

**Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554**

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| In the Matter of |) | |
| |) | |
| Access Charge Reform |) | CC Docket No. 96-262 |
| |) | |
| Price Cap Performance Review for Local Exchange Carriers |) | CC Docket No. 94-1 |
| |) | |
| Transport Rate Structure and Pricing |) | CC Docket No. 91-213 |
| |) | |
| End User Common Line Charges |) | CC Docket No. 95-72 |
| |) | |

FIRST REPORT AND ORDER

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By the Commission: Commissioners Quello, Ness, and Chong issuing separate statements.

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I. INTRODUCTION

1. In passing the Telecommunications Act of 1996 (the 1996 Act),¹ Congress sought to establish "a pro-competitive, deregulatory national policy framework" for the United States' telecommunications industry. With this Order, we begin the third part in a trilogy of actions collectively intended to foster and accelerate the introduction of competition into all telecommunications markets, pursuant to the mandate of the 1996 Act.

2. In the *Local Competition Order*,² we set forth rules to implement section 251 and section 252 of the Communications Act of 1934, as amended. As with all of Part II of Title II of the Communications Act, those sections, and the rules implementing them, seek to remove the legal, regulatory, economic, and operational barriers to telecommunications competition. Among other things, sections 251 and 252 provide entrants with the opportunity to compete for consumers in local markets by either constructing new facilities, leasing unbundled network elements, or reselling telecommunication services.

3. In the *Universal Service Order*,³ which we adopt in a companion order today, we take steps to ensure that support mechanisms that are necessary to maintain local rates at affordable levels are protected and advanced as local telecommunication markets become subject to the competitive pressures unleashed by the 1996 Act. When it enacted section 254 of the Communications Act, Congress detailed the principles that must guide this effort. It placed on the Commission and the states the duty to implement these principles in a manner consistent with the pro-competition purposes of the Act, as embodied in, for instance, the interconnection provisions of the Act.⁴ It stated that "[t]here should be specific, predictable and sufficient Federal and State mechanisms to preserve and advance universal service."⁵

4. Congress also specified that universal service support "should be explicit," and that, with respect to federal universal service support, "[e]very telecommunications carrier that

¹ Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (codified at 47 U.S.C. §§ 151 *et. seq.*) (1996 Act).

² Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98, First Report and Order, 11 FCC Rcd 15499 (1996) (*Local Competition Order*), Order on Reconsideration, CC Docket No. 96-98, 11 FCC Rcd 13042 (1996), *petition for review pending and partial stay granted, sub nom.* Iowa Utils. Bd. v. FCC, 109 F.3d 418 (8th Cir. 1996).

³ Federal-State Board on Universal Service, CC Docket No. 96-45, First Report and Order, FCC 97-157 (rel. May 8, 1997) (*Universal Service Order*).

⁴ See 47 U.S.C. §§ 251-252.

⁵ 47 U.S.C. § 254(b)(5).

provides interstate telecommunications services shall contribute, on an equitable and non-discriminatory basis, to the specific, predictable, and sufficient mechanisms established by the Commission to preserve and advance universal service."⁶ As explained further in the Joint Explanatory Statement of the Committee of the Conference, Congress intended that, "[t]o the extent possible, . . . any support mechanisms continued or created under new section 254 should be explicit, rather than implicit as many support mechanisms are today."⁷ Congress directed the Commission, by May 8, 1997, to complete a universal service proceeding that "include[s] a definition of the services that are supported by Federal universal service support mechanisms and a specific timetable for implementation."⁸

5. Through our accompanying *Universal Service Order*, we establish the definition of services to be supported by federal universal service support mechanisms and the specific timetable for implementation. Further, through this *First Report and Order* in our access reform docket and our *Universal Service Order*, we set in place rules that will identify and convert existing federal universal service support in the interstate high cost fund, the dial equipment minutes (DEM) weighting program, Long Term Support, Lifeline, Link-up, and interstate access charges to explicit federal universal service support mechanisms. As detailed below, we will identify the implicit federal universal service support currently contained in interstate access charges through three methods.

6. First, we will reduce usage-sensitive interstate access charges by phasing out local loop and other non-traffic-sensitive (NTS) costs from those charges and directing incumbent local exchange carriers (LECs) to recover those NTS costs through more economically efficient, flat-rated charges. Because NTS costs, by definition, do not vary with usage, the recovery of NTS costs on a usage basis pursuant to our current access charge rules amounts to an implicit subsidy from high-volume users of interstate toll services to low-volume users of interstate long-distance services.

7. Second, we will rely in part on emerging competition in local telecommunications markets, spurred by the adoption of the 1996 Act, to help identify the differences between the rates for interstate access services established by incumbent LECs under price cap regulation and those that competition would set. The prices for interstate access services offered by competing providers presumably will not contain any implicit universal service support such as that embedded in the incumbent LECs' access charges. Consequently, the introduction of competition inevitably will help to remove implicit support from the incumbent LECs' access charges where competition develops and also will help to identify the extent of implicit support in other areas.

⁶ 47 U.S.C. § 254(d)-(e).

⁷ Joint Explanatory Statement of the Committee of the Conference, S. CONF. REP. NO. 230, 104th Cong., 2d Sess. 131 (1996) (Joint Explanatory Statement).

⁸ 47 U.S.C. § 254(a)(2).

8. Third, we will engage in further deliberations on a forward-looking economic cost-based mechanism that we will use to distribute federal support to rural, insular, and high cost areas, beginning in 1999. Based on cost studies the states will conduct during the coming year (or, at a state's election, based upon Commission-developed proxy methods), an estimate of the forward-looking economic cost of providing service to a customer in a particular rural, insular, or high cost area will be calculated. We will distribute federal universal service support based on the interstate portion of the difference between forward-looking economic cost and a nationwide revenue benchmark. The amount of the support will be explicitly calculable and identifiable by competing carriers, and the support will be portable among competing carriers, *i.e.*, distributed to the eligible telecommunications carrier chosen by the customer. It will be funded by equitable and non-discriminatory contributions from all carriers that provide interstate telecommunications services. Through this *First Report and Order*, we direct that federal universal service support received by incumbent LECs be used to reduce or satisfy the interstate revenue requirement otherwise collected through interstate access charges. Accordingly, through both our *Universal Service Order* and this *First Report and Order* on access reform, interstate implicit support for universal service will be identified and removed from interstate access charges, and support will be provided through the explicit interstate universal service support mechanisms.

9. Although these three steps will set in motion a process that will remove implicit universal service support from access charges, it will not remove all implicit support from all access charges immediately. This result is fully in accord with Congress's directives. Although Congress said in the Act that "support *should be* explicit" (emphasis added), it did not provide that support *shall be* explicit.⁹ Congress's decision to say "should" instead of "shall" is especially pertinent in light of Congress's repeated use of "shall" in the 1996 Act.¹⁰ Moreover, in the Act's legislative history, Congress qualified its intention that "support mechanisms should be explicit, rather than implicit," with the phrase "[t]o the extent possible."¹¹ Thus, Congress recognized that the conversion of the existing web of implicit subsidies to a system of explicit support would be a difficult task that probably could not be accomplished immediately. As explained below, we conclude that a process that eliminates implicit subsidies from access charges over time is warranted primarily for three reasons. First, we simply do not have the tools to identify the existing subsidies precisely at this time. Second, we prefer to rely on the market rather than regulation to identify implicit support because we are more confident of the market's ability to do so accurately. Third, even if we were more confident of our ability to identify all of the existing implicit support mechanisms at this time, eliminating them all at once might have an inequitable impact on the incumbent local exchange carriers.

10. Nor, by our orders today, do we attempt to identify or eliminate the implicit universal

⁹ 47 U.S.C. § 254(e).

¹⁰ See Joseph Farrell, *Creating Local Competition*, 49 Fed. Comm. L.J. 201, 211 (1996) ("shall" appears 2,036 times in 1996 Act, according to staff analysis).

¹¹ Joint Explanatory Statement at 131.

service support mechanisms established by state commissions. We recognize that states are initially responsible for identifying implicit intrastate subsidies. For the reasons stated above, we believe the Commission has discretion under the statute to employ pro-competitive, deregulatory policies to aid in the reform of the existing, complex system of universal service. Where pro-competition policies, such as those set forth in sections 251, 252 and 253, can force prices for telecommunications services to competitive levels, and, as a result, eliminate or, at least, substantially eliminate implicit support, the Act grants us the authority to rely on such policies over a period of time. We find that the Act does not require, nor did Congress intend, that we immediately institute a vast set of wide-ranging pricing rules applicable to interstate and intrastate services provided by incumbent LECs that would have enormously disruptive effects on both ratepayers as well as the affected LECs. Indeed, the congressional mandate that we implement pro-competitive, deregulatory policies is a continuing reminder that, wherever feasible, we should select competition instead of regulation as our means of accomplishing the stated statutory goals. Reliance on competition is the keystone that unifies our universal service and access reform orders.

11. Nevertheless, implicit intrastate universal service support is substantial. States have maintained low residential basic service rates through, among other things, a combination of: geographic rate averaging, high rates for business customers, high intrastate access rates, high rates for intrastate toll service, and high rates for vertical features and services such as call waiting and call forwarding. By not mandating immediate Commission action to eliminate these policies and instead by ordering that the Commission and the states together achieve universal service goals,¹² Congress intended that states, acting pursuant to sections 254(f) of the Communications Act, must in the first instance be responsible for identifying intrastate implicit universal service support. Indeed, by our decisions in this Order and in our companion *Universal Service Order*, we strongly encourage states to take such steps.

12. To achieve the vital, historic, and congressionally-mandated purposes of universal service in every state in an era in which competition replaces monopoly, it is necessary that the states and the Commission develop new and effective mechanisms of complementing the activities of each other. Therefore, as states implement their universal service plans, we will be able to assess whether additional federal universal service support is necessary to ensure that quality services remain "available at just, reasonable, and affordable rates."¹³ Our decisions in this Order are meant in part to provide some elements of the plan and time sufficient to discharge responsibly an aspect of the federal role in this federal-state universal service partnership.

13. In this *First Report and Order*, we also take the actions necessary to permit the market, in the first instance, to expose any implicit universal service support that we may fail to identify as we implement our federal mechanisms for supporting universal service in insular, rural,

¹² See 47 U.S.C. § 254.

¹³ 47 U.S.C. § 254(b)(1).

and high cost areas and to drive access rates toward levels that competition would be expected to produce. Our decision also fulfills the congressional intent that we eliminate the rules that have helped to sustain *de facto* or *de jure* monopolies in access markets and instead create the conditions for competitive entry on a sustainable, long-term basis. That requires, among other things, that we phase out opportunities for inefficient entry that are created primarily by anomalies in the current, monopoly-oriented regime. Consequently, this Order sets forth a plan for removing distortions and inefficiencies in both the current "rate structures" (the term used to describe the manner in which a particular charge is assessed, such as through a per-minute-of-use fee or a flat-rated fee) and "rate levels" (the term used to describe the aggregate size of a particular access charge). By rationalizing the access charge rate structure, we ensure that charges more accurately reflect the manner in which the costs are incurred, thereby facilitating the movement to a competitive market. We also establish, in this *First Report and Order*, a prescriptive mechanism to ensure that, through the operation of price caps and by other means, interstate access charges in areas where competition does not develop will also be driven toward the levels that competition would be expected to produce. The *Price Cap Fourth Report and Order*,¹⁴ which is also the Second Report and Order in this docket and which is also adopted today, modifies the X-Factor in accordance with this plan.

14. In a subsequent order in the present docket, we will provide detailed rules for implementing the market-based approach that we adopt in today's Order. That process will give carriers progressively greater flexibility in setting rates as competition develops, gradually replacing regulation with competition as the primary means of setting prices and facilitating investment decisions. A separate order in this docket will also address "historical cost" recovery: whether and to what extent carriers should receive compensation for the recovery of the allocated costs of past investments if competitive market conditions prevent them from recovering such costs in their charges for interstate access services.

15. By our orders today, we reject the arguments made by some parties that section 254 compels us immediately to remove all universal service costs from interstate access charges.¹⁵ Making "implicit" universal service subsidies "explicit" "to the extent possible" means that we have authority at our discretion to craft a phased-in plan that relies in part on prescription and in part on competition to eliminate subsidies in the prices for various products sold in the market for telecommunications services. Moreover, we have met section 254's clear command that we identify the services to be supported by federal universal service support mechanisms and that we establish a specific timetable for implementation. Under that timetable, we will over the next year identify implicit interstate universal support and make that support explicit, as further provided by

¹⁴ Price Cap Performance Review for Local Exchange Carriers, Fourth Report and Order in CC Docket No. 94-1, and Access Charge Reform, Second Report and Order in CC Docket No. 96-262, FCC 97-159 (adopted May 7, 1997) (*Price Cap Fourth Report and Order*).

¹⁵ See Appendix B, Section IV.A.

section 254(e).¹⁶

16. Coupled with the modifications implemented in our *Universal Service Order*, the changes we put in place today will provide far-reaching benefits to the American people. This Order will restructure access charges, resulting in lower long-distance rates for many consumers, while substantially increasing the volume of long-distance calling. It will promote the spread of competition by replacing significant implicit subsidies with an explicit and secure universal service support system. It will foster competition and economic prosperity by creating an access charge system that is both efficient and fair. We believe that the changes implemented by this Order are necessary to meet the goal set forth in the 1996 Act -- "opening all telecommunications markets to competition."¹⁷

A. Background

1. The Existing Rate System

17. For much of this century, most telephone subscribers obtained both local and long-distance services from the same company, the pre-divestiture Bell System, owned and operated by AT&T. Its provision of local and intrastate long-distance services through its wholly-owned operating companies was regulated by state commissions. The Commission regulated AT&T's provision of interstate long-distance service. Much of the telephone plant that is used to provide local telephone service (such as the local loop, the line that connects a subscriber's telephone to the telephone company's switch) is also needed to originate and terminate interstate long-distance calls. Consequently, a portion of the costs of this common plant historically was assigned to the interstate jurisdiction and recovered through the rates that AT&T charged for interstate long-distance calls. The balance of the costs of the common plant was assigned to the intrastate jurisdiction and recovered through the charges administered by the state commissions for intrastate services. The system of allocating costs between the interstate and intrastate jurisdictions is known as the separations process. The difficulties inherent in allocating the costs of facilities that are used for multiple services between the two jurisdictions are discussed below.

18. At first, there was no formal system of tariffed charges to determine how the BOCs and the hundreds of unaffiliated, independent LECs would recover the costs allocated to the interstate jurisdiction by the separations rules. Instead, AT&T remitted to these companies the amounts necessary to recover their allocated interstate costs, including a return on allocated capital investment.

¹⁶ As with any implicit support mechanism, universal service costs are presently intermingled with all other costs, including the forward-looking economic costs of interstate access and any historic costs associated with the provision of interstate access services. We cannot remove universal service costs from interstate access charges until we can identify those costs, which we will not be able to do even for non-rural LECs before January 1, 1999.

¹⁷ Joint Explanatory Statement at 1.

19. In the 1970s, MCI and other interexchange carriers (IXCs) began to provide switched long-distance service in competition with AT&T. However, AT&T still maintained monopolies in the local markets served by its local subsidiaries, the Bell Operating Companies (BOCs). The BOCs owned and operated the telephone wires that connected the customers in their local markets. Other independent (non-Bell) LECs held similar monopoly franchises in their local service areas. MCI and the other IXCs were dependent on the BOCs and the independent LECs to complete the long-distance calls to the end user.

20. For much of the 1970s, MCI and AT&T fought over the fees -- the access charges -- that MCI should pay the BOCs for originating and terminating interstate calls placed by or to end users on the BOCs' local networks. That battle took place before federal regulators, as well as in the federal courts. In December 1978, under Commission supervision, AT&T, MCI, and the other long-distance competitors entered into a comprehensive interim agreement, known as Exchange Network Facilities for Interstate Access (ENFIA), that set rates that AT&T would charge long-distance competitors for originating and terminating interstate traffic over the facilities of its local exchange affiliates.¹⁸ Several years afterwards, AT&T's divestiture was completed, separating the local exchange operations of the BOCs from the rest of AT&T's operations, including AT&T's long distance business. The BOCs maintained monopoly franchises in their local market, but by splitting them off from AT&T's long-distance business, the federal courts removed an incentive for the BOCs to favor AT&T's long distance business over its competitors. Now AT&T competed directly with MCI and the other competitors to provide interstate service, and all of the competitors paid the BOCs for the service of providing the necessary access to end users.

21. In 1978, the Commission commenced a wide-ranging review of the system by which LECs were compensated for originating and terminating interstate traffic. In 1983, following the decision to break-up AT&T, the Commission adopted uniform access charge rules in lieu of earlier agreements.¹⁹ These rules governed the provision of interstate access services by all incumbent LECs, BOCs as well as independents. The access charge rules provide for the recovery of the incumbent LECs' costs assigned to the interstate jurisdiction by the separations rules.

22. The Commission uses a multi-step process to identify the cost of providing access service. First, the rules require an incumbent LEC to record all of its expenses, investments, and revenues in accordance with accounting rules set forth in our regulations.²⁰ Second, the rules

¹⁸ For additional background on the ENFIA agreement, *see, e.g.*, Investigation of Access and Divestiture-Related Tariffs, CC Docket No. 83-1145, Phase I and Phase II, Part 1, FCC 85-100, 57 Rad.Reg.2d 1229, 1241 (rel. March 8, 1985).

¹⁹ MTS and WATS Market Structure, Third Report and Order, CC Docket No. 78-72, Phase 1, 93 FCC 2d 241, *recon.*, 97 FCC 2d 682 (1983), *second recon.*, 97 FCC 2d 834 (1984).

²⁰ These rules are referred to as the Uniform System of Accounts and are contained in Part 32 of the Commission's Rules. *See* 47 C.F.R. §§ 32.1-9000.

divide these costs between those associated with regulated telecommunications services and those associated with nonregulated activities.²¹ Third, the separations rules determine the fraction of the incumbent LEC's regulated expenses and investment that should be allocated to the interstate jurisdiction.²² After the total amount of interstate cost is identified, the access charge rules translate these interstate costs into charges for the specific interstate access services and rate elements. Part 69 specifies in detail the rate structure for recovering those costs. That is, the rules tell the incumbent LECs the precise manner in which they may assess charges on interexchange carriers and end users.

