

Annex 8.2

FCC Position on Termination Rates

Introduction

1. The US Federal Communications Commission (FCC) has recently issued a consultation document on how it proposes to reform the current wholesale termination regime in the US¹. This Annex presents and summarises the FCC methodology to calculate rates for both fixed and mobile wholesale termination. This approach is not final and, therefore, may be subject to change.

Current US termination regime

2. The current termination regime in the US is characterised by “a complex array of intercarrier compensation² mechanisms.”³ According to the FCC, this multitude of compensation mechanisms (which generally include implicit subsidies) was designed to promote universal service.
3. In 1996⁴, the FCC adopted statutory pricing rules to be used by States when arbitrating interconnection disputes. The FCC recognised that peak-load pricing was the most efficient methodology for the recovery of cost of traffic-sensitive facilities. However, it did not require States to adopt such a pricing approach because of the administrative difficulties associated with it. Instead, it advocated a “*forward-looking, long-run average incremental cost methodology*” which it called the “*Total Element Long-Run Incremental Cost (TELRIC)*”.
4. The TELRIC methodology considers the relevant output increment to be “*all current and reasonably projected future demand...and should also include a reasonable allocation of forward-looking common costs, including overhead costs.*”⁵ TELRIC is therefore, a forward-looking average cost concept.
5. The FCC’s interpretation of the statutory pricing rules for reciprocal compensation was that transport and termination costs should “*be recovered in a cost-causative manner and that usage based charges should be limited to situations where costs are usage sensitive.*”⁶ In particular, the FCC found that, in terminating a call that originates on another carrier’s network, the Local Exchange Carrier’s (LEC’s) additional cost “*primarily consists of the traffic-sensitive component of local switching*”⁷ but not non-traffic sensitive items such as the costs of local loops and line ports. The FCC argued that this interpretation is consistent with the use of TELRIC.
6. The statutory pricing rules governing reciprocal compensation and adopted in the *Local Competition First Report and Order* (i.e. the TELRIC method) remain in effect.

¹ Federal Communications Commission (FCC), Order On remand and Report and Order and Further Notice of Proposed Rule Making, 5 November 2008 (“FCC”2008”), available at http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-08-262A1.pdf.

² Intercarrier compensation is termed wholesale termination rates in the UK and Europe

³ FCC 2008 Page A-68, Para 157 (footnote added).

⁴ *Local Competition First Report and Order*.

http://www.fcc.gov/Bureaus/Common_Carrier/Orders/1996/fcc96325.pdf.

⁵ FCC 2008 Page A-108, Para 238.

⁶ FCC 2008 Page A-77, Para 172.

⁷ Ibid.

Reform of the TELRIC regime

7. In 2001, the FCC commenced a comprehensive reform of intercarrier compensation following “*evidence of increasing regulatory arbitrage⁸, as well as increasing competition and changes in technology⁹*”. Regulatory arbitrage was made possible by a combination of factors, including mainly:
 - the multitude of intercarrier compensation mechanisms mentioned above; and
 - above-cost reciprocal compensation rates.
8. The FCC states in its 2008 report that there is clear evidence that:
 - the application of the TELRIC methodology has led to “*excessively high reciprocal compensation rates¹⁰*”;
 - reciprocal charges appear to generate “*a potential windfall*”;
 - reciprocal charges do not accurately reflect carriers’ additional costs “*as the Commission initially envisioned and Congress intended¹¹*”.
9. Furthermore, as a result, the current TELRIC regime:
 - Imposes significant inefficiencies on users;
 - Distorts investment incentives; and
 - Poses an obstacle to an all-IP broadband world because high voice termination revenue provides little incentives for operators to upgrade their networks to the most efficient technology or to negotiate interconnection agreements that are designed to accommodate the efficient exchange of IP traffic.

The Proposed Reform

10. The FCC states that there is a need to reform the current system in order to “unify and simplify the myriad intercarrier compensation systems in existence”¹². Such reform would, according to the FCC, align its approach more closely with “*the statutory text and with economic theory to eliminate, as far as possible, opportunities for regulatory arbitrage.*”¹³ In particular, the FCC states that:

“This unification and simplification will encourage the efficient use of, and investment in, advanced telecommunications and broadband networks, spur intermodal competition throughout the United States, and minimize the need for future regulatory intervention.”¹⁴

⁸ Regulatory arbitrage is defined by the FCC as “profit-seeking behaviour that can arise when a regulated firm is required to set different prices for products or services with a similar cost structure.”

