless carriers already pay lower access charges –besides, the access charge savings may be passed on in the form of increased minutes in monthly wireless plans instead of reduced per minute fee, resulting in little or no effect on consumer surplus–; and (3) "Over-the-top" Voice over Internet Protocol (VoIP) providers are not subject to access charges and may continue not to be so, hence there will be no competitive pressure on wireline long distance fees.

In comparison, large vertically integrated carriers may gain double benefits from the Missoula Plan. The AT&T-SBC and Verizon-MCI merger enlarged these two carriers' market share in the long distance service market, giving them more market power in offering bundled service packages. Because of the separation of ILECs' local and long distance entities, ILEC long distance affiliates can benefit from the reduced access charge while their local service entities can recover the lost revenue from the RM as prescribed by the Plan. Selwyn (2006) estimates that the ILEC parent companies would have a net financial gain of about $28.7 billion over the initial eight years of the implementation of the Missoula Plan.

In response to this criticism, Clarke and Makarewicz (2007) [27] argued that the long distance phone service market is competitive enough to keep the long distance rates low without any explicit regulatory mandate. Examples of competitiveness in this market, according to the authors, include AT&T's large yet non-dominant market share in long distance services, as well as the ease with which consumers may change their long distance service providers. Since the costs of providing long-distance service are mostly traffic-sensitive, the extra revenue from demand stimulation in a competitive market would be competed away through end-user price reduction.

Many state commissions requested the FCC to explicitly require carriers to flow through 100 percent of the savings in intercarrier compensation rates to their customers and limit LEC revenue recovery under the Plan only to actual losses.[28] Nevertheless, despite the importance of follow-through on tangible consumer benefits, some parties recognized the difficulty of installing such a monitoring mechanism.[29]

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[27] Clarke, N. Richard & Makarewicz, J. Thomas, AT&T. *Economic Benefits from Missoula Plan Reform of Intercarrier Compensation*. February 1, 2007. (attached as Exhibit 1 of AT&T comment).

[28] For example, Reply Comments of the North Carolina Utilities Commission, the Utah Division of Public Utilities, and the Wyoming Public Service Commission, just to name a few.

[29] Reply Comments of Cavlier, McLeodusa, Pac-West and RCN.

D. Restructure Mechanism

The Missoula Plan provided the RM as a revenue recovery mechanism that partially offsets the losses incurred for reductions in intercarrier compensation, to the extent that such revenues are not recovered through restructured intercarrier charges or increased SLCs. Its payments are equal to the reduction in switched access revenues under the Plan (the total access shift) minus the increase in SLC revenue. The size of the RM is estimated by the Plan's supporters to average $1.5 billion by the end of the four-year transition period, which includes an estimate for distributions to CLECs.

Supporters of the Plan held that the RM is a legitimate means of offsetting access revenue loss. AT&T claimed that it is a legal necessity, a means of keeping the telephone service rates in high-cost areas affordable by recovering the costs that are currently recovered by implicit cross-subsidies from the high access charges.

However, opponents stated that the RM is a mechanism to protect ILECs' revenue flow that gives ILECs competitive advantage over other carriers, especially in rural areas where the market is not very competitive to start with. Just to cite a few comments, Broadview Networks, NuVox, One Communications and XO stated that "[b]y preserving revenues when competition has been driving access revenues down, the RM would serve to shield rural Americans from the benefits of competition by creating barriers that protect the rural ILECs from competing entry"[30] and that "[the RM] is simply a method to shift subsidies and keep the ILECs revenue neutral without any statutory, economic, or policy justification."[31] The Texas Office of Public Utility Counsel and the Michigan Public Service Commission also concurred that the RM makes ILECs revenue neutral, but is not technologically neutral.

AT&T and other supporters refuted the argument that the RM would protect ILECs from revenue loss.[32] They argued that in the competitive market nowadays, the ILECs may not be able to raise the SLC to the new levels permitted by the Plan. In that case, they will not be able to fully recover their costs, since the RM is calculated based on the maximum permissible SLC caps. Furthermore, under the Plan, the RM is calculated on a per-line basis for the Track 1 price-cap carriers from Step 1, and for the Track 2 price-cap carriers from Step 4. If those ILECs lose a line, they will lose the RM funding for that line.

There are different views concerning the nature of the RM. Some see it as a new federal USF mechanism under Section 254 of the Act (e.g., AT&T), whereas others see it as an interstate access charge element under Section 201 of the Act (e.g., the Rural Alliance, GVNW Consulting, Inc., Mid-Rivers Telephone Cooperative). Nevertheless, critics of the RM challenged both views. Many opponents stated the RM qualifies for neither rationale. The Illinois Commerce

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[30] Reply Comments of Broadview Networks, NuVox Communications, One Communications Corp. & XO Communications LLC, p. 33.

[31] *Id*, p. 40.

[32] Reply Comments of AT&T; Reply Comments of the Supporters of the Missoula Plan.

Commission stated that "subsidies under the Plan will not flow based on any universal service principles, sound cost causation and recovery principles or on any other rational basis."[33] The NCTA and the NASUCA contended that the RM cannot be viewed as an access charge element because only the ILECs have access to the RM and that the RM will come from contributions paid by end users rather than carriers. It is fundamentally different from the existing National Exchange Carrier Association's (NECA) rate pooling mechanism. CLECs added that the RM cannot be an access charge element because the terminating rates they were allowed to charge are below cost. Most opponents could not regard the RM as a universal service mechanism either, unless it is competitively neutral and available to all providers. But making the RM support available to all CLECs will increase the size of the fund.