23. Determining the costs that an incumbent LEC incurs to provide interstate access services and that, consequently, should be recovered from those services, is relatively straightforward in some cases and problematic in others. Some facilities, such as private lines, can be used exclusively for interstate services and, in such cases, the entire cost of those facilities is assigned to the interstate jurisdiction by the separations rules. Most facilities, however, are used for both intrastate and interstate services. The costs of some of these facilities vary depending on the amount of telecommunications traffic that they handle. The separations rules typically assign these traffic-sensitive (TS) costs on the basis of the relative interstate and intrastate usage of the facilities, as measured, for example, by the relative minutes of interstate and intrastate traffic carried by such facilities. By contrast, the costs of other facilities used for both interstate and intrastate traffic do not vary with the amount of traffic carried over the facilities, *i.e.*, the costs are non-traffic-sensitive. These costs pose particularly difficult problems for the separations process: The costs of such facilities cannot be allocated on the basis of cost-causation principles because all of the facilities would be required even if they were used only to provide local service or only to provide interstate access services. A significant illustration of this problem is allocating the cost of the local loop, which is needed both to provide local telephone service as well as to originate and terminate long-distance calls. The current separations rules allocate 25 percent of the cost of the local loop to the interstate jurisdiction for recovery through interstate charges.²³

24. The Commission has recognized in prior rulemaking proceedings that, to the extent possible, costs of interstate access should be recovered in the same way that they are incurred, consistent with principles of cost-causation. Thus, the cost of traffic-sensitive access services should be recovered through corresponding per-minute access rates. Similarly, NTS costs should be recovered through fixed, flat-rated fees. The Commission, however, has not always adopted rules that are consistent with this goal. In particular, the Commission limited the amount of the allocated interstate cost of a local loop that is assessed to residential and business customers as a flat monthly charge, because of concerns that allowing the flat charges to rise above the specified limits might cause customers to disconnect their telephone service. The residual cost of the loop

²¹ This is governed by Sections 64.901-.904 of our Rules. See 47 C.F.R. §§ 64.901-.904.

²² This step is governed by Part 36 of the Rules. See 47 C.F.R. §§ 36.1-.741.

²³ The general process of separating these costs between the interstate and intrastate jurisdictions is discussed by the Supreme Court in *Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133 (1930).

not recovered from end users through the flat charge is recovered through a per-minute-of-use charge assessed to long-distance carriers.

25. Through the end of 1990, the vast majority of access revenues were governed by "cost-of-service" regulation. Under cost-of-service regulation, incumbent LECs calculate the specific access charge rates using projected costs and projected demand for access services.²⁴ Thus, for example, if an incumbent LEC projects that it will provide 10,000 total minutes of switching for interstate calls and estimates that it must generate \$1,000 dollars in revenue in order to recover the costs of switching that are allocated to the interstate jurisdiction by the separations rules, the access charge for local switching would be set at \$0.10 per minute (\$1,000/10,000 minutes). In 1991, however, we implemented a system of price cap regulation that altered the manner in which the largest incumbent LECs established their interstate access charges. While most rural and small LECs remained subject to all of the Part 69 cost-of-service rules, generally the largest incumbent LECs²⁵ are now subject to price cap regulations set forth in Part 61 of our rules.

26. Price cap regulation fundamentally alters the process by which incumbent LECs determine the revenues they are permitted to obtain from interstate access charges for access services. Briefly stated, cost-of-service regulation is designed to limit the profits an incumbent LEC may earn from interstate access service, whereas price cap regulation focuses primarily on the prices that an incumbent LEC may charge and the revenues it may generate from interstate access services. Under the Part 69 cost-of-service rules, revenue requirements are based on embedded or accounting costs allocated to individual services. Incumbent LECs are limited to earning a prescribed return on investment and are potentially obligated to provide refunds if their interstate rate of return exceeds the authorized level. By contrast, although the access charges of price cap LECs originally were set at the cost-of-service levels that existed at the time they entered price caps, their prices have been limited ever since by price indices that have been adjusted annually pursuant to formulae set forth in our Part 61 rules. Price cap carriers whose interstate access charges are set by these pricing rules are permitted to earn returns significantly higher than the prescribed rate of return that incumbent LECs are allowed to earn under cost-of-service rules. Price cap regulation encourages incumbent LECs to improve their efficiency by harnessing profit-making incentives to reduce costs, invest efficiently in new plant and facilities, and develop and deploy innovative service offerings, while setting price ceilings at reasonable

²⁴ Since 1981, the Commission has allowed certain smaller incumbent LECs to base their access rates on historic, rather than projected, cost and demand. *See* 47 C.F.R. § 61.39.

²⁵ The Commission required price cap regulation for the BOCs and GTE, and permitted other LECs to adopt price cap regulation voluntarily, provided that all their affiliates also convert to price cap regulation and that they withdraw from the NECA pools. Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, CC Docket No. 87-313, 5 FCC Rcd 6786, 6818-20 (1990) (*LEC Price Cap Order*). Currently, the price cap LECs serve more than 92 percent of the total access lines, based on LECs' 1995 and 1996 Annual Access Tariffs filed with the Commission, and account for almost 91 percent of the total interstate revenues for access services, *see* Universal Service Fund Data Collection, CC Docket No. 80-286, Universal Service Fund 1996 Submission of 1995 Study Results by NECA, Oct. 1, 1996.

levels.²⁶ In this way, price caps act as a transitional regulatory scheme until the advent of actual competition makes price cap regulation unnecessary.²⁷

27. Although price cap regulation eliminates the direct link between changes in allocated accounting costs and change in prices, it does not sever the connection between accounting costs and prices entirely. The overall interstate revenue levels still generally reflect the accounting and cost allocation rules used to develop access rates to which the price cap formulae were originally applied. Price cap indices are adjusted upwards if a price cap carrier earns returns below a specified level in a given year. Moreover, a price cap LEC may petition the Commission to set its rates above the levels permitted by the price cap indices based on a showing that the authorized rate levels will produce earnings that are so low as to be confiscatory. In the past, all or some price cap LECs were required to "share," or return to ratepayers, earnings above specified levels. The new rules adopted in the companion *Price Cap Fourth Report and Order* remove this limit on the maximum returns that can be earned by price cap incumbent LECs.

2. Implicit Subsidies in the Existing System

28. Both our price cap and cost-of-service rules contain requirements that inevitably result in charges to certain end users that exceed the cost of the service they receive. To the extent these rates do not reflect the underlying cost of providing access service, they could be said to embody an implicit subsidy. Some of these subsidies are due to the rate structures prescribed by our rules, which in some cases prevent incumbent LECs from recovering their access costs in the same way they have been incurred. For example, although the cost of the local loop that connects an end user to the telephone company's switch does not vary with usage, the current rate structure rules require incumbent LECs to recover a large portion of these non-traffic-sensitive costs through traffic-sensitive, per-minute charges. These mandatory recovery rules inflate traffic-sensitive usage charges and reduce charges for connection to the network, in essence creating an implicit support flow from end users that make many interstate long-distance calls to end users that make few or no interstate long-distance calls.

29. Several Federal-State Joint Boards have observed that additional subsidies and

²⁶ The price cap regulations also give incumbent LECs greater flexibility in determining the amount of revenues that may be recovered from a given access service. The price cap rules group services together into different baskets, service categories, and service subcategories. The rules then identify the total permitted revenues for each basket or category of services. Within these baskets or categories, incumbent LECs are given some discretion to determine the portion of revenue that may be recovered from specific services. Subject to certain restrictions, this flexibility allows incumbent LECs to alter the access charge rate level associated with a given service. For example, within the category of switching services, an incumbent LEC may choose to recover a greater portion of its switching revenues through access charges assessed to one kind of switching service rather than through charges assessed to another switching service. Although the LEC must still observe the switched-access rate structure that is set forth in Part 69 of our rules (which determines what services may be offered and whether charges may be imposed on a per-minute or flat-rated basis), the rate level of the access charge will vary depending on the amount of revenues that the LEC chooses to recover from a given service.

²⁷ Price Cap Performance Review for Local Exchange Carriers, Second Further Notice of Proposed Rulemaking in CC Docket No. 93-124, and Second Further Notice of Proposed Rulemaking in CC Docket No. 93-197, 11 FCC Rcd 858, 862 (1995) (*Price Cap Second FNPRM*).

distortions may be due, not only to the rate structure, but to the separations rules that divide costs between the interstate and intrastate jurisdictions. For example, the current separations rules require larger incumbent LECs to allocate the costs of their switching facilities between the interstate and intrastate jurisdictions on the basis of relative use (*i.e.*, if 30 percent of the minutes of use handled by the LEC's switching facilities are interstate long-distance calls, 30 percent of the LEC's switching costs are allocated to the interstate jurisdiction and recovered through interstate access charges). Our rules, however, permit smaller incumbent LECs to allocate a greater share of their switching costs to interstate access services than would result from the relative use allocator. These smaller incumbent LECs multiply the interstate use ratio by a factor (as high as 3) specified in the separations rules. In its *Recommended Decision*, the Joint Board on Universal Service observed that these separations rules "shift what would otherwise be intrastate costs to the interstate jurisdiction,"²⁸ thereby allowing such LECs to charge lower prices for intrastate services. Similarly, in the *Marketing Expense Recommended Decision*, another Federal-State Joint Board observed that the separations rules allocate a share of the incumbent LECs' retail marketing expenses to the interstate jurisdiction that is unreasonably high, given that the interstate access services consist primarily of wholesale service offerings.²⁹ To the extent these and other separation rules do not apportion costs between the jurisdictions in a manner that reflects the costs incurred to provide service in each jurisdiction, they might be viewed as generating subsidies from the interstate to the intrastate jurisdiction. These subsidies effectively require incumbent LECs to charge higher rates for interstate services and lower rates for intrastate services than would otherwise occur if the subsidies were eliminated.

30. This "patchwork quilt of implicit and explicit subsidies"³⁰ generates inefficient and undesirable economic behavior. For example, a rate structure that requires the use of per-minute access charges where flat-rated fees would be more appropriate increases the per-minute rates paid by IXCs and long-distance consumers, thus artificially suppressing demand for interstate long-distance services. Similarly, the possible overallocation of costs to the interstate jurisdiction may, for some consumers, increase long-distance rates substantially, suppressing their demand for interstate interexchange services. Implicit subsidies also have a disruptive effect on competition, impeding the efficient development of competition in both the local and long-distance markets. For example, where rates are significantly above cost, consumers may choose to bypass the incumbent LEC's switched access network, even if the LEC is the most efficient provider. Conversely, where rates are subsidized (as in the case of consumers in high-cost areas), rates will be set too low and an otherwise efficient provider would have no incentive to enter the market.

²⁸ Federal-State Joint Board on Universal Service, CC Docket No. 96-45, Recommended Decision, 12 FCC Rcd 87, 187, ¶ 189 (rel. Nov. 8, 1996) (*Joint Board Recommended Decision*). The Joint Board found that this allocation structure, known as DEM (dial equipment minute) weighting, is "an implicit support mechanism that is recovered through the switched access rates charged to interexchange carriers by those carriers serving less than 50,000 lines." *Joint Board Recommended Decision* at 237, ¶ 292.

²⁹ Amendment of Part 67 (New Part 36) of the Commission's Rules and Establishment of a Federal-State Joint Board, CC Docket No. 86-297, Recommended Decision and Order, 2 FCC Rcd 2582 (1987) (*Marketing Expense Recommended Decision*).

³⁰ *Local Competition Order* at 15506, ¶ 5.

In either case, the total cost of telecommunications services will not be as low as it would otherwise be in a competitive market. Because of the growing importance of the telecommunications industry to the economy as a whole, this inefficient system of access charges retards job creation and economic growth in the nation.

31. Despite the existence of distortions and inefficiencies, the current system of cross-subsidies has persisted for over a decade. The structure has been justified on policy grounds, principally as a means to serve universal service goals. By providing incumbent LECs with a stream of subsidized revenues from certain customers, the system allows regulators to demand below-cost rates for other customers, such as those in high-cost areas.

3. The Telecommunications Act of 1996

32. The existing system of implicit subsidies and support flows is sustainable only in a monopoly environment in which incumbent LECs are guaranteed an opportunity to earn returns from certain services and customers that are sufficient to support the high cost of providing other services to other customers. The new competitive environment envisioned by the 1996 Act threatens to undermine this structure over the long run. The 1996 Act removes barriers to entry in the local market, generating competitive pressures that make it difficult for incumbent LECs to maintain access charges above economic cost. For example, by giving competitors the right to lease an incumbent LEC's unbundled network elements at cost,³¹ Congress provided IXCs an alternative avenue to connect to and share the local network. Thus, where existing rules require an incumbent LEC to set access charges above cost for a high-volume user, a competing provider of exchange access services entering into a market can lease unbundled network elements at cost, or construct new facilities, to circumvent the access charge.³² In this way, a new entrant might target an incumbent LEC's high-volume access customers, for whom access charges are now set at levels significantly above economic cost. As competition develops, incumbent LECs may be forced to lower their access charges or lose market share, in either case jeopardizing the source of revenue that, in the past, has permitted the incumbent LEC to offer service to other customers, particularly those in high-cost areas, at below-cost prices.³³ Incumbent LECs have for some time been claiming that this process has already made more than trivial inroads on their high-volume

³¹ 47 U.S.C. § 252(d)(1)(A)(i).

³² In Section VI.A of this Order, we conclude that access charges may not be assessed on unbundled network elements since they are not part of the "cost" of providing those elements, as defined in 47 U.S.C. § 252(d)(1)(A)(i).

³³ *See, e.g.*, H. REP. NO. 204, 104th Cong., 1st Sess. 68 (1995) (The bill "would make such internal subsidies much less viable because deregulation would remove the near-guaranteed returns allowed in a regulated market, and with them the ability of the regulated firm to subsidize high-cost customers.") (Congressional Budget Office cost estimate).

customer base.³⁴

33. Recognizing the vulnerability of implicit subsidies to competition, Congress directed the Commission and the states to take the necessary steps to create permanent universal service mechanisms that would be secure in a competitive environment.³⁵ To achieve this end, Congress directed the Commission to strive to replace the system of implicit subsidies with "explicit and sufficient" support mechanisms.³⁶ In calling for explicit mechanisms, Congress did not intend simply to require carriers to identify and disclose the implicit subsidies that currently exist in the industry. Rather, as we determine in the *Universal Service Order* adopted today, Congress intended to establish subsidies that were both "measurable" and "portable" -- "measurable" in a way that allows competitors to assess the profitability of serving subsidized end users; and "portable" in a way that ensures that competitors who succeed in winning a customer also win the corresponding subsidy. A system of portable and measurable subsidies will permit carriers to compete for the subsidies associated with high-cost or low-income consumers. In the long run, this approach may even allow us to set subsidy levels through competitive bidding rather than through regulation. By contrast, under the current system of implicit subsidies, the only carriers that will serve high-cost consumers are those that are required to do so by regulation and that are able (because of their protected monopoly positions) to charge above-cost rates to other end users.

34. In the *Universal Service Order*, we establish "explicit and sufficient" support mechanisms to assist users in high-cost areas, low-income consumers, schools, and health care providers. By creating explicit support mechanisms, we establish a system to advance the universal service goals of the 1996 Act that is compatible with the development of competition in the local exchange and exchange access markets. By creating a portable and measurable system of subsidies, we utilize the power of the market to serve universal service goals more efficiently. That order, in short, guarantees that Congress's universal service goals are met in a way that conforms with the pro-competitive and deregulatory goals of the 1996 Act.

B. Access Charge Reform

35. In light of Congress's command to create secure and explicit mechanisms to achieve universal service goals, we conclude that implicit subsidies embodied in the existing system of interstate access charges cannot be indefinitely maintained in their current form. In this Order,

³⁴ See, e.g., Reply Comments of Bell Atlantic, CC Docket 94-1 (filed June 29, 1994) at 23-2 (citing attached Kahn Affidavit). See also John D. deButts, *An Unusual Obligation*, in HERITAGE AND DESTINY 422-32 (1983) (Address of AT&T Chairman to the National Association of Regulatory Utility Commissioners, September 20, 1973).

³⁵ See, e.g., H. REP. NO. 204, 104th Cong., 1st Sess. 80 (1995) ("The Committee intends that this Joint Board should evaluate universal service in the context of a local market changing from one characterized by monopoly to one of competition.").

³⁶ See 47 U.S.C. § 254(e). See also Joint Explanatory Statement at 131 ("To the extent possible, the conferees intend that any support mechanisms continued or created under new section 254 should be explicit, rather than implicit as many support mechanisms are today.").

therefore, we take two steps with respect to the rules governing the interstate access charges of price cap incumbent LECs.³⁷ First, we reform the current rate structure to bring it into line with cost-causation principles, phasing out significant implicit subsidies. Second, we set in place a process to move the baseline rate level toward competitive levels. Together with the *Universal Service Order*, these adjustments will promote the public welfare by encouraging investment and efficient competition, while establishing a secure structure for achieving the universal service goals established by law. Further, the process we set in place to achieve these goals avoids the destabilizing effects of sudden radical change, facilitating the transformation from a regulated to a competitive marketplace.

1. Rationalizing the Rate Structure

36. In this Order, we reshape the existing rate structure in order to eliminate significant implicit subsidies in the access charge system. To achieve that end, we make several modifications to ensure that costs are recovered in the same way that they are incurred. In general, NTS costs incurred to serve a particular customer should be recovered through flat fees, while traffic-sensitive costs should be recovered through usage-based rates. The present structure violates this basic principle of cost causation by requiring incumbent LECs to recover many fixed costs through variable, per-minute access rates. An important goal of this Order is to increase the amount of fixed costs recovered through flat charges and decrease the amount recovered through variable rates.

37. *Common Line Costs.* Because the costs of using the incumbent LEC's common line (or "local loop") do not increase with usage, these costs should be recovered through flat, non-traffic-sensitive fees. The current rate structure, however, generally allows an incumbent LEC to recover no more than a portion of its interstate common line revenues through a flat-rated Subscriber Line Charge (SLC), which is capped at \$3.50 per month for residential and single-line business users, and \$6.00 per month for multi-line users. The remaining common line revenues must be recovered through a per-minute Common Carrier Line (CCL) charge assessed on IXCs (which, in turn, may recover these charges through their prices to long-distance customers). In order to align the rate structure more closely with the manner in which costs are incurred, we adjust access rates over time until the common line revenues of all price cap LECs are recovered through flat-rated charges.