⁹ The most cited example by the FCC is the case of traffic to dial-up ISPs where the reciprocal rates were so high that some LEC designed their business models to become targeting and serving exclusively ISP customers who received large volume of local traffic because dial-up internet customers would call their ISP and then stay on the line for hours.

¹⁰ FCC 2008 Page A-108, Para 239.

¹¹ FCC 2008 Page A-109, Para 239.

¹² FCC 2008 Page A-68 Para 157.

¹³ FCC 2008 Page A-109, Para 239.

¹⁴ FCC 2008 Page A-68, Para 157.

11. The FCC proposes to move to new uniform termination rates and to adopt a new methodology for considering “*additional costs*” based on the “*the traditional economic definition of incremental cost, as applied to multiproduct firms*”. This incremental cost is defined as the difference between the total cost of a multiproduct firm of supplying all services and its total cost of supplying all services except the service in question¹⁵. Effectively, this is the cost the firm would avoid if it decided not to supply the service in question.
12. The FCC clarifies that, in determining incremental costs:
 - forward-looking costs should still be used (rather than historical costs);
 - Long-run (rather than short-run) incremental cost should still be the appropriate cost concept; and
 - Common costs and overhead allocations are excluded from the calculation of “*additional costs*”.
13. The FCC argues that “*if reciprocal compensation rates truly reflected the incremental ‘additional costs,’ regulatory arbitrage should not occur because a carrier would not make a profit by recovering its incremental cost.*”
14. The FCC also considers the incremental cost of terminating calls on modern telecommunications networks. Noting that no previous cost studies or analyses have attempted to estimate the incremental cost (in the sense proposed by the FCC) of termination, the FCC cites evidence from various sources (including AT&T submissions). This evidence suggests that modern switches (“softswitches”) are largely non-traffic sensitive; that the incremental cost of call termination is either very low for some switches or simply zero; and in any case, significantly less than the cost of termination estimated under a TELRIC methodology. The FCC also notes that packet technologies used in Next Generation Networks imply a “*dramatic reduction*” in the cost of originating and terminating voice call traffic.
15. Even before proposing the current reform, the FCC had already started reducing termination rates. In doing so, the FCC aimed to “*reduce usage-sensitive interstate access charges by phasing out local loop and other non-traffic sensitive costs from those charges and directing incumbent LECs to recover those non-traffic sensitive costs through more economically efficient, flat-rated charges.*” The FCC, nevertheless, expressed concern that eliminating all implicit subsidies at once might have an “*inequitable impact on the incumbent LECs*” and stated its desire to rely on competition to drive access charges toward cost. It however recognized that “*some services may prove resistant to competition*” and it reserved the right to “*adjust rates in the future to bring them into line with forward-looking costs*”.
16. In proposing the current reform, the FCC recognises the adverse effects on markets of moving too quickly to the new regime. There is a concern both in a sudden reduction of carriers’ termination revenues and also, as a result, of an increase in charges to consumers. Because of this, the FCC decided to adopt a gradual ten-year multiple-stage transition plan designed to reduce rates over a sufficient period to “*minimise market disruptions and cushion the impact of their reform on both customers and carriers.*” During this transition period, there will be several rate

¹⁵ This methodology was developed by Faulhaber (*Cross-subsidization: Pricing in Public Enterprises*, 65 American Economic Review. 966, 966–77 (1975)), Baumol (*Minimum and Maximum Pricing Principles for Residual Regulation, in Current Issues in Public Utility Economics* (A. Danielson & D. Kamerschen eds., 1983)) and Baumol et al (*Contestable Markets and the Theory of Industry Structure* 351–56 (1982)).

decreases (and interim rates). By the end of the period, all rates will be decreased to a “*single, final, uniform reciprocal compensation rate for all carriers established*” according to the FCC’s new ‘additional costs’ methodology.