Opponents of the Plan generally disagreed with the provision that the RM will be primarily available for the ILECs to offset their losses in access charge revenues. They were concerned that such a restriction will place CLECs at a competitive disadvantage. For that, AT&T clarified that it actually supports the availability of the Restructure Mechanism to all Eligible Telecommunications Carriers (ETCs) competing in ILECs' service areas, but not to CLECs that do not have carrier-of-last-resort obligations and do not use cross-subsidies to reduce local rates in high-cost areas. On the other hand, rural CLECs argued that they will incur losses in access revenue reform under the Plan and therefore should be entitled to recover access revenue loss from the RM as well.[34] The Rural Independent Competitive Alliance maintained that they should continue to be permitted to file access tariffs at the NECA rate and use the RM to recover revenue loss caused by the implementation of the Plan.[35]

In their proposed modification of the Plan, supporters of the Plan allowed rate-of-return carriers to recover losses due to the implementation of the phantom traffic solution from the RM.[36] However, some commenters strongly objected this new proposal, reasoning that it will add millions of dollars on the RM and give rural ILECs even less incentive to improve efficiency.[37]

E. Early Adopter Fund and the proposed Federal Benchmark Mechanism

The EAF is a mechanism the Missoula Plan prescribed for states to recover a portion of the state funds used to compensate carriers for rebalancing their intrastate access rates prior to the Plan's adoption. Its goal is to reduce the size of explicit state funding mechanisms and its funding can only be used for this specific purpose. The initial estimate of the EAF was $200

[33] Reply Comments of the Illinois Commerce Commission, p.3.

[34] Reply Comments of the South Dakota Rural CLEC Coalition; Reply Comments of General Communication, Inc. (a CLEC in Alaska).

[35] Reply Comments of the Rural Independent Competitive Alliance.

[36] Comments of the Supporters of the Missoula Plan, Attachment A.

[37] Reply Comments of Verizon; Reply Comments of Sprint Nextel.

million; however, many parties considered that this amount was severely underestimated. For example, the New Mexico Public Regulation Commission estimated that approximately $23 million will be needed in order to replace the carriers' revenue loss in the state of New Mexico alone. In their initial comments, the Pennsylvania Public Utility Commission estimated about $127 million per year on Pennsylvania's intercarrier compensation reform and Illinois estimated about $32 million. Some commissions estimated the total early adopter claims could sum up to $2 billion per year.[38]

State commissions continued to debate about the qualifications for Early Adopter States. Some of the points of discussion were whether states must have an explicit state USF in place in order to be compensated through the EAF; how far back should states trace their intercarrier compensation adjustment; and what percentage of state rate-balancing funds should be recovered from the EAF, among other issues. The California Public Utilities Commission recommended that the EAF should be available to states regardless of the manner in which revenues were recovered, as long as they can demonstrate that the revenue losses are solely attributable to intrastate access charge reductions. The Kansas Corporation Commission shared the same view on the EAF distribution. However, the Illinois Commerce Commission disagreed because this approach does not take into consideration the excessively high access charges permitted by some states before mandating rate reductions, therefore, the compensation would favor those states currently or historically having high intrastate access charges. Besides, such an approach will not compensate states that did not use local rate increases or state USF compensation to offset reduced access revenues.

On January 30, 2007, the Plan supporters and a group of state commissions[39] filed a Missoula Plan Amendment to incorporate a Federal Benchmark Mechanism (FBM). The new proposal may help solve the dispute as to which states would be qualified as Early Adopter States and how to calculate such compensation. Under the FBM, local rates will be measured against national residential rate benchmarks to establish comparability among states. The FBM currently sets the Low Rate Benchmark at $20 per line and the High Rate Benchmark at $25 per line. Funding in four categories will be available as illustrated in Table 1. The FBM is estimated to be $806 million and will provide net positive support for 39 states.[40]

The proposed FBM intends to shift more revenue recovery from the RM to end-user rates in states with low end-user rates. States with lower end-user rates will receive less federal funding for cost recovery, but they will be allowed to have a larger SLC increase. Moreover, high-cost states that have not substantially reduced their access charges and have relatively low local rates will receive more compensation from the RM but less or no compensation from the

[38] See Liu and Pérez-Chavolla, 2006; and Comments of these state commissions.

[39] They are the Indiana Utility Regulatory Commission, Maine Public Utilities Commission, Nebraska Public Service Commission, Vermont Department of Public Service, Vermont Public Service Board, and Wyoming Public Service Commission.

[40] Missoula Plan Amendment to Incorporate a Federal Benchmark Mechanism, p.7.

EAF, whereas states that have taken early adopter approaches will receive less compensation from the RM but more from the EAF.

The FBM has already gained support from some state commissions. For example, the Wyoming Public Service Commission espoused the mechanism, stating that it appropriately addressed the cross-state subsidy problem that existed in the original RM and EAF proposal. [41] The FBM has merits in that it provides benchmarks to calculate reasonable compensation for the Early Adopter States that raised their local rates as well as to those that created a state USF to reduce access charges. Besides, the size of the FBM is controlled by limiting the EAF compensation to $10 million for each state that has balanced rates through state USF programs.

In their reply comments, many parties expressed that they did not have adequate time to review the proposed FBM and requested an extension period for filing comments on the FBM. The FCC has already extended the comment period for this issue. Comments were due March 19, 2007 and the reply comments were due April 3, 2007.

F. Cost basis of new intercarrier compensation rates

The Plan places carriers into three Tracks and provides different intercarrier rate reduction goals accordingly. Roughly, Track 1 carriers correspond to RBOCs, CLECs, wireless providers and other non-rural carriers; Track 2 covers most mid-sized rural carriers; Track 3 are the small rural carriers under rate-of-return regulation.