38. For primary residential and single-line business lines, however, we decline to implement this goal by increasing the SLC ceiling above its existing \$3.50 level as urged by many

³⁷ With the limited exceptions identified in Section V, the scope of this proceeding is limited to price cap incumbent LECs. As we explain in that section, the need for access reform is most immediate for these carriers, since they are most vulnerable to competition from interconnection and the availability of unbundled network elements. This proceeding will affect the vast majority of all access lines and revenues, because price cap regulation governs more than 90 percent of all incumbent LEC access lines. We will initiate a separate proceeding later this year to examine the special circumstances of small and rural rate-of-return LECs.

companies, including price cap LECs and IXCs.³⁸ We do not wish to see increases in the price of basic dial tone charged by local exchange carriers to their end users for fear that such increases might cause some consumers to discontinue service, a result that would be contrary to our mandate to ensure universal service.³⁹ We agree with the Joint Board's finding that increasing the SLC ceiling may make telecommunications service unaffordable for some consumers.⁴⁰ Consequently, to the extent that common line revenues are not recovered through the customer's SLC, we conclude that LECs should recover these revenues through a flat, per-line charge assessed on the IXC to whom the access line is presubscribed -- the presubscribed interexchange carrier charge, or PICC.⁴¹ Further, in order to provide IXCs with the opportunity to incorporate these changes into their business plans, we set the PICC for primary residential and single-line business lines at not more than the existing flat-rated line charges for the first year, and we gradually increase the ceiling thereafter until it reaches a level that permits full recovery of the common line revenues from flat charges assessed to both end users and IXCs.⁴²

39. For non-primary residential and multi-line business lines, we conclude that affordability concerns do not require us to retain the current ceiling on the monthly SLC. Consequently, we raise the SLC ceiling for these lines to the level that permits incumbent LECs full recovery for their common line revenues, but never more than \$3.00 above the current SLC ceiling for multi-line business lines today, adjusted for inflation.⁴³ Almost all subscribers will pay SLCs below, and often substantially below, the ceiling. The increase in the SLC ceiling for multi-line businesses will be implemented in the first year. To ameliorate the impact that a dramatic increase in the SLC ceiling might have on residential customers, however, the increase for non-primary residential lines will be phased in over time. The data indicate that raising the SLC ceiling

³⁸ See, e.g., BellSouth Corporation, BellSouth Telecommunications, Inc. (BellSouth) Comments, Attachment 2 at 20; GTE Service Corporation (GTE) Comments at 26-29, Reply at 20-21; Southwestern Bell Telephone Company (SWBT) Comments at 37-38, Reply at 8; U.S. West, Inc. (U S West) Reply at 27-28; Cincinnati Bell Telephone Company (Cincinnati Bell) Comments at 6-7; AT&T Corporation (AT&T) Comments 51-54, Reply at 25-26; Frontier Corporation (Frontier) Comments at 4, 5-7; Sprint Corporation (Sprint) Comments at 11-15; 50-51; Ad Hoc Telecommunications Users Committee (Ad Hoc) Reply at 4; General Services Administration/United States Department of Defense (GSA/DOD) Comments at 9-11, Reply at 5, 7; Tele-Communications, Inc. (TCI) Comments at 10; Reply at 4-5; Time Warner Communications Holdings, Inc. (Time Warner) Comments at 4-5; WinStar Communications, Inc. (WinStar) Comments at 4; WorldCom, Inc. (WorldCom) Comments at 30-31.

³⁹ Among the many goals announced in the 1996 Act, Congress declared that telephone service should be available at "affordable rates." 47 U.S.C. § 254(b)(1).

⁴⁰ *Joint Board Recommended Decision*, 12 FCC Rcd at 472, ¶ 769 (1996).

⁴¹ Where an end user does not select a presubscribed interexchange carrier, we allow an incumbent LEC to collect this charge directly from the end user.

⁴² To the extent that the PICC ceiling prevents full recovery of average per-line common line revenues for primary residential and single-line business lines, the residual amount will be recovered through the PICC imposed upon non-primary residential and multi-line business lines. As described in Section III.A below, as the PICC associated with primary residential and single-line business lines increases, the amount of common line revenues associated with those lines that is recovered through the PICC imposed upon non-primary residential and multi-line business lines will fall to zero.

⁴³ The \$3.00 increase in the SLC cap for these lines is measured on a per-month basis.

to this level will permit incumbent price cap LECs to recover their average common line revenues from 99 percent of their non-primary residential and multi-line business lines.⁴⁴ For the remaining lines, many of which are located in rural areas, the SLC ceiling for non-primary residential and multi-line business lines will ensure that end-user charges are not prohibitive or significantly above the national average,⁴⁵ thereby advancing universal service goals of affordability and access.

40. In summary, the plan we adopt here phases out significant implicit subsidies in the access charge rate structure, while taking into account universal service concerns of affordability and access. The resulting rate structure is more closely aligned with cost principles. Under this plan, most price cap incumbent LECs will recover their interstate common line revenues through flat-rated SLCs and PICCs.

41. *Switching and Transport Charges.* Following the same pricing principle that flat charges should recover fixed costs and variable charges should recover variable costs, we make several modifications to the rate structure for switching and transport services. Among other things, we move the cost of line-side ports to the common line and require their recovery through flat-rated charges. To the extent permitted by the record, we also direct incumbent LECs to reassign costs in the Transport Interconnection Charge (TIC) in order to comply with principles of cost causation and the D.C. Circuit's recent decision in *CompTel v. FCC*.⁴⁶

2. Baseline Rate Level Reductions

42. The rate structure changes that we implement in this Order eliminate some of the distortions that have characterized the access charge system for over a decade. These changes, however, are not alone sufficient to create a system that accurately reflects the true cost of service in all respects. To fulfill Congress's pro-competitive mandate, access charges should ultimately reflect rates that would exist in a competitive market. We recognize that competitive markets are far better than regulatory agencies at allocating resources and services efficiently for the maximum benefit of consumers. We conclude, consequently, that competition or, in the event that competition fails to develop, rates that approximate the prices that a competitive market would produce, best serve the public interest.

43. The rate restructuring we implement in this Order results in substantial reductions in the charges for usage-rated interstate access services. These reductions move these access charges

⁴⁴ See Supporting Material filed with 1996 Annual Access Tariff Filing, filed with Commission on April 2, 1996. This LEC forecast data were used by LECs to set SLC rates that became effective on July 1, 1996.

⁴⁵ We have also taken account of concerns raised by rural carriers and consumers groups that the increase in the SLC for non-primary residential lines and multi-lines could lead to substantial price increases in rural areas. Consequently, we are adopting these changes only for price cap incumbent LECs and will review rate structure modifications affecting small, rural carriers in a separate proceeding. See Section V.B, *infra*.

⁴⁶ *Competitive Telecommunications Ass'n v. FCC*, 87 F.3d 522 (D.C. Cir. 1996).

a long way towards their forward-looking cost levels.⁴⁷ Furthermore, in addition to these rate structure adjustments, we also take several steps in this Order to address specific cost misallocations that cause access charges to be set above economic costs. For example, we require incumbent LECs to make an exogenous cost adjustment to reflect the full amortization of certain equal access costs. We also issue a Further Notice of Proposed Rulemaking to consider our tentative conclusion that certain General Support Facility (GSF) costs should be reallocated to detariffed services.

44. We recognize that the prescriptive measures that we implement today represent the first step toward our goal of removing implicit universal service subsidies from interstate access charges and moving such charges toward economically efficient levels. In the NPRM, we identified two separate ways to continue this process in the future -- a prescriptive approach in which we actively set rates at economic cost levels, and a market-based approach that relies on competition itself to drive access charges down to forward-looking costs. We conclude in this Order, based on our experience in exchange access and other telecommunications markets and the record in this proceeding, that a market-based approach to reducing interstate access charges will, in most cases, better serve the public interest. Although the Commission has considerable expertise in regulating telecommunications providers and services efficiently for the maximum benefit of consumers, we believe that emerging competition will provide a more accurate means of identifying implicit subsidies and moving access prices to economically sustainable levels. Further, as discussed above, we believe that this approach is most consistent with the pro-competitive, deregulatory policy contemplated by the 1996 Act. Accordingly, where competition is developing, it should be relied upon in the first instance to protect consumers and the public interest.

45. We acknowledge that a market-based approach under this scenario may take several years to drive costs to competitive levels. We also recognize that several commenters have urged us to move immediately to forward-looking rates by prescriptive measures utilizing forward-looking cost models. We decline to follow that suggestion for several reasons. First, as a practical matter, accurate forward-looking cost models are not available at the present time to determine the economic cost of providing access service. Because of the existence of significant joint and common costs, the development of reliable cost models may take a year or more to complete. This situation might be contrasted with that addressed in our *Local Competition Order*, where we endorsed the use of cost models to estimate the cost of providing unbundled network elements. There, we observed that unbundled elements have few joint and common costs, so that devising accurate cost models for unbundled network elements is more straightforward.⁴⁸

⁴⁷ Economists recognize that substantial progress in driving prices toward forward-looking costs eliminates a disproportionate amount of economic distortion. See, e.g., F. M. SCHERER AND DAVID ROSS, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 662 (1990) (observing that dead weight welfare loss "rises as a quadratic function of the relative price distortion").

⁴⁸ *Local Competition Order*, 11 FCC Rcd at 15846, ¶ 678.

46. In addition, even assuming that accurate forward-looking cost models were available, we are concerned that any attempt to move immediately to competitive prices for the remaining services would require dramatic cuts in access charges for some carriers. Such an action could result in a substantial decrease in revenue for incumbent LECs, which could prove highly disruptive to business operations, even when new explicit universal support mechanisms are taken into account. Moreover, lacking the tools for making accurate prescriptions, precipitous action could lead to significant errors in the level of access charge reductions necessary to reach competitive levels. That would further impede the development of competition in the local markets and disrupt existing services. Consequently, we strongly prefer to rely on the competitive pressures unleashed by the 1996 Act to make the necessary reductions.

47. To the extent that some commenters contend that the immediate elimination of all implicit subsidies is mandated by the 1996 Act, we disagree. Neither in the 1996 Act nor its legislative history did Congress state that all forms of implicit universal service support shall be made explicit by May 8, 1997. To the contrary, Congress stated that the conversion of implicit subsidies to explicit support is a goal that "should be" pursued "[t]o the extent possible."⁴⁹ Congress most certainly did not state that we must reach that goal by May 8, 1997. Rather, it directed that, by that date, we issue rules that "shall include a definition of the services that are supported by Federal universal service support mechanisms and a specific timetable for implementation."⁵⁰ Our companion order satisfies that timetable, and this Order establishes a process that will eliminate some implicit subsidies quickly and more gradually eliminate others.

48. We are confident that the pro-competitive regime created by the Act and implemented in the *Local Competition Order* and numerous state decisions will generate workable competition over the next several years in many cases, and we would then expect that access price levels to be driven to competitive levels. We also recognize, however, that competition may develop at different rates in different places and that some services may prove resistant to competition. Where competition has not emerged, we reserve the right to adjust rates in the future to bring them into line with forward-looking costs. To assist us in that effort, we will require price cap LECs to submit forward-looking cost studies of their services no later than February 8, 2001, and sooner if we determine that competition is not developing sufficiently for the market-based approach to work. We anticipate that the tools needed to complete these cost studies will be available soon, well before this deadline. Indeed, our *Universal Service Order* requires comparable cost models to be ready by 1998. We will then review competitive conditions and the submitted cost studies.

49. As we acknowledged in the NPRM, a market-based approach will permit and, indeed, require us progressively to deregulate the access charge regime as competition develops. In a subsequent order, we will examine specific issues concerning the timing and degrees of pricing

⁴⁹ 47 U.S.C. § 254(e); Joint Explanatory Statement at 131.

⁵⁰ 47 U.S.C. § 254(a)(2).

flexibility. That order will identify the competitive triggers that must be met to justify relaxation of specific regulatory constraints. We also recognize the need to examine whether incumbent LECs should be compensated for any historical costs that they have no reasonable opportunity to recover as a result of the transformation from a regulated to competitive marketplace. We recognize that this issue may raise difficult questions of both law and equity, and we intend to respond fully to concerns about historical cost recovery in a subsequent order to be issued this year.

50. Finally, we adopt in this Order our earlier tentative conclusion that incumbent LECs may not assess interstate access charges on information service providers (ISPs). We find that our existing policy promotes the development of the information services industry, advances the goals of the 1996 Act, and creates significant benefits for the economy and the American people. With respect to second and additional residential lines, which are often used by consumers to access ISPs, our goal is to move towards price levels and structures that reflect underlying costs, and thereby to create a neutral market environment in which these lines neither give nor receive subsidies. We will address fundamental questions concerning ISP usage of the public switched network as part of a broader set of issues under review in a related *Notice of Inquiry*.⁵¹

51. Section II of this Order provides an overview of the rate structure adjustments adopted today. Section III offers detailed explanations of these changes, which include adjustments to the rate structure for the common line, local switching, transport, SS7, and switching, and modifications to the TIC. In Section IV, we adopt a market-based approach to reducing access charges and address several specific rate level adjustments. In Section V, we determine which of the changes adopted in this Order should apply to rate-of-return LECs.

52. Section VI touches upon several additional issues, including the applicability of access charges to unbundled network elements, our treatment of terminating access, and ISPs. We also discuss modifications that may be needed to reconcile our access charge rules with the *Universal Service Order* released today. In Section VII, we issue an FNPRM to seek comment on proposals to alter the current allocation of GSF costs and to allow incumbent LECs to impose a PICC on special access lines.

II. SUMMARY OF RATE STRUCTURE CHANGES AND TRANSITIONS

53. In rationalizing the switched access rate structure in this Order, our primary goal is to ensure that traffic-sensitive costs are recovered through traffic-sensitive charges and NTS costs are recovered through flat-rated charges, wherever appropriate. Because many NTS costs are currently recovered through per-minute charges, the principal effect of our Order is to reduce the amount recovered through per-minute interstate access charges and increase the amounts recovered through flat-rated charges. We phase in these changes over time to ameliorate any

⁵¹ See Usage of the Public Switched Network by Information Service and Internet Access Providers, CC Docket No. 96-263, Notice of Inquiry, FCC 96-488 (rel. Dec. 24, 1996).

disruptions these adjustments might cause end users.

A. Common Line Rate Structure Changes

54. Because the cost of using the incumbent LEC's common line does not increase with usage, the costs should be recovered through flat non-traffic-sensitive fees. In this Order we increase the amount of common line revenues recovered through flat-rated charges over time until incumbent LECs can recover all of their interstate common lines revenues through NTS fees.

55. *Primary Residential and Single-Line Business Lines.* We agree with the Federal-State Joint Board on Universal Service that the SLC ceiling for primary residential and single-line business lines should not be increased, because a higher SLC could make telecommunications service unaffordable for some consumers. To the extent common line revenues cannot be recovered through the customer's existing SLC, we conclude that LECs should recover these revenues through a flat, per-line charge (the "primary interexchange carrier charge" or "PICC") assessed, not on the end user, but on the end user's presubscribed interexchange carrier.⁵² We set a ceiling on the PICC at the level of existing per-line charges for the first year.

56. In order to give IXCs an opportunity to adjust to the new charge, we gradually increase the PICC ceiling over the next several years until it reaches a level that permits full recovery of common line revenues -- plus a portion of "residual TIC" revenues. To the extent that the ceiling on the primary residential and single-line business PICC does not allow for full recovery of these common line revenues immediately, the remaining revenues will be recovered through a PICC imposed upon non-primary residential and multi-line business lines, and through per-minute charges.

57. As the PICC ceiling for primary residential and single-line business lines increases, the amount of common line revenues transferred to non-primary residential and multi-line business lines will fall to zero. At that point, all common line costs for primary residential and single-line business lines will be recovered through flat-charges on those lines.

58. *Non-Primary Residential and Multi-Line Business Lines.* Because affordability concerns are not as significant for these lines, we permit a modest increase in the SLC to permit recovery of the price cap LEC's average per-line common line revenues, but never to more than \$3.00 above the SLC ceiling for multi-line business lines today, adjusted for inflation. To ameliorate the impact that an increase in the SLC might have on residential customers, the increase in the SLC ceiling will be phased in for non-primary residential lines over several years.

59. We also establish a flat-rated PICC on non-primary residential and multi-line business lines. This PICC will cover common line revenues that exceed the ceilings on SLCs and primary

⁵² Where an end user does not select a presubscribed interexchange carrier, we allow a price cap LEC to collect this charge directly from the end user.

residential PICCs.⁵³ We set a ceiling on this PICC in the first year of \$1.50 for non-primary residential lines and \$2.75 for multi-line business lines, and permit those ceilings to increase gradually thereafter. We anticipate that the actual PICC imposed upon multi-line business lines will, on average, decrease from 1998 to 1999, and for every year thereafter, and will fall to less than \$1.00 by 2001.

60. To the extent that the ceilings on SLCs and PICCs do not allow recovery through flat charges of all common line revenues, LECs shall be permitted to impose a per-minute CCL charge assessed on originating minutes.⁵⁴ As the PICC cap for non-primary residential and multi-line business lines increases -- and as revenues transferred from primary residential and single-line businesses fall to zero -- the per-minute CCL charge will fall to zero, too. Eventually, we anticipate that most, if not all, price cap LECs will be able to recover the full per-line revenues associated with non-primary residential and multi-line business lines through the SLC, after taking into account the assistance provided through the explicit high-cost universal service support mechanisms. In addition, residual TIC revenues will also be recovered through the PICC on non-primary residential and multi-line business lines. As described more fully below, to the extent that the PICC ceilings prevent full recovery of the residual TIC, the remaining amount will be recovered through a per-minute residual TIC.

B. Other Rate Structure Changes

61. *Switching.* The traffic-sensitive costs of local switching will continue to be recovered through per-minute local switching charges.

62. For price cap LECs, the NTS costs associated with line ports will no longer be included in the local switching charge, and instead will be recovered through the flat-rated common line charges discussed above. Price cap LECs will also assess a monthly flat-rated charge directly on end users that are subscribing to integrated services digital network services, digital subscriber line, or other services that have higher line port costs than basic, analog service. This charge recovers the amount by which the cost of the line port exceeds the cost of a line port for basic, analog service. Costs of local switching attributable to trunk ports are moved to a separate service category within the traffic-sensitive basket. These costs will be recovered through flat-rated monthly charges collected from users of dedicated trunk ports and per-minute, traffic-sensitive charges assessed on users of shared trunk ports. The new rate structure also includes an optional call set-up charge.

63. *Transport.* Effective July 1, 1998, the unitary rate structure option for tandem-

⁵³ It may also recover some residual TIC revenues and certain marketing expenses, as discussed below.

⁵⁴ To the extent that the sum of a LEC's originating local switching charge and any residual per-minute CCL, TIC, and marketing expense (see section IV.D) charges exceeds the sum of its originating local switching, CCL, and TIC charges on December 31, 1997, the excess shall be collected through a per-minute charge on terminating access. We expect that this will only apply to a few LECs, and to none beyond 1998.

switched transmission is eliminated and the costs of tandem-switched transmission must be recovered through the existing three-part rate structure. For price cap LECs, a new flat-rated monthly charge recovers the NTS costs of tandem switching attributable to dedicated ports. A new per-minute rate element recovers the costs of multiplexers used between tandem switch DS-1 port interfaces and the DS-3 circuits used to transport traffic from tandem to end offices. For all incumbent LECs, the formula used to compute the tandem-switched transport rate is based on actual usage of the circuit, rather than an assumed 9000 minutes of use per month.

64. For all incumbent LECs, certain costs currently recovered through the TIC are reassigned to specified facilities charges, including tandem-switching rates. For price cap LECs, those costs of the TIC that remain (the "residual TIC") are recovered through the PICC. To the extent that the PICC ceiling prevents recovery of the entire residual TIC through the flat-rated PICC, the remaining portion will be collected through a per-minute residual TIC. As the ceilings on the PICCs increase, a larger percentage of the residual TIC will be recovered through the PICC. Beginning in July 1997, price cap reductions will be targeted to the per-minute residual TIC until it is eliminated. We expect that the per-minute TIC charge will be eliminated in two to three years. Residual per-minute TICs shall be assessed only on incumbent LEC transport customers, and therefore shall no longer be assessed on competitive access providers (CAPs) that interconnect with the LEC switched network at the end office.

65. *SS7 Signalling*. Price cap LECs may, but are not required to, adopt a rate structure for SS7 signalling that unbundles SS7 signalling functions, as was permitted in the *Ameritech SS7 Waiver Order*.⁵⁵

66. *Retail Marketing Expense*. Price cap LECs may no longer recover certain marketing expenses through per-minute access charges assessed on IXCs. These expenses are recovered from end users through per-line charges on second and additional residential lines and multi-line business lines, subject to ceilings on SLCs. Any residual shall be recovered through the PICCs on these lines and then through per-minute charges on originating access, subject to the exception described in Section III.A, below.

III. RATE STRUCTURE MODIFICATIONS

A. Common Line

1. Overview

67. In the 1983 *Access Charge Order*, the Commission established a comprehensive mechanism for incumbent LECs to recover the costs associated with their provision of access

⁵⁵ Ameritech Operating Companies Petition for Waiver of Part 69 of the Commission's Rules to Establish Unbundled Rate Elements for SS7 Signalling, Order, 11 FCC Rcd 3839 (1996) (*Ameritech SS7 Waiver Order*).

service required to complete interstate and foreign telecommunications.⁵⁶ The access plan distinguished between traffic sensitive costs and NTS costs incurred by an incumbent LEC to provide interstate access service. An incumbent LEC's NTS costs of providing interstate access, or costs that do not vary with the amount of usage, include the common line, or "local loop," which connects an end user's home or business to a LEC central office.⁵⁷

68. In the *Access Charge Order*, the Commission emphasized that its long range goal was to have incumbent LECs recover a large share of the NTS common line costs from end users instead of carriers, and to recover these costs on a flat-rated, rather than on a usage-sensitive, basis.⁵⁸ The Commission recognized, however, that a sudden increase in the flat rates imposed by LECs on end users could have a detrimental effect on universal service. For this reason, the rules adopted in 1983 apportioned charges for common line costs between a monthly flat-rated end-user SLC and a per-minute CCL charge assessed to the IXCs. The SLC is based on average interstate-allocated common line costs, which the incumbent LEC may average over an entire region or over a study area,⁵⁹ depending on how it files its interstate tariff. These charges currently are the lesser of the per-line average common line costs allocated to the interstate jurisdiction or \$3.50 per month for residential and single-line business users, and \$6.00 per month for multi-line business users.⁶⁰ Any remaining common line revenues permitted under our price cap rules are recovered by incumbent price cap LECs through per-minute CCL charges assessed on the IXCs, and are ultimately recovered by IXCs from end-users through long distance toll

⁵⁶ MTS and WATS Market Structure, CC Docket No. 78-72, Third Report and Order, 93 F.C.C. 2d 241 (1983) (*Access Charge Order*), modified, 97 F.C.C. 2d 682 (1983) (*Reconsideration Order*), further modified, 92 F.C.C. 2d 834 (1984) (*Second Reconsideration Order*), aff'd in principal part and remanded in part sub nom. *NARUC v. FCC*, 737 F.2d 1095 (D.C. Cir. 1984), cert. denied, 469 U.S. 1227 (1985).

⁵⁷ See, e.g., *Access Charge Order*, 93 FCC 2d at 268-69.

⁵⁸ *Id.* at 268-269.

⁵⁹ A "study area" is usually an incumbent LEC's existing service area in a given state. The study area boundaries are fixed as of November 15, 1984. *MTS and WATS Market Structure: Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board, Decision and Order*, 50 Fed. Reg. 939 (1985 *Lifeline Order*).

⁶⁰ Revenues permitted under our price cap rules for common line services may be significantly different from the interstate allocated costs assigned to the common line access element by our Part 36 and Part 69 cost allocation rules. For each price cap basket, the rates allowed are determined based on price cap formulas, without reference to interstate allocation of costs. We measure the earnings of price cap carriers by comparing revenues to interstate allocated costs. See 47 C.F.R. §§ 61.45(c), 65.702, & 69.104. The data indicate that only two study areas served by price cap LECs, (Bell Atlantic in the District of Columbia, and GTE in Minnesota) have interstate-allocated common line costs that are less than the current \$3.50 SLC. These two study areas represent less than two percent of subscriber lines nationwide. See Supporting Material filed with 1996 Annual Access Tariff Filing, filed with Commission on April 2, 1996. (1996 LEC Annual Access Tariff Forecast Data.) This LEC forecast data were used by LECs to set SLC rates that became effective on July 1, 1996.

charges.⁶¹

69. Because common line and other NTS costs do not increase with each additional minute of use transmitted over the loop, the current per-minute CCL charge that recovers loop costs represents an economically inefficient cost-recovery mechanism and implicit subsidy. A rate structure that recovers NTS costs through per-minute charges creates an incentive for customers to underutilize the loop by requiring them to pay usage rates that significantly exceed the incremental cost of using the loop. Additionally, a rate structure that forces high-volume customers to pay significantly more than the cost of the facilities used to service them is not sustainable in a competitive environment because high-volume customers can migrate to a competitive LEC able to offer an efficient combination of flat and per-minute charges, even if the competitive LEC has the same or higher costs than the incumbent LEC.

70. The Federal-State Universal Service Joint Board stated, in its *Recommended Decision*, that primary residential and single-line business lines are essential to the provision of universal service,⁶² and that current rates for local services are generally affordable based on subscribership levels.⁶³ The Joint Board also concluded that the SLC, as a charge assessed directly on local telephone subscribers, has an impact on universal service concerns such as affordability,⁶⁴ and recommended that the Commission leave the current SLC ceilings in place for primary residential and single-line business lines.⁶⁵ In our companion *Universal Service Order*, consistent with that recommendation, we conclude that we should not raise the current \$3.50 SLC ceiling on primary residential and single-line business lines.⁶⁶

71. We adjust the SLC ceilings for multi-line business lines and residential lines beyond the primary connection. Adjusting the SLC ceilings for multi-line business lines and non-primary

⁶¹ The data indicate that incumbent price cap LECs recover approximately 10.4 billion dollars in total common line revenue. Approximately \$7 billion of the common line costs are recovered through the SLC, and approximately \$3.4 billion are recovered through the CCL charge. Thus, incumbent price cap LECs recover approximately one-third of their common line costs through per-minute CCL charges. *1996 LEC Annual Access Tariff Forecast Data*.

⁶² Federal-State Joint Board on Universal Service, CC Docket No. 96-45, Recommended Decision, 12 FCC Rcd 87, 132-133 (rel. Nov. 8, 1996) (*Joint Board Recommended Decision*).

⁶³ *Id.* at 154. The Joint board noted that "[s]ubscribership levels, while not dispositive on the issue of affordability, provide an objective criterion to assess the overall success of state and federal universal service policies in maintaining affordable rates." *Id.*

⁶⁴ *Id.* at 472.

⁶⁵ *Id.* at 463. See also Separate Statement of FCC Commissioner Rachelle B. Chong, (dissenting from the Joint Board's recommendation that the Commission should lower the SLC for primary residential and single-line business lines). *Id.* at 556.

⁶⁶ *Universal Service Order*, Section XII.C.

residential lines will permit incumbent LECs to recover directly from end users more of the common line revenues permitted under our price cap rules for those lines and will reduce the amount of NTS costs related to these lines that are currently recovered through CCL charges. Where the SLC ceilings do not allow the incumbent LEC to recover its price cap common line revenues through end-user charges, the remaining, or "residual" amount will be recovered through flat, per-line charges assessed to each customer's presubscribed interexchange carrier. This presubscribed interexchange carrier charge, or "PICC", will increase gradually until the incumbent price cap LECs' full interstate-allocated common line revenues permitted under our price cap rules are recovered through a combination of flat-rated SLCs and PICCs. To the extent that the flat-rated charges do not recover, during the initial phase, the full interstate-allocated common line revenues permitted under our price cap rules, incumbent LECs may continue to assess the IXCs a per-minute CCL charge based on the costs not recovered through flat-rated charges. This per-minute charge, however, will be generally much lower than today's CCL charge and will be eliminated once all common line revenues are recovered through a combination of SLCs and PICCs.

2. Subscriber Line Charge

a. Background

72. In the NPRM, we proposed to increase the ceiling on the SLC for second and additional lines for residential customers, and for all lines for multi-line business customers, to the per-line loop costs assigned to the interstate jurisdiction.⁶⁷ Alternatively, we proposed to eliminate the ceiling for multi-line business customers and for residential connections beyond the primary connection, especially where the incumbent LEC has entered into interconnection agreements and taken other steps to lower barriers to actual or potential local competition.⁶⁸ We sought comment on these proposals.⁶⁹ We also invited parties to comment on whether any changes that we adopt to the ceiling on SLCs for incumbent price cap LECs should be extended to incumbent rate-of-return LECs, and on the relationship of any such changes to the *Joint Board Recommended Decision*.⁷⁰ We sought comment on whether to establish a transition mechanism for this increase if the ceilings on SLCs for multi-line business lines and residential lines beyond the primary connection are increased and whether such a transition could be implemented consistent with

⁶⁷ NPRM at ¶ 65.

⁶⁸ *Id.*

⁶⁹ NPRM at ¶ 65.

⁷⁰ *Id.*

section 254, the Act's universal service provision.⁷¹ We sought comment on whether geographic averaging of SLCs is an implicit subsidy that is inconsistent with the requirements of section 254(e), and thus on whether we are required to deaverage SLCs.⁷²

b. Discussion

73. The Commission has had the longstanding goal of ensuring that all consumers have affordable access to telecommunications services.⁷³ In its *Recommended Decision*, the Joint Board stated that current rates for local telephone services are generally affordable and that the SLC, as a charge assessed directly on local telephone subscribers, has an impact on universal service concerns such as affordability.⁷⁴ The Joint Board further recommended that the Commission maintain the current SLC ceilings for primary residential and single-line business lines,⁷⁵ and we adopt that recommendation in our companion *Universal Service Order*.⁷⁶ Numerous parties in this proceeding argue that we should raise or eliminate the SLC ceiling on all lines to permit LECs to recover the full interstate allocated costs of the local loop from end-users.⁷⁷ This would increase the average SLC for all residential and single-line business lines from \$3.50 per month to \$6.10 per month.⁷⁸ We conclude that it would be inappropriate to make significant changes to the SLC cap for primary residential and single-line business lines. Primary residential and single-line business lines are central to the provision of universal service. Because of concerns about affordability, and in light of the significant changes that are still underway in this proceeding, in the federal universal service support proceeding, and possible future changes

⁷¹ *Id.* at ¶ 66.

⁷² *Id.* at ¶ 67.

⁷³ *See, e.g.*, MTS and WATS Market Structure, Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board, CC Docket Nos. 78-72, 80-286; Decision and Order, FCC 85-643 (rel. Dec. 27, 1985).

⁷⁴ *Joint Board Recommended Decision*, 12 FCC Rcd at 472.

⁷⁵ *Id.* at 463.

⁷⁶ *Universal Service Order* at Section XII.C.

⁷⁷ *See, e.g.*, GTE Service Corporation (GTE) Comments at 26-29, Reply at 20-21; Southwestern Bell Telephone Company (SWBT) Comments at 37-38; Cincinnati Bell Telephone Company (Cincinnati Bell) Comments at 6-7; AT&T Corporation (AT&T) Comments 51-54, Reply at 25-26; Frontier Corporation (Frontier) Comments at 4, 5-7; Sprint Corporation (Sprint) Comments at 11-15; 50-51; Ad Hoc Telecommunications Users Committee (Ad Hoc) Reply at 4; General Services Administration/United States Department of Defense (GSA/DOD) Comments at 9-11, Reply at 5, 7; Tele-Communications, Inc. (TCI) Comments at 10; Reply at 4-5; Time Warner Communications Holdings, Inc. (Time Warner) Comments at 4-5; WorldCom, Inc. (WorldCom) Comments at 30-31.

⁷⁸ As discussed below, the data indicate that nationwide, the average interstate allocation of common line costs is \$6.10 per line. *1996 LEC Annual Access Tariff Forecast Data*.

to the separations process, we conclude that the current SLC for these lines should not be raised. Consistent with the Joint Board's recommendation and our conclusion in the *Universal Service Order*, therefore, the ceiling on the SLC for primary residential and single-line business lines will remain at \$3.50 or the permitted price cap common line revenues per line, whichever is less.

74. With regard to multi-line users, the Joint Board suggested in its *Recommended Decision* that universal service support should not be extended to non-primary residential lines and multi-line business lines because it found that cost of service is unlikely to be a factor that would cause multi-line users not to subscribe to telephone service.⁷⁹ Subsequently, the state members of the Joint Board filed a report with the Commission in which they proposed that we retain high cost support for all lines served in high cost study areas during a transition to a forward-looking cost methodology.⁸⁰ Consistent with that proposal, we adopt, in our *Universal Service Order*, a modified version of the existing high-cost support system and continue support for all residential and business connections in areas currently receiving high cost support until at least January 1, 1999.⁸¹ We therefore continue to provide high cost support for non-primary residential and multi-line business lines at this time, by allocating a lower portion of these costs to the intrastate jurisdiction than would otherwise be the case.⁸² In that order, we also express our concern, however, that providing universal service support for non-primary residential and multi-line business lines in high-cost areas may be inconsistent with our long-term universal service goals, and that overly expansive universal service support mechanisms potentially could harm all consumers by increasing the expense of telecommunications services for all.⁸³ We state that we will continue to evaluate the Joint Board's recommendation to limit universal service support to primary residential connections and businesses with single connections.⁸⁴

75. We conclude here that it is necessary to adjust the ceilings on the interstate SLCs on both non-primary residential and multi-line business lines in order to create a rate structure that supports our long-term universal service goals, is pro-competitive, and is sustainable in a competitive local exchange market. Section 254 of the Act requires that all consumers have access to basic telephone service at just, reasonable, and affordable rates that are comparable

⁷⁹ *Joint Board Recommended Decision*, 12 FCC Rcd 87 at 133.

⁸⁰ State Members Report on the Use of Cost Proxy Models at 3 (dated Mar. 26, 1997).

⁸¹ *Universal Service Order* at Section IV.D and VII.D.

⁸² *Universal Service Order* at Section VII.D.

⁸³ *Universal Service Order* at Section IV.D.

⁸⁴ *Universal Service Order* at Section IV.D.

among different regions of the nation.⁸⁵ This section of the Act also requires that universal service support be achieved through support mechanisms that are "specific, predictable, and sufficient."⁸⁶ Because universal service concerns about ensuring affordable access to basic telephone services are not as great for non-primary residential and multi-line business lines as they are for primary residential and single-line business lines, we must take action to remove the implicit subsidies contained in our current interstate access charges. Thus, we are adopting a rate structure that will permit LECs to recover greater amounts of their costs on a flat-rated basis from end users and to reduce the amount of revenues they must recover through per-minute access charges. Our initial implementation improves upon the current rate structure because it reduces subsidies by recovering more costs from the cost causer. It also creates a rate structure that is more pro-competitive than the existing one by providing for greater flat-rated recovery of NTS costs. Without these modifications, new entrants, which are not subject to the non-cost-causative rate structure requirements, would be in a position to target the incumbent LECs' most profitable, high-volume customers based on regulatory requirements. A loss of profitable customers would increase the incumbent LECs' costs of providing service to the rest of their customers, especially to those in high-cost areas. Consistent with our universal service goal of ensuring that all consumers receive affordable rates that are comparable in different parts of the nation, however, the SLC adjustments will be subject to ceilings to prevent end-user customers in high-cost areas from paying SLCs that are significantly higher than in other parts of the country.

76. In virtually all cases, current SLC ceilings do not permit incumbent LECs to recover their average per-line interstate-allocated common line costs.⁸⁷ As a result of the existing SLC ceilings, which have been in place for the past decade, incumbent LECs must recover the shortfall through usage-sensitive CCL charges assessed on IXCs. The IXCs in turn recover most or all of these costs from toll users in the form of per-minute charges, keeping toll rates artificially high and discouraging demand for interstate long distance services. The high per-minute toll charges also create support flows between different classes of customers. For example, because end-user customers vary widely in their use of interstate long distance services, low-volume toll users do not pay the full cost of their loops while high-volume toll users contribute far more than the total cost of their loops. In addition high-volume toll users, who include significant numbers of low-income customers, effectively support non-primary residential and multi-line business customers.⁸⁸

⁸⁵ 47 U.S.C. § 254(b)(3).

⁸⁶ 47 U.S.C. § 254(b)(5).

⁸⁷ The data indicate that only two study areas served by price cap LECs, (Bell Atlantic in the District of Columbia, and GTE in Minnesota) have interstate-allocated common line costs that are less than the current \$3.50 SLC. These two study areas represent less than two percent of subscriber lines nationwide. *See 1996 LEC Annual Access Tariff Forecast Data.*

⁸⁸ *See* Robert W. Crandall, *Universal Service Subsidies and Consumer Welfare: Long-distance Access Charges*, Brookings Institution (April, 1997), Table 1, (showing that roughly 30 percent of households with income under \$10,000 spend more on long-distance calls than do 50 percent of the households with income over \$75,000).