Carriers must meet the definition of a Covered Rural Telephone Company (CRTC)[42] to be treated as a Track 2 or 3 carriers. In general, the Plan will have Track 1 carriers reduce intercarrier rates to a lower level than Track 2 carriers, and Track 2 lower than Track 3. The Plan also allows a longer phase-in period for Track 3 carriers.[43]

[41] Reply Comments of the Wyoming Public Service Commission.

[42] A CRTC is either a Track 2 or Track 3 carrier. It must be an ILEC in a particular study area as of August 1, 2006, meet the definition of rural in the Act, not be owned by a Bell Operating Company or its affiliate and serve fewer than 1 million lines; or it must be an ILEC and qualify as a 2 percent carrier under the criteria contained in section 251(f)(2) in all study areas it holds as of August 1, 2006 and must have a holding company average of less than 19 lines per square mile; or must be non-rural, interstate ROR and select incentive regulation by December 31, 2006.

[43] For details, see Rosenberg, Pérez-Chavolla and Liu, 2006.

Table 1. Proposed Federal Benchmark Mechanism

	Target	Purpose	Funding
Category A Funding	Early Adopter States that raised local rates to reduce access charges.	Replace some or all the SLC increase that would otherwise be permitted.	Raise SLC up to High Benchmark Target; If R>$25, F_A= Δ SLC; If R<$25 and R+ Δ SLC >$25, F_A= R+ Δ SLC - $25.
Category B Funding	States with residential per line revenues already higher than the High Benchmark Target before any SLC increase.	Reduce consumer contributions to intrastate USF and reduce interstate residential SLC.	Recover from the FBM 75% of the difference between residential per-line revenue and the Benchmark; With R>$25, F_B= (R - $25) - 75%.
Category C Funding	Early Adopter States with explicit state USF.	Reduce contributions to state USF.	Combined Category B & C fund is limited to the lesser of $10 million or the size of the state USF. F_c = (State USF - F_B) or ($10M - F_B), whichever is lesser.
Low Rate Adjustment	Non-Early Adopter States with residential per line revenue below the Low Benchmark Target.	Replace some of the RM funding with an increased SLC cap.	If R + Δ SLC < $20 and the state receives RM, the carrier will raise an additional SLC increase (additional Δ SLC ≤ $2.00 and the (R + total Δ SLC)≤$20.00) and deduct the same amount the carrier receives from the RM.

Notes:
R = Residential Revenue per Line
F = Compensation per Line from the specific fund category
Δ SLC = permitted interstate residential SCL increase
State USF = the amount of eligible intrastate USF

Commenters questioned the legitimacy of the rate design based on the classification of Tracks, rather than on actual costs. For example, NCTA objected to the rate structure based on Track classification, pointing out that, under the Plan, cable operators and all CLECs are classified as Track 1 providers, although they may also serve rural areas.[44] NCTA argued that it is not fair to treat ILECs and non-ILECs serving the same area differently. Vonage also agreed that ILECs and non-ILECs should not pay different rates for the same network function.[45] The Rural Independent Competitive Alliance stated that rural CLECs operating in high-cost areas should not be treated the same as large urban ILECs.[46] In its defense of the Track-based rate design, AT&T stated that Section 201 (b) of the Act allows the FCC to decide whether the rates are just and reasonable, and that different charges may be made for different classes of communications.

Opponents underscored that the Plan supporters did not provide any cost analysis support to justify the arbitrary three-Track rates proposed for reciprocal compensation and interconnection. Section 252 (d) of the Act requires that any reciprocal compensation and access charges must be based on costs. Therefore, the proposed intercarrier compensation rate structure must link to the underlying costs of providing the services. Commenters continued to debate the appropriateness of various rates. For example, CLECs argued that the termination rates for non-access traffic prescribed for them are below cost. Verizon argued that, under the proposed modification of the Plan, Track 2 carriers' tandem transit service rate will be too high, given the inflation adjustment allowed for the tandem transit price cap. Broadview Networks, NuVox, One Communications and XO stated that "[b]y failing to even attempt to comport with [statutory pricing] standards, the Plan's proposals for these rates are unequivocally unlawful."[47]

The Plan's critics also argued that the Plan does not unify the rates for all carriers. The approach is simply to replace one disparate rate system with another because the new regime will still provide opportunities for arbitrage. Carriers would prefer to qualify for lower-Track status because of the generally higher access rates and slower pace of reform permitted under the Plan. Frontier Communications, a mid-sized Track 2 ILEC, suggested that the Plan should eliminate Track 2 and put all Track 2 ILECs into Track 3.[48] In response to that, the Supporters of the Missoula Plan proposed to reclassify some ILECs to a lower Track.[49] Some carriers also suggested that Track 3 rural exchanges should remain in that category after being acquired by

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[44] Reply Comments of the NCTA.

[45] Reply Comments of Vonage.

[46] Reply Comments of the Rural Independent Competitive Alliance.

[47] Reply Comments of Broadview Networks, NuVox Communications, One Communications Corp. & XO Communications LLC, p.29.

[48] Reply Comments of Frontier Communications.

[49] Comments of the Supporters of the Missoula Plan, Attachment A.

rural companies.[50] Such expansion of the CRTC group was objected by many commenters, especially CLECs in rural areas, which were concerned that this would be an expensive concession to certain ILECs at the expense of CLECs.[51]

In addition, rural CLECs, classified as Track 1 carriers under the current Plan, argued that they should continue to have a rural CLEC exemption and should be treated as CRTCs for the Rural Transport Rule because their costs are aligned with the costs of rural ILECs, and are significantly higher than the Track 1 rates. AT&T, on the other hand, argued that CLECs are not subject to the same price regulation and carrier-of-last-resort obligations of rural ILECs and, therefore, they shall not be treated the same.