77. In order to create a rate structure that supports our long-term universal service goals, is pro-competitive, and is sustainable in a competitive market, we modify our rate structure requirements to permit incumbent LECs to recover costs in a manner that more accurately reflects the way those costs are incurred. Because common line costs do not vary with usage, these costs should be recovered on a flat-rated instead of on a per-minute basis. In addition, these costs should be assigned, where possible, to those customers who benefit from the services provided by the local loop. Accordingly, the SLC ceilings for non-primary residential and multi-line business lines will be adjusted generally to a level that permits incumbent LECs to recover, directly from the end user, their average per-line interstate common line revenues.⁸⁹

78. For multi-line business lines, the SLC will be adjusted to recover the average per-line interstate-allocated common line costs beginning July 1, 1997. To the extent incumbent price cap LECs, mostly in rural areas, have common line costs that significantly exceed the national average, we establish a ceiling on SLCs for multi-line business lines of \$9.00, adjusted annually for inflation. To ameliorate any possible adverse impact of adjustments in SLC ceilings for non-primary residential lines, we adopt an approach that will gradually phase in adjustments in the SLC ceilings for these lines. The SLC for non-primary residential lines will be adjusted initially beginning January 1, 1998. For the first year, beginning January 1, 1998, the SLC ceiling for non-primary residential lines will be adjusted to the incumbent LEC's average per-line interstate-allocated costs, but may not exceed \$1.50 more than the current SLC ceiling. Beginning January 1, 1999, the monthly SLC ceiling for these lines will be adjusted for inflation and will increase annually by \$1.00 per-line, until the SLC ceiling for non-primary residential lines is equal to the ceiling permitted for multi-line business lines.

79. The data indicate that the long term ceilings we are establishing will permit incumbent price cap LECs to recover their average per-line common line revenues⁹⁰ from 99 percent of their non-primary residential and multi-line business lines.⁹¹ For the few incumbent price cap LECs that have common line costs in certain study areas that exceed the ceiling, the ceiling will serve as an economic safeguard for those customers who would otherwise pay significantly higher SLCs.⁹² We conclude that maintaining a ceiling for non-primary residential and multi-line business

⁸⁹ As discussed in Section IV.D, below, in addition to the average per-line interstate-allocated common line costs, price cap LECs may include, in the SLC for non-primary residential and multi-line business lines, certain marketing expenses attributable to these lines.

⁹⁰ As discussed in Section III.A.3. below, when the multi-line PICC no longer recovers common line revenues, the calculation of the SLC will be changed from one based on interstate allocated *costs* to one based on common line *revenues* permitted under our price cap rules.

⁹¹ See 1996 LEC Annual Access Tariff Forecast Data.

⁹² The data indicate that twelve study areas served by three price cap LECs (GTE, U S West, and Citizens Utilities) have average common line costs that exceed \$9.00. These areas represent less than two percent of subscriber lines nationwide. See 1996 LEC Annual Access Tariff Forecast Data.

customers in high-cost areas is a reasonable response to a legitimate universal service concern because, consistent with section 254(b)(3), it ensures that these customers have access to telecommunication services at rates that are comparable to rates charged for similar services in urban areas.⁹³

80. We believe that the approach we adopt should prevent widespread discontinuance of lines by multi-line customers. The record indicates that nationwide, the average interstate allocation of common line costs is only \$6.10 per line, and that for more than half of multi-line business lines, the interstate common line costs are below the existing \$6.00 ceiling.⁹⁴ Therefore, when the SLC ceiling is adjusted July 1, 1997, more than half of multi-line business lines will see no immediate increase in their SLC. The \$5.00 SLC ceiling for non-primary residential lines for the first year is a net increase of \$1.50 per month and the gradual increase, if any, in subsequent years, is designed to allow these customers time to adjust to the new rate structure. Moreover, we expect the rate structure modifications we adopt in this order to benefit the majority of multi-line customers through reductions in per-minute long distance rates. Thus, for many customers, the access restructuring will lead to an overall reduction in their telephone bill. We also note that, because we are adjusting the SLC on non-primary residential lines only to a level that recovers the average interstate allocated costs attributable to the line, to the extent that a customer chooses not to purchase an additional line because of the SLC increase, it is because the benefits of the second line to that customer are less than the average cost of the line.

81. Many parties contend that adjusting the SLC ceiling for non-primary residential lines and multi-line business lines will affect economic development in rural areas.⁹⁵ To respond to this concern, with the limited exception of cost allocation to new elements, discussed in Section V, below, we are limiting application of the rate structure modifications we adopt in this Order to incumbent price cap LECs only. Most consumers in rural areas are served by small rate-of-return LECs that are not affected by the SLC adjustment we are adopting. We will review rate structure modifications affecting small, rural carriers in a separate proceeding when we address access charge reform for those carriers. To the extent there are incumbent price cap LECs that serve high-cost areas of the country and have common line costs that exceed the national average, we are maintaining a ceiling on the SLCs for these lines to ensure that subscribers do not pay rates

⁹³ 47 U.S.C. § 254(b)(3).

⁹⁴ See *1996 LEC Annual Access Tariff Forecast Data*.

⁹⁵ See, e.g., Harris, Skrivan & Associates, LLC (Harris, Skrivan & Associates) Comments at 6; TCA-Inc.-Telecommunications Consultants (TCA) Comments at 4; GVNW Inc./Management (GVNW) Comments at 7; John Staurulakis, Inc. (Staurulakis) Comments at 7-9; Western Alliance Comments at 22-24; ITCs, Inc. (ITC) Comments at 3; National Exchange Carrier Association, Inc. (NECA) Comments at 13, Reply at 7-9; Rural Telephone Coalition (Rural Tel. Coalition) Comments at 8; Pennsylvania Internet Service Providers Comments at 8-9; Commercial Internet Exchange Association (CIEA) Comments at 13; Reply at 10.

that greatly exceed the national average.⁹⁶

82. We are not persuaded by arguments that an upward adjustment to a SLC ceiling that was set over a decade ago, and that has never been adjusted for inflation, would violate section 254(b)'s requirement that consumers in all regions of the nation have affordable access to telecommunications and information services at rates that are reasonably comparable to those services provided in urban areas.⁹⁷ The data indicate that if the SLC ceilings for business and residential lines had been adjusted annually for inflation since they became effective in 1984 and 1989, respectively, the \$6.00 business SLC ceiling would have increased by 1996 to \$9.00 per line, and the \$3.50 residential and single-line business SLC ceiling would have increased to \$4.39 per line.⁹⁸ Thus, for multi-line business customers, the SLC ceiling we adopt today is not significantly different from what it would have been, if it had been adjusted for inflation annually. Moreover, to adopt a ceiling lower than \$9.00 would effectively create an additional impermissible subsidy for a class of customers not enumerated by Congress in section 254 of the 1996 Act as beneficiaries of fundamental universal service goals. We find that the \$9.00 ceiling we adopt today strikes a reasonable balance between our desire to establish a more efficient interstate access charge rate structure consistent with our long-term universal service goals in a competitive local exchange environment, and the need to avoid precipitous rate increases to consumers in high cost areas. Although SLCs in some areas may ultimately be lower than SLCs in high-cost areas, we conclude that \$9.00 SLCs remain "reasonably comparable" to those in urban areas.⁹⁹

83. We are also not persuaded that we should maintain the current SLC ceiling for non-primary residential lines because of claims that incumbent LECs will be unable to identify second lines for purposes of billing different SLCs to these lines. Additional telephone lines are a well-established telecommunications product marketed by LECs. This product is supported by a marketing and billing infrastructure that will enable LECs to distinguish non-primary residential lines for purposes of billing different SLCs. We note that we are not defining "primary" or "non-primary" lines in this Order. In a further notice of proposed rulemaking in the Universal Service proceeding, we will address this issue, and release an order defining "primary" and "non-primary"

⁹⁶ We will address access charge modifications as they apply to rate-of-return rural LECs in proceeding later this year. See Section V.A, below.

⁹⁷ See, e.g., ITC Comments at 3; Rural Tel. Coalition Comments at 8, Reply at 11; TDS Telecommunications Corporation (TDS) Comments at 3-4, Reply at 4; Western Alliance Comments at 23; TCA Comments at 3-4.

⁹⁸ Calculations are based on Consumer Price Index for "All Items," *Trends in Telephone Service*, Table 6, (March 28, 1997).

⁹⁹ In Section IV.D, below, we conclude that price cap LECs may recover certain marketing expenses through the SLC on non-primary residential and multi-line business lines. That, however, does not affect the SLC ceilings for these lines.

residential lines by the end of the year.¹⁰⁰

84. We are unpersuaded by arguments that we should forgo these changes on the grounds that increasing the SLC ceilings for non-primary residential lines will create undue incentives for subscribers to order their primary lines from the incumbent LEC and their additional lines from competitors. The changes we adopt in this Order are intended to permit incumbent LECs to move their prices for non-primary residential and multi-line business lines toward more economically efficient levels by substantially reducing implicit subsidies flowing between different classes of customers. Once these subsidies are eliminated and the new universal service regime is fully implemented, incumbent LECs will be able to recover their common line costs from customers through a rate structure that accurately reflects the manner in which these costs are incurred, and through a targeted, portable universal service contribution where necessary. At that point, both incumbent LECs and new entrants should be able to compete efficiently in the local exchange market. Subscribers, therefore, should not have an incentive to use other carriers for their additional lines unless a competitor is operating more efficiently and can offer local exchange service at a lower rate than the incumbent LEC is able to offer. Indeed, the ability of a competitive local exchange carrier to offer local exchange service at a lower rate is precisely the type of competition envisioned by the 1996 Act: it will encourage the incumbent LEC to reduce its costs of providing service in order to meet or beat the prices of its competition.

85. To address the concerns of some commenters that charging a higher SLC for second and additional residential lines will encourage subscribers to order their additional line from competitors, we will permit LECs to charge competitors the higher SLC when the competitor provides a customer with a second line through resale of an incumbent LEC offering. If prior to the development of full competition, we find that disparity between SLC charges on primary and additional residential lines becomes a significant problem, we will reexamine this issue in conjunction with further reforms we adopt in an upcoming order.

86. Certain incumbent LECs have requested that any rule that increases the SLC ceiling for non-primary residential lines should be optional for LECs.¹⁰¹ We adopt this proposal in part and will not require LECs to charge a higher SLC for non-primary residential lines. Thus, if an incumbent LEC finds that charging higher SLCs leads to a large number of disconnections, it is free to charge less. To the extent price cap LECs choose to charge a SLC that is less than the maximum allowed, however, they may not recover these foregone revenues through the PICC or CCL charges. This restriction is consistent with our current price cap rules, which prevent LECs

¹⁰⁰ *Universal Service Order* at Section IV.D.

¹⁰¹ *See, e.g.,* Bell Atlantic Telephone Companies and NYNEX (BA/NYNEX) Comments at 33-34; Pacific Telesis (PacTel) Reply at 22; Citizens Utilities Company (Citizens Utilities) Comments at 28-29.

from transferring SLC costs to the CCL charge.¹⁰²

87. Several incumbent price cap LECs argue in favor of deaveraging SLCs, stating that an averaged SLC creates cross-subsidies between high-cost and low-cost areas, in violation of section 254 of the Act.¹⁰³ We will resolve this issue, along with issues concerning the timing and degrees of geographic deaveraging, pricing flexibility, and ultimate deregulation in an upcoming order.

3. Carrier Common Line Charge

a. Background

88. Because we are retaining the \$3.50 ceiling on SLCs for primary residential and single-line business customers, virtually all price cap LECs will be unable to recover, through the SLC, all of their common line revenues permitted under our price cap rules. In the NPRM, we sought comment on possible revisions to the current CCL charge structure that would allow incumbent price cap LECs to recover these NTS common line costs in a way that reflects the way costs are incurred. We proposed a recovery mechanism suggested by the Joint Board in its *Recommended Decision*¹⁰⁴ that would permit incumbent LECs to recover common line costs not recovered from SLCs through a flat, per-line charge assessed against each end-user's presubscribed interexchange carrier.¹⁰⁵ The Joint Board suggested that the Commission allow incumbent LECs to collect the flat-rated charge directly from end users who have not selected a primary interexchange carrier ("PIC.")¹⁰⁶ We sought comments on this approach and also invited parties to discuss any potential problems created when end-user customers have selected PICs, but use other IXC for Internet, fax, interexchange, or other interstate services by "dialing-around" the PIC.¹⁰⁷

89. We also sought comment on several alternative approaches to the per-minute recovery of interstate NTS loop costs proposed by the Competition Policy Institute (CPI), including a "bulk billing" method that would assess a charge against the IXC based upon its

¹⁰² 47 C.F.R. § 69.104.

¹⁰³ See, e.g., U S West Comments at 56; Ameritech Comments at 12-13; BellSouth Comments at 32; GTE Comments at 30-31.

¹⁰⁴ *Joint Board Recommended Decision*, 12 FCC Rcd at 474.

¹⁰⁵ NPRM at ¶¶ 59-63.

¹⁰⁶ *Joint Board Recommended Decision*, 12 FCC Rcd 87 at 474.

¹⁰⁷ NPRM at ¶ 60. Customers are able to "dial-around" their presubscribed interexchange carrier by dialing 10XXX before their area code and 7-digit exchange number.

percentage share of interstate minutes of use or revenues, a "capacity charge," a "trunk port charge," and a "trunk port and line port" charge.¹⁰⁸ We invited parties to comment on whether any changes that we adopt to the recovery of interstate NTS local loop costs for price cap LECs should be extended to rate-of-return LECs, and on the relationship of interstate NTS loop cost recovery to the universal service mechanisms proposed in the *Joint Board Recommended Decision*. We asked parties to address how such an extension to rate-of-return LECs would affect small business entities, especially small incumbent LECs.¹⁰⁹

90. Additionally, we asked parties to address whether an alternative mechanism for recovering common line costs currently recovered through the CCL charge would be necessary if we were to eliminate the SLC ceiling for certain lines. We asked interested parties to address the extent to which any proposed alternative recovery mechanism for recovering common line costs currently recovered through the CCL charge would affect small business entities, including small incumbent price cap LECs and new entrants. We also sought comment on whether section 254(g) precludes an IXC from charging its customers the flat, per-line monthly rate assessed on that line if the amount of that charge varied among customers in different areas within a state or among customers in different states, and if so, whether conditions exist sufficient to require us to forbear from the application of section 254(g) to IXC recovery of flat-rate CCL charges.¹¹⁰

b. Discussion

91. The \$3.50 SLC ceiling for primary residential and single-line business customers prevents most incumbent price cap LECs from recovering, through end-user charges, all of the common line revenues permitted under our price cap rules.¹¹¹ To the extent that common line revenues are not recovered through SLCs, incumbent LECs will be allowed to recover these revenues through a PICC, a flat, per-line charge assessed on the end-user's presubscribed interexchange carrier.

92. We adopt the Joint Board's recommendation that incumbent LECs may collect directly, from any customer who does not select a presubscribed carrier, the PICC that could otherwise be assessed against the presubscribed interexchange carrier. Assessing the PICC directly against end users that do not presubscribe to a long distance carrier should eliminate the incentive for customers to access long-distance services solely through "dial-around" carriers in order to avoid paying long-distance rates that reflect the PICC. Several parties argue that this

¹⁰⁸ *Id.* at ¶ 61

¹⁰⁹ *Id.*

¹¹⁰ *Id.* at ¶¶ 62-63.

¹¹¹ *See* n.32, above.

type of billing arrangement will create administrative difficulties because it will require LECs to prorate charges for both the end user and the IXC when a customer leaves an IXC in the middle of the billing cycle. To avoid any potential administrative difficulties resulting from customers leaving their presubscribed interexchange carriers in the middle of a billing cycle, we will permit LECs to assess the full PICC at the beginning of each billing cycle.

93. We recognize that this flat, per-line PICC will not prevent customers from "dialing around" their presubscribed long distance carrier to obtain interstate service. Collecting a PICC from a customer, however, in and of itself, creates no incentive for a customer to presubscribe to one carrier and use "dial-around" service of another. If the presubscribed carrier is an efficient competitor, it should be able to offer usage-based rates comparable to the prices of a competitor, thus eliminating any artificial benefits of "dial-around" capability. A combination of lower per-minute long distance rates and attractive long-distance pricing packages that reward customers for increasing their usage of the presubscribed interexchange carrier's services should also help deter customers from using separate long-distance carriers for various services solely because of regulation. There is customer contact value in being a customer's presubscribed interexchange carrier. Regulators have long concluded that the convenience of making a long-distance call by simply dialing "1+" conveys certain advantages.¹¹² And the advantages of "1+" dialing will only increase if, as many predict, we move to a world in which "one-stop shopping" for a multiplicity of services becomes the primary paradigm for provision of telecommunication services. We conclude that the record does not support a finding that assessing a charge on the presubscribed carrier will artificially encourage "dial-around" traffic to such a degree that we should not adopt access charge modifications that will move substantially toward efficient pricing for common line elements and lower usage charges for long-distance service. If evidence appears to us that our rules do substantially contribute to undue use of "dial-around" capabilities to circumvent presubscribed interexchange services, we stand ready to revisit this issue at a later time.

94. The rate structure we are adopting calls for the single-line PICC ultimately to recover the difference between revenues collected through the SLC and the per-line common line revenues for primary residential lines and single-line business lines permitted under our price cap rules.¹¹³ In order to provide incumbent LECs and IXCs with adequate time to adjust to this rate structure change, we cap the PICC for primary residential and single-line business lines at \$0.53 per month for the first year, beginning January 1, 1998, and establish ceilings on increases thereafter. We note that the monthly \$0.53 PICC is approximately equal to the current presubscribed per-line charges that are assessed to IXCs for the Universal Service Fund and

¹¹² See, e.g., *Local Competition Order*, 11 FCC Rcd at 15511.

¹¹³ As discussed in Section III.B, below, line port costs will be reassigned from the local switching rate element to the common line rate element. As discussed in Section III.D, price cap LECs may also recover residual TIC revenues through PICCs.

Lifeline Assistance plan,¹¹⁴ which are being eliminated in our *Universal Service Order*.¹¹⁵ Beginning January 1, 1999, the ceiling on the monthly PICC on primary residential and single-line business lines will be adjusted for inflation and will increase by \$0.50 per year until the sum of the SLC plus the flat-rated PICC is equal to the price cap LEC's permitted common line revenues per line. In no event shall the sum of the single-line SLC and PICC exceed the sum of the maximum allowable multi-line SLC and multi-line PICC.

95. Sprint asserts that if LECs recover NTS common line costs through deaveraged rates assessed on IXCs, we must forbear from applying section 254(g)¹¹⁶ to the extent it requires an IXC to average geographically any flat charges an IXC passes on to its customers.¹¹⁷ WorldCom asserts that IXCs should be permitted to recover their costs in any manner the market will allow, and that unless the Commission forbears with respect to the application of section 254(g) to these costs, IXCs that operate nationally will be forced to average together numerous subscribers' loop costs, and thus use long-distance rates as a vehicle for cross-subsidies that run counter to the overall policies of section 254(b) and (c).¹¹⁸ We conclude that the information in the record before us does not demonstrate that we are required, by section 10(a) of the Act,¹¹⁹ to forbear from enforcing section 254(g) as it relates to the manner in which IXCs recover their costs.

96. Section 10(a) of the 1934 Act requires the Commission to forbear from applying any regulation or provision of the Communications Act of 1934 if: (1) enforcement of that provision is unnecessary to ensure that the relevant charges and practices are just and reasonable and not unjustly or unreasonably discriminatory; (2) enforcement of that provision is unnecessary to protect consumers; and (3) forbearance from applying such provision or regulation is consistent with the public interest.¹²⁰ We conclude that, on the basis of the current record, IXCs have not demonstrated that forbearance of section 254(g) is warranted at this time.

97. We find that establishing a broad exception to section 254(g) to permit IXCs to pass

¹¹⁴ IXCs currently pay \$0.0991 for the Lifeline Assistance and \$0.4380 for the Universal Service Fund, a total of \$0.5371. NECA Transmittal No. 729, F.C.C. Tariff No. 5, (filed Nov. 15, 1996).

¹¹⁵ See *Universal Service Order*, at Sections VII.C and XIII.F.

¹¹⁶ Section 254(g) requires that "rates charged by providers of interexchange telecommunications services to rural and high cost areas shall be no higher than the rates charged by each such provider to its subscribers in urban areas." 47 U.S.C. § 254 (g).

¹¹⁷ See, e.g., Sprint Reply at 27.

¹¹⁸ WorldCom Comments at 34.

¹¹⁹ 47 C.F.R. § 160.

¹²⁰ *Id.*

through flat-rated charges on a deaveraged basis may create a substantial risk that many subscribers in rural and high-cost areas may be charged significantly more than subscribers in other areas. Accordingly, we cannot conclude that enforcing our rate averaging requirement is unnecessary to ensure that charges are just and reasonable. In addition, because assessing subscribers flat-rated charges on a deaveraged basis could lead to significantly higher rates for subscribers in high-cost areas, we find no basis in this record to conclude that it is unnecessary to enforce section 254(g) to ensure protection of consumers or to protect the public interest. In contrast, IXC's cite no countervailing public interest considerations but merely make broad, unsupported assertions of the need to deaverage rates in light of the varying PICC amounts expected to be assessed by incumbent LECs. We also note that IXC's now pay access charges that often vary from location to location and from incumbent LEC to incumbent LEC, and still maintain geographically averaged rates. We therefore conclude that, based on the record before us, the IXC's have not met the test set forth in section 10(a) of the Act, and forbearance of section 254(g) is not warranted.

98. We note that we will continue to examine the issue of whether conditions exist that require us to forbear from application of section 254(g) as it relates to recovery of the PICC costs from subscribers. We will resolve this and other specific issues concerning the timing and degrees of pricing flexibility and ultimate deregulation in an upcoming order.

99. To the extent that the SLC ceilings on all lines and the PICC ceilings on primary residential and single-line business lines prevent recovery of the full common line revenues permitted by our price cap rules, incumbent price cap LECs may recover the shortfall through a flat-rated, per-line PICC on non-primary residential and multi-line business lines.¹²¹ The incumbent LECs will calculate this additional charge by dividing residual permitted common line revenues by the number of non-primary residential and multi-line business lines served by the LEC. For the first year, the ceiling on the PICC will be \$1.50 per month for non-primary residential lines and \$2.75 per month for multi-line business lines. To the extent that these PICCs do not recover an incumbent LEC's remaining permitted CCL revenues, incumbent LECs will be allowed to recover any such residual common line revenues through per-minute CCL charges assessed on originating access minutes. The per-minute charges shall be calculated based on forecasts of originating access minutes as currently provided in our rules.¹²²

100. We generally will not permit incumbent LECs to recover residual common line revenues through per-minute CCL charges assessed on terminating access minutes, because terminating minutes are not likely to be subject to as much competitive pressure as originating

¹²¹ As discussed in Sections III.D and IV.D, price cap LECs may also recover residual TIC revenues and certain marketing expenses through PICCs on non-primary residential and multi-line business lines, subject to the ceilings described below.

¹²² 47 C.F.R. § 69.105.

access minutes. As discussed in Section III.D, below, we are similarly adopting a rule that requires that incumbent LECs be allowed to recover certain residual transport interconnection charge costs through access charges assessed on originating minutes. In placing these various residual costs on originating minutes only, however, we do not want to destroy the salutary effects of our access charge reforms by creating higher prices for originating minutes than exist under our current access charge rules. To the extent, therefore, that the sum of local switching charges, the per-minute CCL charge, the per-minute residual TIC, and any per-minute charges related to marketing expenses¹²³ exceed the current sum of local switching charges and the per-minute CCL charge and TIC assessed on originating minutes, the excess may be recovered through charges assessed on terminating minutes. We emphasize that any such amounts recovered through charges assessed on terminating minutes would be temporary and would be phased out as the non-primary residential SLC ceilings and the PICC ceilings are adjusted, and in any event, no later than July 1, 2000.

101. Beginning January 1, 1999, the PICC will be adjusted for inflation and will increase by a maximum of \$1.00 per year for non-primary residential lines and \$1.50 per year for multi-line business lines, until incumbent LECs recover all their permitted common line revenues through a combination of flat-rated SLC and PICCs. These increases will cease as the PICCs on primary residential and single-line business lines recover more of the common line revenues permitted under price cap rules. In addition, as the incumbent price cap LECs increase their PICCs for primary residential and single-line business lines, they shall reduce the amount recovered from the residual per-minute CCL charges and reduce their PICCs on non-primary residential and multi-line business lines by a corresponding amount in accordance with the procedures described below. While the plan we adopt today does not eliminate, even on a flat-rated basis, transitional higher rates for business users, it redistributes collection from a very few high-volume users to business users generally. This will permit the charges to be sustainable while we finish refining access charges and implement a forward-looking cost-based universal service mechanism for rural, insular, and high cost areas. We also acknowledge that our plan will require customers with multiple telephone lines to contribute, for a limited period, to the recovery of common line costs that incumbent LECs incur to serve single-line customers. We conclude that this aspect of the plan is a reasonable measure to avoid an adverse impact on residential customers.

102. As the PICC ceilings on primary residential and single-line business lines increase, the residual per-minute CCL charge will decrease until it is eliminated. After the residual per-minute CCL is eliminated, incumbent LECs shall make further reductions due to the increase in the PICC ceilings for primary residential and single-line business lines, first to the PICCs on multi-line business lines until the flat-rated PICCs for those lines are equal to the flat-rated PICCs for non-primary residential lines. Thereafter, incumbent LECs shall apply the annual reductions to both classes of customers equally until the combined SLC and PICCs for primary residential and

¹²³ See Section IV.D, below.

single-line business lines recover the full average per-line common line revenues permitted under our price cap rules, and the additional flat-rated PICCs on non-primary residential and multi-line business lines no longer recover common line revenues.¹²⁴ If the incumbent LEC's per-line common line revenues permitted by our price cap rules exceed the SLC ceiling for non-primary residential lines and multi-line businesses, the flat-rated charges will continue to apply to those lines so that the sum of the SLCs and flat-rated charges is equal to the permitted common line revenues. Once the multi-line PICC no longer recovers any common line revenues, the calculation of the SLC will be changed from the average per-line interstate allocation of revenue requirement¹²⁵ to the average per-line common line revenues permitted by our current price cap rules. With this change, the LEC will not be able to recover more than the average per-line common line revenues permitted under our price cap rules from any access line. We note that at least one party contends that under our current rules, certain price cap carriers could be required to charge negative carrier common line charges, if the revenues recovered through the SLC, which continues to be developed on a cost-of-service basis, exceed the PCI for the common line basket.¹²⁶ This adjustment to the calculation of the SLC will solve any such problem.

103. We are concerned that assessing PICCs on multi-line business lines may create an artificial and undue incentive for some multi-line customers to convert from switched access to special access to avoid the multi-line PICC charges. A migration of multi-line customers to special access could significantly reduce the amount of revenue that could be recovered through per-minute charges, and would result in higher PICCs for the non-primary residential and multi-line business lines remaining on the switched network. We tentatively conclude that we should therefore apply PICCs to purchasers of special access lines as well. The NPRM, however, may not have provided sufficient notice to interested parties that we might apply certain rate structure modifications to special access lines. We therefore seek comment on this issue in Section VII.A, below.

104. We reject claims that a flat-rated, per-line recovery mechanism assessed on IXC's would be inconsistent with section 254(b)¹²⁷ which requires "equitable and nondiscriminatory contribution to universal service" by all telecommunications providers.¹²⁸ The PICC is not a

¹²⁴ As discussed in Sections III.D and IV.D, below, the PICC will recover TIC revenues and certain marketing expenses in addition to common line revenues. Therefore, multi-line PICCs may continue to recover non-common line revenues, even though SLCs and PICCs for primary residential and single-line business lines recover the average per-line common line revenues permitted under our price cap rules.

¹²⁵ 47 C.F.R. § 69.104(c)

¹²⁶ See Letter from Albert Shuldiner, Counsel for Aliant Communications Co. to William F. Caton, Acting Secretary, FCC, April 30, 1997.

¹²⁷ 47 U.S.C. § 254(b).

¹²⁸ Sprint Comments at 15-16; AT&T Reply at 28-29.

universal service mechanism, but rather a flat-rated charge that recovers local loop costs in a cost-causative manner. Numerous commenters responding to the NPRM support a flat-rated cost recovery mechanism,¹²⁹ and we conclude that the PICC is preferable to the other proposals made in the NPRM. We agree with MCI and the Minnesota Independent Coalition that proposals based on the number of trunks or ports that an IXC purchases from the incumbent LEC may encourage IXCs to use fewer trunks or ports than are needed and thereby have an adverse effect on service quality. We decline to adopt the bulk billing approach set out in the NPRM, as well as Ameritech's proposed Loop/Port Recovery charge and the approach proposed by the Competition Policy Institute, because these mechanisms are substantially affected by usage and do not reflect the NTS manner in which common line costs are incurred. The Alliance for Public Technology's proposed "facilities charge," which is a hybrid system that accounts both for level of use and intensity of use by all telecommunication carriers that use the local network, is flawed because it is based partly on usage and is complex and administratively burdensome. A cost-recovery mechanism that recovers common line costs through flat-rated charges imposed on end-user customers and IXCs is an administratively simple mechanism. Further, under our plan, interstate common line access charges will become more closely aligned with allocated interstate costs than they would be under any of the alternative proposals.

105. The plan we describe above should move us from the pricing scheme that has been in place for more than a decade to a flat-rated pricing scheme that seeks to promote competition, while balancing universal service considerations. We recognize that the modifications we adopt in this Order do not eliminate all the existing support flows. The modifications, however, do move to eliminate subsidies built into the current rate structure, to an extent that is compatible with preserving the universal service goals of providing support to primary residential and single-line business and to customers in high-cost areas pursuant to the mandate of section 254. As we set final support levels for universal service, address any legal issues related to the transition from embedded to forward-looking economic costs, and factor in the development of competition, we will identify and deal with any remaining legal issues relating to the recovery of these revenues. In addition, the plan we are adopting allows incumbent price cap LECs to recover costs in the manner that reflects the way in which they are incurred. We believe that this realignment of rates with costs will reduce the per-minute access charges assessed on IXCs and benefit consumers through lower long-distance rates, as well as create a pro-competitive local exchange market in

¹²⁹ See, e.g., United States Telephone Association (USTA) Comments at 55-56; BA/NYNEX Comments at 35-36; BellSouth Comments at 68, Reply at 10-11; PacTel Comments at 64, Reply at 21; U S West Comments at 54; Citizens Utilities Comments at 27-28; Roseville Telephone Company (Roseville Tel.) Comments at 4, 8; Rural Tel. Coalition Comments at 6, Reply at 9; Competitive Telecommunications Association (CompTel) Comments at 29; Cable and Wireless, Inc. (Cable & Wireless) Comments at 10; Excel Telecommunications, Inc. (Excel) Comments at 11; LCI International Telecom Corp. (LCI) Comments at 20-21, Reply at 6; MCI Telecommunications Corporation (MCI) Comments at 77; Public Service Commission of the District of Columbia (District of Columbia Commission) Comments at 3-4; South Dakota Public Utilities Commission (South Dakota Commission) Comments at 3; National Association of Regulatory Utility Commissioners (NARUC) Comments at 13; National Cable Telephone Association, Inc. (NCTA) Comments at 26; American Communications Services, Inc. Reply at 17.

which LECs will be able to compete more efficiently.

4. Common Line PCI Formula

a. Background

106. When we adopted price cap regulation in 1990, we established a separate common line basket in order to balance the price cap goal of economically efficient prices with important goals, such as universal service, that were reflected in common line rates prior to the adoption of price caps. Because common line costs are non-traffic sensitive, growth in demand leads to a reduction in average per-minute common line charges. Therefore, in the *LEC Price Cap Order*, we established a price cap index ("PCI") formula for the price cap basket that differed from the PCI formula we established for the other three baskets, to ensure that carrier common line charges declined as common line demand increased.¹³⁰ Specifically, we added a term, "g/2," to the common line PCI formula, to represent half the growth in demand per line in the prior year.¹³¹ This adjustment was made because we originally concluded that both LECs and IXC's have the ability to influence common line growth, and that both LECs and IXC's should benefit from increases in demand.¹³²

107. In the *LEC Price Cap Performance Review*, we found that incumbent LECs in fact have little influence over per-minute common line demand, and tentatively concluded that we should remove the "g" term from the common line formula,¹³³ because including an industry-wide moving average X-Factor in the common line formula might tend to double-count demand growth. We sought comment, in the *Price Cap Fourth Further NPRM*, whether to apply the same PCI formula to the common line basket that we use for the other baskets if we were to adopt a TFP-based X-Factor.¹³⁴ We also invited comment on whether we could eliminate g/2 from the common line formula if we retain a separate common line formula.¹³⁵ In this Order, we adopt a plan that should quickly convert the CCL charge from a per-minute charge to a flat-rated per-line charge assessed on interexchange carriers. We also revise the common line formula to

¹³⁰ *LEC Price Cap Order*, 5 FCC Rcd at 6793, 6795.

¹³¹ *LEC Price Cap Order*, 5 FCC Rcd at 6795. The Commission did not adopt a common line formula based on an average of the per-line and per-minute approaches, because in some circumstances, this would have produced the anomalous result of CCL rates increasing in response to increases in demand. *Id.* at 6795. The mathematics of the common line formula are explained in detail in Appendix E of the *LEC Price Cap Order*, 5 FCC Rcd at 6942-44.

¹³² *LEC Price Cap Order*, 5 FCC Rcd at 6795.

¹³³ *LEC Price Cap Performance Review*, 10 FCC Rcd at 9079.

¹³⁴ *Id.* at 13680.

¹³⁵ *Price Cap Fourth Further NPRM*, 10 FCC Rcd at 1368.

reflect the phase out of the CCL charge.

b. Discussion

108. We conclude that the separate common line PCI formula should be eliminated, and that the PCI formula for the traffic-sensitive and trunking baskets should be used for the common line basket, once traffic-sensitive CCL charges have been eliminated. In this Order, we have reduced substantially traffic-sensitive CCL charges, and replaced them with the per-line PICC. The remaining traffic-sensitive CCL charges imposed by incumbent price cap LECs will be reduced and then eliminated over the next two or three years. Once common line costs are recovered solely through per-line charges, increased minutes will not affect common line recovery. Therefore, when the traffic-sensitive CCL charges have been eliminated, it will no longer be necessary to ensure that CCL rates decline as per-minute demand increases. Incumbent price cap LECs that no longer assess per-minute CCL charges will use the same PCI formula for the common line basket as they use for the traffic-sensitive and trunking baskets.

109. In the *LEC Price Cap Order*, we established "g/2" as the common line PCI formula because we believed that because both LECs and IXC contributed to encouraging common line demand growth, both LECs and IXCs should share in the benefits of common line demand growth.¹³⁶ In the *LEC Price Cap Performance Review*, we tentatively concluded that IXCs contributed more to common line demand growth, but declined to revise the common line formula at that time because we were contemplating eliminating the common line PCI formula completely, and because we did not wish to create unnecessary rate churn.¹³⁷ To avoid unnecessary rate churn here, we decide to retain "g/2" while carriers continue to charge per-minute CCL charges.

110. We revise sections 61.45(c) and 61.46(d), which govern the common line PCI and API, respectively, to reflect our revisions to the common line rate structure in the common line PCI formula. First, we redesignate section 61.45(c) as 61.45(c)(1) and adopt a new section 61.45(c)(2) that requires price cap LECs to use the separate common line formula only while they continue to charge per-minute CCL charges. Section 61.45(c)(2) also states that the common line PCI will be governed by the same PCI formula LECs use for the traffic-sensitive and trunking baskets. Second, we redesignate section 61.46(d) as 61.46(d)(1), and amend section 61.46(d)(1) to recognize that LECs now impose PICC charges as well as CCL charges on IXCs. We also adopt a new section 61.46(d)(2) to govern PICC charges once per-minute CCL charges have been phased out. These revisions are set forth in Appendix C of this Order.

¹³⁶ *LEC Price Cap Order*, 5 FCC Rcd at 6795.

¹³⁷ *LEC Price Cap Performance Review*, 10 FCC Rcd. at 9079-80.

5. Assessment of SLCs and PICCs on Derived Channels

a. Background

111. Integrated services digital network (ISDN) services permit digital transmission over ordinary local loops through the use of advanced hardware and software.¹³⁸ ISDN offers data transmission at higher speeds and with greater reliability than standard analog service. Most incumbent LECs currently offer two types of ISDN service, Basic Rate Interface (BRI) service and Primary Rate Interface (PRI) service. BRI service allows a subscriber to obtain two voice-grade-equivalent channels and a signalling/data channel over an ordinary local loop, which generally is provided over a single twisted pair of copper wires.¹³⁹ PRI service allows subscribers to obtain 23 voice-grade-equivalent channels and one data signalling channel over two pairs of twisted copper wires.¹⁴⁰ BRI service generally is used by individuals and small businesses, and PRI service generally is used by larger businesses. LEC services other than ISDN use derived channel technology to provide multiple channels over a single facility.¹⁴¹ The LECs also use derived channel technologies within their networks, for example, to provide customers with individual local loops. In such situations, the end user has not generally requested derived channel service and thus most likely is not aware that the LEC is using this technology.

112. On May 30, 1995, we released a Notice of Proposed Rulemaking seeking comment

¹³⁸ In order for a LEC to provide ISDN, it must have a digital switch in the central office serving the customer, and substitute an ISDN line or trunk card for the standard cards that would otherwise be used in the central office with the loop facilities serving the customer. The customer also must use special ISDN-capable customer premises equipment.