Whereas some commenters stated that the Plan will give rural carriers, especially rural ILECs, windfall benefits,[52] others supported favorable treatment for rural companies in high-cost areas because of universal service concerns.[53] AT&T argued that it is necessary to keep some regulatory distinction between rural and non-rural ILECs because of the high-cost nature of rural ILEC networks, their financial vulnerability, and universal service policy goals. Rural LECs concurred that the proposed rates for rural LECs are cost-based and fair. They emphasized that telecommunications investment in high-cost areas is risky and capital intensive. It is not reasonable to expect rural LECs to instantaneously upgrade to the most modern technology without regards to the recovery of sunk costs from previous investment.[54] Rural LECs emphasized that using the Total Element Long Run Incremental Cost (TELRIC)[55] alternative to calculate access charges will not allow rural LECs to recover their costs and is, therefore, confiscatory under the Takings Clause of the Constitution.

Other commenters brought up alternatives for the non-uniform rate structure. Verizon suggested that the FCC should not impose arbitrary cost-based rates for intercarrier compensation; rather, it should rely on voluntary negations between carriers and let market competition determine access rates.[56] Cavalier, McLeodUSA, Pac-West and RCN suggested that

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[50] See, for example, Reply Comments of Mid-Rivers Telephone Cooperative, Inc.

[51] See, for example, Reply Comments of General Communication, Inc.

[52] See, for example, Reply Comments of Verizon.

[53] See, for example, Reply Comments of the Montana Public Service Commission.

[54] Reply Comments of GVNW Consulting, Inc.

[55] TELRIC was established in 1996 by the FCC. It's the formula used by state commissions to determine the wholesale rates (or price ceiling) for network elements that are charged by ILECs (e.g., interconnection and co-location). It is a forward-looking cost model based on the most cost-efficient technologies, instead of the current cost of an ILEC network.

[56] Reply Comment of Verizon.

the FCC should provide default rate floors, and state commissions should have flexibility in deciding whether to adopt them.[57]

G. Tandem Transit Service and the TELRIC alternative

Tandem transit service is a switched non-access transport service provided by a third party carrier using its tandem switch to effectuate indirect interconnection between two carriers within a Local Access and Transport Area (LATA), or in Alaska, within a local calling area. It includes both tandem switching and tandem switched transport (also called common transport), or the functional equivalent, between the transit tandem location and a terminating carrier's Edge. If the terminating carrier is an ILEC, and the tandem transit provider interconnects with the ILEC at a meet point, tandem transit service stops at that meet point.[58]

The Plan requires carriers providing tandem transit service at a charge at Step 0 to continue to do so at rates not higher than those in effect at Step 0. Carriers not charging other carriers for tandem transit services at Step 0 may begin to do so at rates not higher than those it imposes on other carriers under similar circumstances. Beginning at Step 2, rates for tandem transit service for reciprocal compensation will be capped at $0.0025 per Minute of Use (MOU) and will be subject to commercial agreements consistent with the Plan's provisions. Besides, a tandem transit provider may not geographically disaggregate its nationwide rate. Beginning at Step 4, the cap for tandem transit service provided entirely within a Metropolitan Statistical Area (MSA) will be lifted, and the FCC will determine the competitive triggers to eliminate the cap on transit service between two different MSAs.

There is heated debate whether ILECs have the obligation to provide tandem transit service. Carriers that rely on ILECs to provide tandem transit service insisted that ILECs have this obligation under Section 251(b) (5) and 251(c) (2) of the Act. The Edge interconnection rules and the modification of the transport rules will allow ILECs to refuse interconnecting with other networks or to impose high rates for transit service. Broadview Networks, NuVox, One Communications and XO argued that the proposed Edge interconnection rules impose burdens on CLECs and other non-ILECs and allow ILECs to charge "unjustified and outrageously high charges"[59] for tandem transit services.

Similar views were shared among other non-ILECs. Vonage commented that under the FCC's *Local Competition First Report and Order*, ILECs have the obligation to interconnect with requesting carriers at any technically feasible point "on terms and conditions that are just, reasonable, and nondiscriminatory, and at a level of quality equal to that which an ILEC provides to itself in the provision of retail services."[60] Small LECs further emphasized that the ILECs'

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[57] Reply Comments of Cavalier, McLeodUSA, Pac-West and RCN.

[58] See Rosenberg, Pérez-Chavolla and Liu, 2006.

[59] Reply Comments of Broadview Networks, NuVox Communications, One Communications Corp. & XO Communications LLC , p. 30.

[60] Reply Comments of Vonage, p.11.

provision of transit service at a reasonable rate is critical to encourage facility-based competition. In many areas, the provision of tandem transit service is not competitive. Without proper rules on tandem transit rates, terms, and conditions, small LECs are subject to potential abuse of market power by large tandem providers.[61]

Nevertheless, ILECs argued that they do not have the obligation of providing tandem transit service. Verizon asserted that no section of the Act imposes such obligations on ILECs, pointing out that: (1) Section 251(a)(1) of the Act requires every carrier to be interconnected with all other carriers, either directly or indirectly, but it does not give carriers the right to request transiting service from a third-party; (2) Section 251 (c)(2) of the Act requires ILECs to interconnect with CLECs for the transmission and routing of telephone exchange service and exchange access, but it applies only to the physical linking of two networks for the mutual exchange of traffic; it does not apply to the transport and termination of traffic performed by an intermediate carrier; (3) Section 251 (b)(5) of the Act applies only to reciprocal compensation arrangements, whereas transit traffic neither originates nor terminates on the network of the transiting carriers and, therefore, is not reciprocal in nature; and (4) Section 201(a) of the Act provides the FCC with authority to mandate physical connection obligations on common carriers only after opportunity for hearings and based on public interest findings, but no such findings could be made on the record this far. Furthermore, Verizon maintained that ILECs have voluntarily provided the service to competitors through negotiated agreements or tariffs in the past and that the market-based pricing approach has been proved effective and should continue to be so.