¹³⁹ The two voice-grade-equivalent channels, which are called bearer or B channels, can be used for voice local exchange service or for data transmission at speeds up to 64 kbps. The third channel is a 16 kbps data channel, called the delta or D channel, which is used for signalling and packet data services. The Bell Atlantic Telephone Companies Petition for Waiver of Section 69.104 of the Commission's Rules in Connection with ISDN Services (filed Feb. 10, 1995) at 4 n.8 (*Bell Atlantic Waiver Petition*).

¹⁴⁰ In the case of PRI ISDN, the 23 B channels and the D channel can transmit voice or data at speeds up to 64 kbps. When a customer has more than one PRI connection at a given location, all of the B channels can share a single D channel, permitting the customer to obtain 24 voice-grade-equivalent channels for each PRI connection after the first one. *Bell Atlantic Waiver Petition* at 4, n.8

¹⁴¹ For example, NYNEX Telephone Companies (NYNEX) uses derived channel technology to provide FLEXPATH service, which provides a customer with 24 digital voice-grade-equivalent trunk channels over a T-1 facility between a suitably equipped central office and a digital PBX. PBX Conversion Service, another NYNEX offering, provides digital trunking capability, with up to 24 trunk access lines, between a customer's digital PBX and an analog-to-digital interface located at the central office switch. NYNEX's Data Over Voice service provides customers with a voice-grade channel and a data channel over a single copper pair. Memorandum Opinion and Order, NYNEX Telephone Companies Revisions to Tariff F.C.C. No. 1, 7 FCC Rcd 7938 n.11 (Com. Car. Bur. 1992), *aff'd on recon.*, 10 FCC Rcd 2247 (1995). Several other LECs provide similar services using derived channel technology. See, e.g., Cincinnati Bell Comments at 6.

on the application of SLCs to ISDN and other derived channel services.¹⁴² In that NPRM, we noted that our current rules, which assess one SLC per derived channel, may discourage efficient use of ISDN services,¹⁴³ and we sought comment on several options, ranging from continuation of the current rules applying one SLC to each derived channel to requiring LECs to assess one SLC per each pair of copper wires or each physical facility.¹⁴⁴ Other options presented in the NPRM included: (1) basing the application of SLCs on a ratio of the average LEC cost of providing a derived channel service, including the trunk or line card costs, to the average cost of providing an ordinary local loop or T-1 facility; (2) applying one SLC for every two derived channels; (3) reducing the number of SLCs applied to derived channel services while increasing slightly the SLC rates; or (4) giving LECs flexibility concerning the number of SLCs they assess for derived channel services, at the same time adjusting the price cap rules to prevent an increase in CCL charges.¹⁴⁵

113. In addition to the comments filed in response to the ISDN SLC NPRM, several BOCs provided data on the relative NTS costs of single and derived channel services.¹⁴⁶ The cost data included information about all NTS cost components, including components located in the central office, such as line cards. As shown in Table 1 below, the cost data indicates that the ratio of NTS loop costs of BRI ISDN to standard analog service is approximately 1 to 1. The ratio of NTS loop costs of PRI ISDN to standard analog service, excluding NYNEX's data, is approximately 5 to 1. As shown in Table 2, NYNEX's data appear to be outliers because the ratios of its outside plant and NTS costs for PRI ISDN to standard analog service are almost twice those of other incumbent LECs. NYNEX's data, therefore, are excluded from the

¹⁴² End User Common Line Charges, CC Docket No. 95-72, Notice of Proposed Rulemaking, 10 FCC Rcd 8565 (1995) (*ISDN SLC NPRM*).

¹⁴³ Section 69.104 of the Commission's rules, 47 C.F.R. § 69.104, provides for a monthly per line charge for end users that subscribe to local exchange service, stating that surcharges shall be assessed for each line between the customer's premises and a Class 5 Office that is or may be used for local exchange transmissions. In 1992, NYNEX which had been charging a SLC for each of the voice-grade-equivalent channels provided on a T-1 facility, filed a tariff in which it proposed to assess only one SLC for each T-1 facility used to provide a customer with certain services, even though the T-1 facility provided that customer with up to 24 voice-grade-equivalent channels. The Common Carrier rejected the Transmittal, finding that it did not comply with the commission's Part 69 rules governing assessment of SLCs. The Commission affirmed the Bureau's conclusion that Section 69.104 of the rules requires assessment of a SLC for each derived channel. Memorandum Opinion and Order, NYNEX Telephone Companies Revisions to Tariff F.C.C. No. 1, 7 FCC Rcd 7938, ¶ 2 (Com. Car. Bur. 1992) *aff'd on recon.*, 10 FCC Rcd 2247 (1995).

¹⁴⁴ *ISDN SLC NPRM* at ¶ 21.

¹⁴⁵ *Id.* at ¶¶ 22-23, 27-30, 32-34.

¹⁴⁶ In their responses, three of the BOCs, BellSouth, NYNEX, and Southwestern Bell, asked for confidential treatment of portions of the information submitted. NYNEX publicly filed the information we requested, but submitted as confidential additional information that contained more detailed cost data. The confidential data were not necessary to perform our analysis, and the following tables only include data that was filed on the public record. We have returned to the respective companies data for which confidential treatment was sought.

calculation of the average ratio for PRI ISDN to standard analog service.

TABLE 1**Ratio of costs of standard analog service to BRI ISDN service**

| | Outside Plant (loop only) costs | All NTS costs |
|------------------------|---------------------------------|----------------|
| Ameritech | 1:1.07 | 1:1.45 |
| Bell Atlantic | 1:1.01 | 1:1.36 |
| NYNEX | 1:0.85 | 1:1.23 |
| Pacific Bell | 1:1.05 | 1:1.13 |
| US West | 1:0.80 | 1:1.07 |
| | | |
| Average ratio of costs | 1:0.96* | 1:1.24* |

TABLE 2**Ratio of costs of standard analog service to PRI ISDN service**

| | Outside Plant (loop only) costs | Outside Plant (loop only) costs (excluding NYNEX data) | All NTS costs | All NTS costs (excluding NYNEX data) |
|------------------------|---------------------------------|--|-----------------|--------------------------------------|
| Ameritech | 1:5.68 | 1:5.68 | 1:8.9 | 1:8.9 |
| Bell Atlantic | 1:4.13 | 1:4.13 | 1:15.80 | 1:15.80 |
| NYNEX | 1:10.94 | excluded | 1:27.74 | excluded |
| Pacific Bell | 1:4.67 | 1:4.67 | 1:8.70 | 1:8.70 |
| US West | 1:5.33 | 1:5.33 | 1:10.60 | 1:10.60 |
| | | | | |
| Average ratio of costs | 1:6.5* | 1:4.95* | 1:15.13* | 1:10.5* |

*Averages may differ due to rounding.

114. We incorporated by reference, in the current proceeding, all pleadings filed in response to the 1995 ISDN SLC NPRM, as listed in Appendix A of that order.¹⁴⁷ In the NPRM for the current proceeding, we invited comments on the effect of the 1996 Act on determining how many SLCs should be applied to ISDN services. We also sought comment on whether mandatory rate structures or rate caps should be prescribed for ISDN service or other derived channel services.¹⁴⁸

b. Discussion

115. Consistent with the goal of this Order of realigning cost recovery in a manner that more closely reflects the manner in which those costs are incurred, we conclude that we should establish separate SLC rates for ISDN service based on the NTS loop costs of BRI and PRI ISDN service. We agree with the majority of commenters that a SLC for ISDN service equal to a SLC for single-channel analog service multiplied by the number of derived channels exceeds the NTS costs of ISDN service and therefore artificially discourages efficient use of ISDN. We find that basing ISDN SLCs on relative costs is most likely to assign costs of ISDN service to customers who subscribe to, and benefit from, that service. Further, we find that the current SLC-per-derived channel rule requires LECs to assess charges that are not related to the NTS costs of the service provided.

116. As set out above, the record indicates that the NTS loop costs of PRI ISDN service, excluding switching costs, reflect a cost ratio of approximately 5:1 compared to the NTS loop costs of single-channel analog service. We therefore conclude that we should amend our rules to establish, effective July 1, 1997, a SLC rate for PRI ISDN service equal to five times the incumbent LEC's average per-line interstate-allocated common line costs, subject to a ceiling of five times \$9.00, adjusted annually for inflation. Similarly, the record shows that the NTS loop costs of BRI ISDN service, excluding NTS switching costs, when rounded to the nearest half SLC, reflect a 1:1 cost ratio relative to the NTS loop costs of single-channel analog service. Therefore, we here amend our rules to provide for a SLC rate for BRI ISDN service equal to the incumbent LEC's average per-line interstate-allocated common line costs, subject to the same ceilings otherwise applicable to non-primary residential lines. Thus, beginning January 1, 1998, the SLC ceiling for BRI ISDN service will be set at the lesser of the incumbent LEC's average per-line interstate-allocated costs, or \$5.00. Each subsequent year, beginning January 1, 1999, the SLC ceiling will be adjusted for inflation and increased by \$1.00 per line, until the ceiling equals that permitted for multi-line business lines.

117. The cost data submitted by the BOCs in response to our request for information

¹⁴⁷ All pleadings filed in response to the 1995 *ISDN SLC NPRM* will be so noted.

¹⁴⁸ NPRM at ¶ 70.

includes information about all NTS cost components, including components located in the central office, such as line cards and trunk cards. The data confirm that line cards and trunk cards for PRI ISDN service in particular constitute a significant portion of the total NTS costs that are dedicated to the provision of service to the subscriber, and that ISDN line cards and trunk cards are many times more expensive than the cards used for standard analog service. As discussed in Section III.B, below, LECs will be required to recover the difference between the cost of an ISDN line card and the cost of a line card used for basic, analog service through a separate charge assessed directly on ISDN end users. For purposes of determining the rate levels for ISDN SLCs, therefore, we considered only the NTS loop costs associated with providing ISDN service.

118. As with other non-primary residential and multi-line business lines, incumbent price cap LECs may assess flat-rated PICCs on ISDN service to the extent necessary to recover the shortfall of common line revenues caused by SLC ceilings. Incumbent price cap LECs are permitted to assess one PICC for BRI ISDN service and five PICCs for PRI ISDN service. It is necessary for incumbent LECs to be able to assess up to five PICCs on PRI ISDN service because, as discussed above, the record indicates that the NTS loop costs of providing PRI ISDN service, excluding switching costs, reflect a cost ratio of approximately 5:1 compared to NTS loop costs of single-channel analog service. Because the PICC recovers NTS common line costs not recovered through the SLC, prohibiting incumbent LECs from charging as many as five PICCs for PRI ISDN service could prevent them from recovering the common line costs associated with providing PRI ISDN service in cases where the common line costs exceed the SLC ceiling.

119. Incumbent LECs shall assess PICCs on BRI and PRI ISDN services in conjunction with those on the non-primary residential and multi-line business lines. For the first year, the BRI ISDN PICC will be capped at \$1.50 per month, and the PRI ISDN PICC will be capped at \$2.75 per month. Each subsequent year these two PICCs shall increase by no more than an inflation adjustment, plus \$1.00 and \$1.50, respectively.

120. The record does not contain sufficient information to enable us to determine the relative NTS costs of derived channel services other than ISDN. We therefore limit our decision to BRI and PRI ISDN service. We agree with NYNEX that we should not apply the rules we adopt here regarding SLCs when the LEC uses derived channel technology but the end user has not requested derived channel service. Unless a subscriber orders ISDN or another service that requires derived channel technology, we see no reason to vary from our general rule that the incumbent LEC should charge one SLC for each channel regardless of how it is provisioned.¹⁴⁹

¹⁴⁹ This is consistent with our prior treatment, in other contexts, of derived channel technology. International Business Machines Corporation, Petition for Declaratory Ruling that LADT Services be Offered only through Telephone Company Organizations Separate from Network Operations, Memorandum, Opinion and Order, FCC 85-292 (rel. June 11, 1985) (*LADT Order*); *recon.*, FCC 86-122 (rel. Mar 25, 1986).

121. We are not persuaded by PacTel's argument that ISDN service is not an interstate service and should not, therefore, be regulated by the Commission. ISDN lines are not directly assigned to the intrastate jurisdiction, but are treated as common lines. The Commission's jurisdiction thus includes the interstate-allocated portion of the costs of the ISDN lines. The rules we adopt in this order govern only the manner in which LECs recover the interstate-allocated common line costs associated with providing ISDN service.

122. Before the Commission initiated CC Docket No. 95-72, Bell Atlantic, Pacific Bell, GTE, Cincinnati Bell, U S West, and Bellsouth sought waivers of Section 69.104 of the Commission's rules as it applies to ISDN service.¹⁵⁰ In their petitions, these LECs urged the Commission to amend its rules regarding the application of SLCs to ISDN service. We have amended our rules regarding the applications of SLCs to ISDN service. We therefore dismiss the waiver petitions of Bell Atlantic, Pacific Bell, GTE, Cincinnati Bell, U S West, and Bellsouth on the grounds that they are moot.

B. Local Switching

1. Non-Traffic Sensitive Charges

a. Background

123. The local switch connects subscriber lines both with other local subscriber lines and with interoffice dedicated and common trunks. A local switch consists of (1) an analog or digital switching system; and (2) line and trunk cards, which connect subscriber lines and interoffice trunks, respectively, to the switch. Because all of this equipment is deployed within the central office, all of its costs are assigned to the central office switching accounts of the Commission's Uniform System of Accounts and to the local switching category of central office expenses for jurisdictional separations purposes.¹⁵¹ The interstate portion of these costs is currently recovered through per-minute local switching charges levied on IXCs.¹⁵²

¹⁵⁰ The Bell Atlantic Telephone Companies Petition for Waiver of Section 69.104 of the Commission's Rules in Connection with ISDN Services (filed February 10, 1995); Pacific Bell Petition for Waiver of Part 69.104 as Applied to Derived Channel Services such as ISDN (filed February 21, 1995); The GTE Telephone Companies Petition for Waiver of Section 69.104 of the Commission's Rules in Connection with ISDN Services (filed March 2, 1995); Cincinnati Bell Telephone Company's Petition for Waiver of Section 69.104 of the Commission's Rules in Connection with ISDN-BRI Services (filed March 16, 1995); U S West Communications, Inc., Petition for Waiver of Section 69.104 of the Commission's Rules as Applied to ISDN Services (filed April 4, 1995); BellSouth Telecommunications, Inc. Petition for Waiver of Section 69.104 of the Commission's Rules in Connection with ISDN Services (filed April 5, 1995).

¹⁵¹ 47 C.F.R. §§ 32.2001(j), 36.125.

¹⁵² 47 C.F.R. § 69.106.

124. In the NPRM we observed that a significant portion of local switching costs may not vary with usage. For example, the cost of line cards or line-side ports appears to vary with the number of loops connected to the switch, not with the level of traffic over the loops. We tentatively concluded that LECs should not recover these costs through per-minute charges. Instead, we tentatively concluded that it is more reasonable and economically efficient to recover costs of equipment dedicated to individual customers, such as line-side ports and trunk ports associated with dedicated transport, through flat-rated charges. Trunk-side ports not associated with dedicated transport and the central processing portion of the switch, on the other hand, are shared among multiple carriers. We asked if these costs are driven by usage or by the number of lines and trunks served by the switch. We sought comment on whether rate structures for shared local switching facilities should consist of usage-sensitive, flat-rated, or a combination of both flat-rated and usage-sensitive rate elements. We asked commenters to recommend methods of identifying non-traffic-sensitive (NTS) local switching costs.¹⁵³

b. Discussion

125. We conclude that, consistent with principles of cost-causation and economic efficiency, NTS costs associated with local switching should be recovered on a flat-rated, rather than usage sensitive, basis. The record before us indicates clearly that the costs of the line side port (including the line card, protector, and main distribution frame) are NTS. We conclude, therefore, that these costs should be recovered through flat-rated charges. Accordingly, for price-cap LECs, we reassign all line-side port costs from the Local Switching rate element¹⁵⁴ to the Common Line rate elements.¹⁵⁵ For price cap companies, these costs will be recovered through the common line rate elements, including the SLC and flat-rated PICC, described in Section III.A., above.

126. LECs incur differing costs for line ports used in the provision of different services. The SLC and PICC cost recovery mechanisms will recover only the cost of a line port used to provide basic, analog service, whether the end user has basic, analog service, or another form of service. As discussed above, data submitted in response to the ISDN SLC NPRM show that ISDN line cards cost significantly more than line cards associated with a basic, analog, subscriber

¹⁵³ NPRM at ¶¶ 72-73.

¹⁵⁴ Currently, NTS costs of line-side ports are recovered through per-minute local switching charges assessed under section 69.106 of our rules, 47 C.F.R. § 69.106.

¹⁵⁵ Part 69 establishes two common line elements, the End User Common Line element, 47 C.F.R. § 69.4(a), and the Carrier Common Line element, 47 C.F.R. § 69.4(b)(2). Price cap LECs currently calculate adjustments to these charges in accordance with 47 C.F.R. § 61.46. Other LECs currently compute these charges in accordance with 47 C.F.R. §§ 69.104 - 69.105.

line.¹⁵⁶ To the extent that the costs of ISDN line ports, and line ports associated with other services, exceed the costs of a port used for basic, analog service, price cap LECs will recover this excess amount through a separate end-user charge.

127. We conclude that the costs of a dedicated trunk port (including the trunk card and DS1/voice-grade multiplexers, if needed) should be recovered on a flat-rated basis because these costs are also NTS in nature. These costs should be recovered from the carrier purchasing the dedicated trunk terminated by that port. Similarly, we conclude that the costs of shared trunk ports should be recovered on a per-minute of use basis from the users of common transport trunks. We therefore establish two separate rate elements for recovery of these costs. Price cap LECs may recover the costs of each dedicated trunk port on a flat-rated basis from the purchaser of the dedicated trunk terminating at the port. In order to ensure that these purchasers of dedicated trunks do not pay the costs of shared trunk ports that they do not use, price cap LECs must also establish a usage-sensitive rate element for recovery of the costs of shared trunk ports. The costs of these shared trunk ports will be recovered on a per minute-of-use basis from users of common transport trunks terminating at these ports. We therefore add a separate category for all trunk port costs within the traffic sensitive basket, 47 C.F.R. § 61.42(e)(1). As with the other categories within this basket, the "trunk ports" category will have an upper service band index of +5 percent and no lower service band index.