Even though no parties required the ILECs to provide tandem transit service for free, there is disagreement about the proposed rates in the Plan. AT&T declared that the Plan already adopts a moderate approach in this regard, as it requires only carriers that currently provide transit, to continue doing so over the life of the Plan, subject to reasonable rate caps. Setting rates higher than the proposed level would financially disadvantage carriers that use the transit service, whereas setting rates too low would prohibit the entry of competitive transit providers. Some centralized equal access providers argued that if the proposed tandem transit rules apply to the non-access services they provide, the proposed cap of $0.0025 is below the cost of providing switching and transport services.[62]

However, some commenters stated that the proposed tandem transit rate is too high, citing Section 201(b) and Section 252(d) of the Act, which set "just and reasonable" pricing principles. Broadview Networks, NuVox, One Communications and XO argued that the excessive tandem transit rate gives connecting carriers the incentive to build out direct network

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[61] E.g., Reply Comments of GVNW Consulting, Inc.; also see reply comments of many CLECs.

[62] Reply Comments of the Centralized Equal Access Providers. Those carriers provide regulated interstate and intrastate access services and non-access services to rural areas.

interconnection; yet it is inefficient to do so when the traffic volume is low.[63] Sprint Nextel emphasized that the Regional Bell Operating Companies (RBOCs) have virtual monopoly in the transit market and have advantageous bargaining positions in negotiating transit contracts with requesting carriers. Sprint Nextel recommended the $0.00125 weighted average rate as a cap for transit rate. It also suggested that the federally prescribed transit rate cap should not be lifted until the transit market is effectively competitive.[64]

Commenters discussed whether the TELRIC method would be a better alternative to determine the tandem transit rate. The California Public Utilities Commission, the Utah Public Service Commission, the Wisconsin Public Service Commission, Time Warner and Cavalier supported use of the TELRIC method. More specifically, the California Public Utilities Commission recommended using Verizon's TELRIC-based UNE rate of $0.001928 as the rate cap for originating and terminating traffic for Track 1 carriers on a nationwide basis; Verizon's TELRIC-based UNE rate of $0.000417 could be used as the rate cap for tandem transport rate. The California Public Utilities Commission also proposed setting a threshold higher than the 400,000 MOU limit per month, beyond which a carrier could be subject to a high premium transit rate. The California Public Utilities Commission also suggested that the transit rate cap should not be lifted at Step 4, unless a competitive market analysis determines otherwise.

AT&T and Verizon strongly opposed the TELRIC method. AT&T argued that although Section 252 (d)(2) specifies the "additional cost" standard, it requires only that transport and termination rates reflect the additional cost of terminating each call; it does not direct the FCC to use the TELRIC standard on tandem transit service. Verizon pointed out that the FCC has already decided not to apply the TELRIC pricing method to rates set under Section 201 of the Act and that the principles of Section 252(d) apply only to a limited set of rates that do not include tandem transit service. Moreover, both carriers underscored as disadvantages of the TELRIC methodology that it "rests on incompatible economic premises and is subject to pervasive result-oriented manipulation"[65] and that "it has been widely and rightly criticized as anti-competitive and harmful to consumers."[66] Furthermore, if each state commission were to prescribe their own TELRIC-based rates, there would be national disparity in intercarrier compensation rates and transit rate caps.

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[63] Reply Comments of Broadview Networks, NuVox Communications, One Communications Corp. & XO Communications LLC.

[64] Reply Comments of Sprint Nextel.

[65] Reply Comments of AT&T Inc., p.17.

[66] Reply Comments of Verizon, p.23.

H. Impact of Edge interconnection on CLECs

Under the Plan, with the exception of smaller rural carriers, each carrier must designate at least one point of interconnection, i.e., an "Edge,"[67] in every LATA to receive traffic from other carriers' networks. A carrier may designate a point of presence if no physical switch is present in a LATA. Each carrier has a financial obligation to transport its originating non-access traffic to the terminating carrier's Edge. A carrier may satisfy its financial obligations for transport by constructing its own facilities, obtaining facilities from a third-party carrier, or purchasing transport services from the terminating carrier.

The Rural Transport Rule governs interconnection between Track 1 and CRTCs (Track 2 and Track 3 carriers). The rule specifies that when a Track 1 carrier interconnects with a CRTC, the Track 1 carrier shall transport its non-access traffic to the CRTC's Edge. The financial obligation for transporting CRTC-originated non-access traffic is shared with the interconnecting Track 1 carrier. The Track 1 carrier will establish the interconnection arrangement for CRTC originated non-access traffic and will decide whether the interconnection will be direct or indirect. If it elects to interconnect indirectly with the CRTC, the Track 1 carrier will have the financial obligation for tandem transit service. If the Track 1 carrier elects to interconnect directly, the CRTC's financial obligation for transport is as follows: (1) Under the modified Rural Transport Rule, a CRTC is required to bear the financial obligation for transporting its originating non-access traffic a distance not to exceed 10 miles beyond the meet point it shares with the Track 1 carrier; (2) under the full Rural Transport Rule, the CRTC bears the financial obligation for the transport to deliver its originating non-access traffic to the meet point it shares with the Track 1 carrier; (3) the Track 1 carrier has the remaining financial obligation for the transport to deliver CRTC originated non-access traffic to its Edge for termination. Certain Track 2 carriers that elect lower originating and terminating rates are entitled to the full Rural Transport Rule.[68]

In the reply comments, AT&T defended the Plan's Edge rules as a critical component of intercarrier compensation reform. It specifies a unified way to identify "the points in carriers' network where various compensation rules are triggered."[69] AT&T clarified that CLECs may interconnect with an ILEC's network at any technical feasible point, and they may choose whether to use the ILEC's transport service. If a carrier drops traffic off at another carrier's Edge, it pays a low termination rate. If a point is not the Edge of another carrier's network, the originating carrier will pay a transport rate for the terminating carrier to "backhaul" the traffic

[67] An Edge is a location on the terminating carrier's network where it receives traffic to perform the termination function. An Edge is generally the demarcation point where a carrier's interconnection obligation to transport its originating traffic ends. It can be an End Office, Access Tandem, Mobile Switching Center (MSC), Point of Presence (POP), or Trunking Media Gateway.

[68] AT&T PowerPoint presentation on the Missoula Plan at the Intercarrier Compensation Workshop, Springfield, IL, October 4, 2006.

[69] Reply Comments of AT&T, p.57.

from that point to its Edge, and the backhaul rates are capped at a higher level than termination rates. AT&T further stressed that the backhaul rates are based on the ILEC's interstate transport rates and are just and reasonable under Section 201 of the Act. Besides, the Edge rules are default rules only. "Carriers can always choose to interconnect at other points based either on commercial negotiations or on any applicable statutory interconnection rights they may have."[70] ILECs also asserted that the status quo arrangement allows originating CLECs to choose inefficient interconnection points and add additional costs to the ILECs' network and their customers. The proposed rules in the Plan are designed to correct the historical wrong.

Classified as Track 1 carriers, CLECs were concerned that the Edge rules will allow ILECs to choose the Edges and require them to build out additional facilities in order to interconnect with ILECs' Edges and incur formidable costs. Many commenters shared the concern about the costly network reconfiguration and its anti-competitive consequences.[71] The obligation of hauling traffic to ILECs' network Edges would put CLECs under financial stress, unnecessarily duplicate part of the ILEC network, and make it more difficult for CLECs to compete with ILECs.

Some commenters declared that the Edge rules are anti-competitive because they favor ILECs in interconnection arrangements. Under the proposed Edge interconnection rules, the ILECs will charge CLECs for hauling CLEC-originated traffic from the point of interconnection to the ILEC's Edge at a much higher rate than the termination rates CLECs would otherwise pay ILECs. The Edge rules require CLECs to haul traffic to multiple Edges of an ILEC's network, whereas ILECs may only haul their traffic to a single Edge of a CLEC's network. Cavalier, McLeodUSA, Pac-West and RCN pointed out that the Rural Transport Rule will require CLECs and other Track 1 carriers to pay for interconnection transport in both directions between their Edges and the meet points of the Track 3 ILEC, but they will be compensated only for the first ten miles of the transport service from the Track 1 ILEC's network to the Track 3 ILEC's Edge. Opponents emphasized that CLECs should not be responsible for the costs of ILECs' interconnection transmission facilities to deliver ILEC-originated traffic to CLEC networks.

The Utah Public Service Commission brought up similar concerns about the Edge interconnection rules, but it supported the idea that Track 1 carriers should be able to designate an end office as an Edge; otherwise, there will be blockage in the tandem, and Track 1 carriers will have to incur great cost to augment the tandem. The California Public Utility Commission suggested that the Edge rules should apply only to rural carriers, two percent carriers, and competitive carriers, and that Track 2 and Track 3 carriers should not be allowed to designate an end office as an Edge when the end office subtends the carriers' own access tandem.

Opponents of the Edge rules also argued that under the Act, ILECs have the statutory obligation to offer interconnection at any technically feasible point; allowing ILECs to designate

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[70] Reply Comments of AT&T Inc., p.61.

[71] For example, Joint CLEC Commenters, Broadview Networks, NuVox Communications, One Communications Corp. & XO Communications LLC, Texas Office of Public Utility Counsel, Ohio Public Utilities Commission, just to name a few.

Edges violates the statute and overrides previously negotiated interconnection agreements among carriers. Sprint Nextel pointed out in this respect that, to prevent ILECs from abusing the Edge proposal for their own advantage, the FCC should clarify first that the proposal will be a default standard when negotiation efforts fail and second, that ILECs will not be allowed to unilaterally change the points of interconnection designated in existing, effective interconnection agreements.[72]

The Edge Rules also caused concerns about numbering resources. The Michigan Public Service Commission commented that "[a]dditional Edges may also exacerbate requests from CLECs for additional Central Office codes (10,000 telephone numbers) for Local Routing Numbers (LRNs) in rural areas where there is no mandatory thousand block number pooling, which will create a premature need for area code relief."[73]

I. Other Issues

The commenters also discussed a number of other related issues in their reply comments. For example, commenters debated whether it is appropriate to use telephone numbers as an interim geographic proxy and the impact of using such an approach. The Missoula Plan adopts a telephone number-based proxy to indicate the geographic locations of phone call endpoints for the purpose of applying relevant compensation categories (e.g., reciprocal compensation versus access charge). Some commenters were concerned that it may put great stress on numbering resources. However, supporters argued that, under the Plan, geographical endpoints of a call will become less relevant for intercarrier compensation that carriers are entitled to receive. With such a telephone number-based mechanism, carriers, especially VoIP providers, will have less incentive to occupy large blocks of telephone numbers. AT&T acknowledged that it is an imperfect proxy for a call's actual geographic endpoints, but it is a reasonable proxy given the lack of feasible alternatives.

Some commenters were concerned that the Plan will require the FCC to rescind the mirroring rule for dial-up traffic bound for Internet Service Providers (ISPs) and replace it with the new markets rule. Cavalier, McLeodUSA, Pac-West and RCN argued that dial-up traffic is constantly declining and the rationale for the mirroring rule still holds, even in rural areas. The proposed new market rule will lead the policy back to a disparate rate structure based on distinctions among types of calls. They did not support the change of the mirroring rule because the rural ILECs failed to justify their need for cost recovery.

In addition, Sprint Nextel brought up the issue of special access rates. In this regard, Verizon stated that special access rates are not part of intercarrier compensation for the exchange of traffic and should be addressed separately in the FCC's special access pricing rulemaking proceeding.

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[72] Reply Comments of Sprint Nextel.

[73] The Michigan Public Service Commission, p.3.

Despite all the disagreement and contention, some consensus did emerge in both the comments and reply comments on the necessity to address the phantom traffic problem and treatment of VoIP traffic. In general, all parties are in more agreement on the phantom traffic treatment proposal than on any other aspect of the Plan. The solution for the phantom traffic problem requires clear call signaling rules to identify end points of the traffic. An enforcement mechanism needs to be installed to acquire detailed information about the source of traffic and implement proper terminating charges. The Missoula Plan includes an interim and a comprehensive solution for the phantom traffic problem. Some commenters felt that the Plan is still vague about specific mechanisms to identify traffic and lacks implementation details, such as penalties for violation.[74] The VoIP issue involves specific compensation principles governing the traffic exchange between Public Switch Telephone Network (PSTN) and Internet Protocol (IP) network. Commenters debated whether it is necessary to implement rules to delineate intrastate and interstate VoIP traffic.

Most parties agreed that the FCC should take action on the VoIP and phantom traffic problems in separate dockets if the industry fails to reach a consensus about the Missoula Plan. These two issues appeared more urgent and can be dealt with separately without fully implementing intercarrier compensation reform. Prompt solutions of the two issues would bring more clarity and certainty to the industry.

III. Conclusion

The Missoula Plan proposed a reform that will involve a revenue shift among different carriers of about $10 billion per year.[75] Inevitably, there will be winners and losers in this revolution. As discussed in the previous section, supporters and opponents disagreed on a number of major issues on the Plan. The debate was full of conflict of interests and contradictory arguments. The two sides have very different perspectives on the revenue allocation and market competition as a result of the Plan.

First of all, the industry seems divided in terms of the support for the Plan. Supporters of the Plan emphasized the extensive compromise that resulted in the Missoula Plan proposal and the long list of endorsers for the Plan. However, the opponents of the Missoula Plan alleged that there is no real industry-wide consensus for the Plan and that it is only supported by AT&T, its affiliates, and rural ILECs, all of whom would have windfall gains under the Plan. The division of interests appears clear particularly between ILECs and CLECs, between wireline carriers and wireless carriers, and between urban and rural carriers.

Secondly, commenters contended on the merits of the status quo and the proposal plan. Supporters of the reform claimed that the existing intercarrier compensation regime has too many loopholes for arbitrage. They applauded the Plan's solution to the current intercarrier

[74] Reply Comments of the Utah Public Service Commission.

[75] Rosenberg, Pérez-Chavolla & Liu, 2006, p.2.

compensation regime as being "reasonable and even-handed."[76] AT&T held that the Missoula Plan is a middle way between the status quo "broken" intercarrier compensation regime and the politically unviable bill-and-keep regime.[77] More specifically, AT&T stated that

> "…the Plan makes each carrier more *responsible* to its own end users for quality and efficiency of service, and thus empowers end users in general, rather than regulators, to pick winners and losers in the market place. At the same time, the Plan will not drive intercarrier rates down to zero, as a bill-and-keep approach would, and thus will not impose the same degree of upward pressure on end-user rates. Instead, the Plan prescribes only modest, phased-in increases to the regulatory *caps* on monthly end-user charges, and competition will often preclude carriers from raising rates even that far."[78]

Opponents of the Plan refuted this view by arguing that the three-Track system created by the Plan would simply replace one system of disparities with another, and carriers still would have an incentive to arbitrage when they compete in the same calling area.[79] Opponents also called the Plan "illegal and unsound."[80] They asserted that the Plan would transfer the financial burdens of reducing access charges to consumers, via the increased SLC and other subsidy mechanisms; besides, the Plan would result in the same disparate asymmetric rates.

On the urgency to reach some solution to problems in the current intercarrier compensation regime, supporters of the Plan commented that reform is imperative and that the FCC should not "let the perfect become the enemy of the good."[81] They also argued that opponents have voiced some self-contradictory criticisms and presented no meaningful alternatives or counterproposals. Nevertheless, opponents objected to the drastic overhaul of the

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[76] *Id*, p. 1.

[77] The bill-and-keep approach is strongly advocated by many wireless carriers and internet-related enhanced service providers. See, for example, Reply Comments of Leap Wireless International, Inc. and Reply Comments of the Information Technology Industry Council.

[78] Reply Comments of AT&T Inc., pp. 3-4. (emphasis in the original text)

[79] Reply Comments of Cavalier, McLeodUSA, Pac-West Telecomm and RCN; Reply Comments of Verizon.

[80] Reply Comments of Broadview Networks, NuVox Communications, One Communications Corp., and XO Communications LLC, p. 1.

[81] Reply Comments of the Supporters of the Missoula Plan, p. 3.

existing intercarrier compensation regime, involving substantial transfer of costs and benefits among carriers, states, and consumer groups.[82]

Furthermore, commenters strongly disagreed on the competitive impact of the proposed Plan. Supporters of the Plan argued that the Plan is pro-competitive because carriers will be less dependent on the implicit subsidy imbedded in the legacy regime, especially the subsidy from access revenue, which has dwindled due to increasing inter-modal competition.[83] But opponents claimed that the Plan is anti-competitive because it preserves the ILECs' revenue stream and makes it more costly for CLECs to provide services.[84] Broadview Networks, NuVox, One Communications and XO argued that the Plan is hardly competitively neutral because it would establish numerous subsidies for Track 3 carriers at the expense of ILECs, CLECs, wireless and other alternative service providers in Track 1, as well as mid-size ILECs in Track 2. Vonage stated that "the Missoula Plan pursues a brand new vision for intercarrier compensation and universal service intended only to perpetuate unfair and market distorting regimes for the benefit of their primary stakeholders."[85]

Lastly, the argument about the Plan's impact on consumer benefits seems unresolved, given the context of rapidly changing technologies and consumer demands. Although the industry commenters greatly outnumbered consumer advocacy commenters, some state commissions have brought up pertinent points on the burden of increasing consumer charges as a result of the Plan, especially for those users who would not benefit from the access charge reduction to a great extent. Some oversight of the long distance carriers' flow-through of access charge reduction and rural carriers' commitment to broadband network expansion was considered relevant.

[82] Broadview Networks, NuVox Communications, One Communications Corp., and XO Communications LLC claimed in their reply comments that "[s]imply put, the Missoula Plan is nothing more than an enormous, $40 billion, wealth transfer from consumers to ILECs" (p. 12).

[83] Reply Comments of the Early Adopter State Commission.

[84] Reply Comments of the NCTA.

[85] Reply Comments of Vonage, p. 7.

Appendix I. List of Parties that Filed Reply Comments with the FCC

1. Ad Hoc Telecommunications Users Committee
2. Alabama Public Service Commission
3. Arizona Corporation Commission
4. AT&T
5. Broadview Networks, NuVox Communications, One Communications Corp. & XO Communications
6. Cavalier Telephone, McLeodUSA Telecommunications Services, Pac-West Telecomm, RCN Corp.
7. Centralized Equal Access Providers (Iowa Network Services, Onvoy & South Dakota Network)
8. Cinergy Communications
9. Comporium Corp.
10. Early Adopter State Commissions & several Missoula plan supporters
11. Early Adopter State Commissions
12. Embarq
13. Frontier Communications
14. General Communication, Inc.
15. GVNW Consulting
16. Illinois Commerce Commission
17. Information Technology Industry Council
18. Interstate Telcom Consulting, Inc.
19. Iowa Utilities Board
20. Kansas Corporation Commission
21. Kansas Corporation Commission
22. Leap Wireless International
23. Massachusetts Department of Telecommunications and Energy
24. Michigan Public Service Commission
25. Mid-Atlantic Conference of Regulatory Utility Commissioners (MACRUC) & State Commissioners of the MACRUC States
26. Mid-Rivers Telephone Cooperative, Inc.
27. Minnesota Independent Coalition
28. Montana Public Service Commission
29. National Association of State Utility Consumer Advocates (NASUCA)
30. National Cable and Telecommunications Assoc. (NCTA)
31. National Telecommunications Cooperative Association (NTCA)
32. Neutral Tandem, Inc.
33. New Jersey Board of Public Utilities
34. New Jersey Division of Rate Counsel
35. New Mexico Public Regulation Commission
36. North Carolina Utilities Commission & the Public Staff - North Carolina Utilities Commission
37. North Dakota Public Service Commission
38. Pennsylvania Public Utility Commission
39. People of the State of California and California Public Utility Commission

40. Public Service Commission of Wisconsin
41. Public Utilities Commission of Ohio (PUCO)
42. Qwest Comunications International, Inc.
43. Regulatory Commission of Alaska
44. The Rural Alliance
45. Rural Independent Competitive Alliance (RICA)
46. Rural Iowa Independent Telephone Assoc.
47. South Dakota Public Utilities Commission
48. South Dakota Rural CLEC Coalition
49. Sprint Nextel Corporation
50. State of Hawaii
51. Supporters of the Missoula Plan
52. SureWest Communications
53. Teletruth
54. Teletruth
55. Texas Office of Public Utility Counsel, Consumer Federation of America & Consumers Union
56. United States Telecom Assoc. (USTelecom)
57. Utah Division of Public Utilities
58. Verizon
59. Virgin Mobile USA
60. Vonage Holdings Corp.
61. Washington Utilities and Transportation Commission
62. Wisconsin State Telecommunications Association (Small Company Committee)
63. Wyoming Public Service Commission

Source:
CC Docket 01-92, available at the FCC Electronic Comment Filing System http://gullfoss2.fcc.gov/prod/ecfs/comsrch_v2.cgi; Also available at the NRRI Intercarrier Compensation page, http://www.nrri.ohio-state.edu/Telecom/hot-topics-links/intercarrier-compensation/stakeholder-docs/comments/