128. We do not establish a fixed percentage of local switching costs that incumbent LECs must reassign to the Common Line basket or newly created Trunk Cards and Ports service category as NTS costs. In light of the widely varying estimates in the record, we conclude that the NTS portion of local switching costs likely varies among LEC switches. Accordingly, we require each price cap LEC to conduct a cost study to determine the geographically-averaged portion of local switching costs that is attributable to the line-side ports, as defined above, and to dedicated trunk side ports. These amounts, including cost support, should be reflected in the access charge elements filed in the LEC's access tariff effective January 1, 1998. Once established, this service category, like all others in the traffic sensitive basket, shall be subject to price cap adjustments for inflation and productivity. Although some LECs have obtained

¹⁵⁶ In response to our request for information in *End User Common Line Charges*, CC Docket No. 95-72, all of the BOCs submitted information on the NTS costs of providing ISDN service. See Letter and attachments from Anthony M. Alessi, Director, Federal Relations, Ameritech, to William F. Caton, Acting Secretary, Federal Communications Commission, October 23, 1995; Response to Data Request from Bell Atlantic, October 18, 1995; Letter and attachments from W.W. Jordan, Executive Director, Federal Regulatory, BellSouth, to Kathleen Wallman, Chief, Common Carrier Bureau, October 18, 1995; Letter and attachments from Joseph Di Bella, Counsel, NYNEX Government Affairs, to Kathleen M.H. Wallman, October 24, 1995; Letter and attachments from Sheryl L. Herauf, Director, Federal Regulatory Relations, Pacific Telesis, to William F. Caton, October 18, 1995; Letter and attachments from Paul Walters, Attorney, Southwestern Bell, to William F. Caton, October 11, 1995; Letter and attachments from Cyndie Eby, Executive Director, Federal Regulatory, US West, to William F. Caton, October 18, 1995. BellSouth, NYNEX, and Southwestern Bell requested confidential treatment for some of the information they submitted. In concluding that there are greater NTS costs associated with ISDN line cards, however, we did not rely on the allegedly confidential data because data adequate to support our conclusion was not subject to any request for confidential treatment.

authority to geographically deaverage transport rates under a zone density pricing plan, because the costs of trunk ports will remain within the Traffic Sensitive basket, we conclude that trunk port costs should remain geographically averaged for now. We will consider deaveraging of these costs in connection with our assessment of other forms of pricing flexibility in a subsequent Order in this proceeding.

129. We direct all price cap LECs to include in their tariff filings implementing this Order an exogenous downward adjustment to the Traffic Sensitive basket, 47 C.F.R. § 61.42(d)(2), and corresponding exogenous upward adjustment to the Common Line Interstate Access Elements basket, 47 C.F.R. § 61.42(d)(1) to reflect the recovery of the interstate NTS costs of line-side ports from the Common Line rate elements.

130. USTA, SNET, and BA/NYNEX argue that we should not codify any specific local switching rate elements. We disagree. In the NPRM, we proposed to eliminate local switching rate elements only when an actual competitive presence is established for an exchange access service in a relevant geographic area, as measured by (1) demonstrated presence of competition; (2) full implementation of competitively neutral universal service support mechanisms; and (3) credible and timely enforcement of pro-competitive rules.¹⁵⁷ We tentatively concluded in the NPRM that, in the absence of actual competition, the mere availability of unbundled network elements under efficient rate structures would not provide incumbent LECs with sufficient incentive to adopt efficient, cost-causative access rate elements or structures.¹⁵⁸ The record before us indicates that flat-rated pricing for line ports and dedicated trunk ports is efficient, and reflective of cost causation. We will first amend the baseline switched access rate structure to reflect this determination. Then, in a subsequent Report and Order in this docket, we will determine when and under what circumstances we will allow incumbent LECs greater flexibility in designing interstate access rate structures.

131. In addition, despite arguments from BA/NYNEX to the contrary, we find that the benefits to be gained from a more efficient, cost-causative rate structure outweigh the burden of establishing these flat-rate elements. Independent estimates from Cable & Wireless and USTA, both using NYNEX data, indicate that as much as, or even more than, half of local switching costs may be NTS.¹⁵⁹ Since the current, per-minute rate structure for the local switch was established, digital switches have become increasingly predominant in the network.¹⁶⁰ Given

¹⁵⁷ NPRM at ¶¶ 201-02.

¹⁵⁸ NPRM at ¶ 214.

¹⁵⁹ USTA Comments, Attachment 2 at 31; Cable & Wireless Comments at 12-13.

¹⁶⁰ We adopted the current, per-minute rate structure for local switching in 1983, *MTS and WATS Market Structure*, Phase I, Third Report and Order, 93 F.C.C.2d 241, 304-07 (1983). On reconsideration, we considered AT&T's proposal to redefine the local switching element to provide carriers with flexibility to establish a "transport

USTA's estimate that six percent of the costs of an analog switch and 51 percent of the costs of a digital switch are NTS,¹⁶¹ we find that local switching costs have become increasingly NTS and now warrant the creation of a NTS recovery mechanism. Including NTS local switching costs in per-minute access charges contributes significantly toward unnecessarily high per-minute long distance rates for all customers. Restructuring rates to reflect more accurately cost-causation will promote competition, reduce per-minute charges, stimulate long-distance usage, and improve the overall efficiency of the rate structure.

132. We also reject proposals to recover the entire NTS portion of local switching costs from the new universal service support mechanisms.¹⁶² In the *Universal Service Order*, we agreed with the Joint Board that we should establish a "nationwide benchmark based on average revenues per line for local, discretionary, interstate and intrastate access services, and other telecommunications revenues that will be used with either a cost model or a cost study to determine the level of support carriers will receive for lines in a particular geographic area."¹⁶³ We find that it would be inconsistent with the Joint Board's recommendation if we were to mandate recovery of NTS local switching costs directly from universal service support mechanisms, independent of the revenue benchmark, and the percentage of high cost support recoverable from the federal universal service mechanisms at this time.¹⁶⁴

133. It is not necessary to await action by the Joint Board on Separations¹⁶⁵ before

termination" category, containing all equipment in the switch that terminates the line to trunk facilities from the IXC's POP, and a "common switching" category, containing the traffic sensitive local exchange switching used by a carrier. *MTS and WATS Market Structure*, Phase I, Memorandum Opinion and Order, 97 F.C.C.2d 682, 735-37 (1983). In response, we stated that, "[t]he flexibility that AT&T specifically requests for pricing the Local Switching element reflects a belief that our access charge plan should be revised to permit telephone companies to recover their costs for both end user and traffic sensitive access elements through a mixture of non-recurring charges and flat and usage-based periodic charges and that the carriers rather than this Commission should determine what that mixture should be While we believe that the access charge rules should evolve over time to reflect the menu of access services that AT&T foresees, we believe that the broad discretion AT&T proposes must await the development of the costing tools that can support the additional disaggregation of costs. Therefore we reject this proposal." *Id.* at 736. As digital switches have become increasingly prevalent within the network, we conclude that the time has come to establish some NTS elements for the NTS costs of line and dedicated trunk ports. We will consider questions of additional flexibility in connection with our assessment of the market-based approach to access reform.

¹⁶¹ USTA Comments, Attachment 2 at 31.

¹⁶² *E.g.*, BellSouth Reply at 10.

¹⁶³ *See Universal Service Order* at Section VII.C.5.

¹⁶⁴ *Id.* at Section VII.C.6.

¹⁶⁵ In allocating costs between the intrastate and interstate jurisdictions, the Commission consults with the states through the operation of the Joint Board on Separations. *See* 47 U.S.C. § 410(c); *Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board*, Notice of Proposed Rulemaking and Order Establishing a Joint Board, 78 F.C.C.2d 837 (1980).

revising the recovery mechanisms applicable to the interstate portion of the costs attributed to line ports and dedicated trunk ports. Our revision of the mechanisms used to recover the interstate portion of the costs in Part 32 local switching accounts that the jurisdictional separations process allocates to the interstate jurisdiction will have no direct effect on that allocation because these costs will continue to be separated in Part 36 based on relative dial-equipment-minutes of use. The fact that local switching costs are apportioned between jurisdictions based on a relative interstate and state usage is irrelevant to the choice of pricing structure for recovering those costs, however. Economic efficiency does not require the jurisdictional separation of NTS costs be based on an NTS (flat) factor. The jurisdictional separations process only determines whether the billed charges (flat or variable) are characterized as intrastate or interstate. Economic efficiency does require that NTS costs, regardless of how they are separated, be recovered in each jurisdiction through flat charges. Thus, there was no loss of economic efficiency when the Commission, agreeing with the recommendation of the Joint Board, simplified the separation of local switching by eliminating the former distinction between NTS and traffic-sensitive costs and creating a single switching category that is assigned to the jurisdictions based on dial equipment minutes.¹⁶⁶

134. On the other hand, economic efficiency will be increased if local switching costs (regardless of the jurisdiction to which they are assigned) are recovered through a combination of flat charges for NTS costs and traffic sensitive charges for the remainder. Because, at the time that the Commission established the current jurisdictional separations process, it did not consider the distinction between the switch and the port that we address today, the current jurisdictional separations process does not distinguish port costs from the costs of the local switch itself.¹⁶⁷ We have the authority and obligation, independent from the Joint Board, to establish appropriate rate structures for recovering the costs the jurisdictional separations process allocates to the interstate jurisdiction.¹⁶⁸ We take steps today to address the fact that the costs of line ports and dedicated trunk ports are more properly recovered for Part 69 purposes from the Common Line and Direct-Trunked Transport rate elements as NTS charges, instead of from the traffic sensitive Local Switching element. We will, however, examine any jurisdictional separations issues presented by NTS switching costs in our upcoming separations NPRM.

¹⁶⁶ *MTS and WATS Market Structure*, Report and Order, 2 FCC Rcd 2639, 2642 (1987).

¹⁶⁷ 47 C.F.R. § 36.125(b). See *MTS and WATS Market Structure*, Report and Order, 2 FCC Rcd at 2642 (adopting Joint Board recommendation). The Commission subsequently explained that digital switches use concentrators to allow a small number of components to serve a large number of lines, taking advantage of the fact that most lines are unused most of the time. Because increased usage volume per line reduces the concentration level and increases the number of switch components required, the Commission concluded that "the costs of modern digital switches is actually predominantly [traffic sensitive]." *MTS and WATS Market Structure*, Order on Reconsideration and Supplemental Notice of Proposed Rulemaking, 3 FCC Rcd 5518, 5526 (1988). In performing this analysis, therefore, the Commission did not indicate that it gave specific consideration to the costs associated with of line ports and dedicated trunk ports. These components must be provisioned in a 1:1 ratio with lines and trunks, respectively, and their costs do not vary with traffic levels.

¹⁶⁸ E.g., 47 U.S.C. §§ 151, 152, 154(i-j).

135. Costs may vary for shared local switching facilities according to the number of lines connected, or the traffic over those lines.¹⁶⁹ In the former case, the costs of the shared facility may be recovered in the most cost-causative manner by imposing a proportionate share of the costs on each line while, in the latter case, usage-sensitive charges may better reflect cost causation. With respect to such shared local switching facilities, including the switching matrix and shared trunk ports, we gave states flexibility in our interconnection proceeding to establish either per-minute usage charges, or flat-rated charges, as appropriate.¹⁷⁰ In the access context, however, we will continue to require price cap incumbent LECs to recover the costs of shared local switching facilities, including the central processor, switching matrix, and shared trunk ports, on a per-minute basis. On the basis of the information in the record before us, it would be difficult to identify the NTS and traffic-sensitive portions of the costs of shared switching facilities and to verify the accuracy of LEC studies attempting to do so.¹⁷¹ Therefore, until we gain more experience with rate structures for unbundled network elements that are implemented pursuant to Sections 251 and 252 and that segregate these costs into traffic-sensitive and NTS components, we will continue to adhere to the current, per-minute rate structure for shared switching facilities.

2. Traffic Sensitive Charges

136. In the NPRM, we sought comment on several alternative rate structures for recovery of usage-sensitive local switching costs. Specifically, we sought comment on whether the Commission should require or permit LECs to establish a separate charge for call setup, and if so, whether the charge should be levied on all call attempts, or only completed calls.¹⁷² We also sought comment on whether the Commission should require or permit incumbent LECs to establish peak and off-peak pricing structures for shared local switching facilities,¹⁷³ and whether the existing per-minute rate structure adequately reflects the manner in which traffic-sensitive local switching costs are incurred.¹⁷⁴

¹⁶⁹ Compare Cable & Wireless Comments at 12-13 and Citizens Utilities Comments at 30 and GSA/DOD Comments at 4 and Texas Commission Comments at 11-12 with BellSouth Comments, Attachment 2 at 14.

¹⁷⁰ *Local Competition Order* at ¶¶ 810-18.

¹⁷¹ MCI Comments at 80-82.

¹⁷² NPRM at ¶¶ 75-76.

¹⁷³ NPRM at ¶¶ 77-78.

¹⁷⁴ NPRM at ¶ 79.

a. Call Setup Charges

137. Among price cap carriers today, most call setup is performed with out-of-band signalling, generally using the SS7 signalling network.¹⁷⁵ In light of the widely varying estimates of the costs of call setup in the record,¹⁷⁶ we conclude that these costs may be more than a *de minimis* portion of the costs of local switching. The record indicates that these call setup charges are incurred primarily on a per-call rather than a per-minute basis.¹⁷⁷ By requiring recovery the costs of call setup on a per-minute basis, our current rate structure mandates an implicit subsidy running from customers that make lengthy calls to those that make many short-duration calls. Therefore, we find that we should not continue to require the price cap LECs to recover costs of call setup from per-minute local switching charges.

138. Accordingly, we will revise Section 69.106 of our rules¹⁷⁸ to permit, but not to require, price cap LECs to establish a separate per-call setup charge assessed on IXC's for all calls handed off to the IXC's point of presence (POP). As noted earlier, because an incumbent LEC originating an interstate call incurs call setup costs even if the call is not completed at the called location, we permit these LECs to recover call setup charges on all originating interstate calls that are handed off to the IXC's POP, and on all terminating calls that are received from an IXC's POP. With respect to originating call attempts, we agree with the California Commission that, when the call is handed off to the IXC's POP, the incumbent LEC's switches and signalling network have performed their functions and the incumbent LEC has incurred the full cost of call setup.¹⁷⁹ We also permit incumbent LECs to impose a setup charge for terminating calls received from an IXC's POP, whether or not that call is completed at the called location, because the incumbent LEC signalling network in either case must perform its setup function.

139. We conclude that the call setup charge should not be mandatory because some

¹⁷⁵ Ameritech comments that it uses SS7 for over 95 percent of its customers, that its use of SS7 is increasing, and that other large incumbent LECs probably have comparable figures. Ameritech Comments at 16. For a more detailed description of the operation of the SS7 signalling network, *see* Section III.E.

¹⁷⁶ While Sprint estimates that call setup costs represent approximately two to six percent of the costs of a typical call (Sprint Reply at 14), PacTel estimates that it costs five times more to set up a call than it does to provide a minute of use (PacTel Comments at 68). Using the industry average call duration cited by the California Commission (Reply at 3) of 3.86 minutes, call setup charges would represent a much larger percentage of the total costs of a typical call than Sprint estimates.

¹⁷⁷ *E.g.*, Excel Comments at 12; TRA Comments at 37; Ameritech Comments at 15; PacTel Comments at 69; Citizens Utilities Comments at 30; Frederick & Warinner Comments at 6-7; Minnesota Independent Coalition Comments at 15; Alabama Commission Comments at 8; California Commission at 2-3; Texas Commission at 14; TCI Comments at 12.

¹⁷⁸ 47 C.F.R. § 69.106.

¹⁷⁹ California Commission Reply at 2.

incumbent LECs may determine that call setup costs either are in fact *de minimis* or are otherwise outweighed by the costs of the network and operations support systems (OSS) upgrades necessary to install measurement and billing systems. In such cases, it would be economically inefficient to mandate a separate call-setup charge because the costs of collecting the charge might exceed the revenue collected from the charge itself. We are aware that, by making the call-setup charge permissive only, we may allow certain incumbent LECs' rate structures to continue to subsidize short-duration calls. We nevertheless conclude that we should not mandate separate collection of a call-setup charge in cases where the LEC determines that the costs of eliminating this subsidy exceed the benefits to be gained. In contrast, we find that those incumbent LECs that either have or obtain the ability to implement a call-setup charge should have the flexibility to adopt this cost-causative rate structure.

140. No party disputes the fact that incumbent LECs incur costs of call setup for call attempts, in addition to completed calls. Some parties, however, argue that call setup charges should be assessed only on completed calls in order to reduce customer confusion. We anticipate that consumer confusion will be minimal, however, because the call setup charge we permit will be imposed on IXCs, not end users. We find it unlikely that IXCs would choose to pass this charge along to their customers in the form of a separate charge per call attempt. For instance, IXCs today generally charge their customers for completed long distance calls even though they incur access charges for many uncompleted calls as well.¹⁸⁰

141. Other commenters state that setup charges imposed on call attempts will result in charges being imposed on a caller that has not received service. LCI asserts that "customers do not expect to pay for uncompleted call attempts, and the carriers are not entitled to recover their costs of uncompleted call attempts,"¹⁸¹ citing the Commission's decision in *VIA USA, Ltd.*¹⁸² The text cited from that order, however, addresses only customer expectations that have arisen because our current rules make no explicit provision for the recovery of costs of an uncompleted call. We now find that a call setup charge, assessed to an IXC, should not be prohibited because a rate structure that recovers some switching costs through a per-call setup charge on all call attempts is more cost-causative than one limited to the recovery of costs only from completed

¹⁸⁰ IXCs today incur access charges for originating access minutes of use from the time when the originating LEC hands a call off to the IXC's POP, regardless of whether the call is completed at the called location. 47 C.F.R. § 69.2(a). As a result, originating *access* minutes of use are approximately seven percent greater than originating *conversation* minutes of use. IXCs today do not generally choose to bill their customers directly for access minutes of use charged by the LEC for uncompleted calls or for the interval before the called party answers. See Federal Communications Commission, Com. Car. Bur., Industry Analysis Division, Telecommunications Industry Revenue: TRS Fund Worksheet Data, 8, fig. 3 (Estimates of Toll Rates and Access Costs per Conversation Minute) (Dec. 31, 1996).

¹⁸¹ LCI Comments at 26 n.41.

¹⁸² In *VIA USA*, the Commission stated as a factual matter that, "*in the system as currently structured* by facilities-based carriers, customers do not expect to pay for an uncompleted call. Nor do carriers expect to be compensated." 10 FCC Rcd 9540, 9545 (1995) (emphasis added).

calls.

142. Still other commenters argue that, if we permit call setup charges to be imposed for call attempts, we will, at best, open the door to unauditible billing errors or, at worst, facilitate incumbent LEC fraud and duplicity. These commenters argue that the incumbent LEC will be able to generate additional revenue, or degrade the service of IXC competitors, by blocking calls at its own switch. Based on this record, we conclude that these concerns are not well-founded. By permitting a setup charge only for originating call attempts that are handed off to the IXC's POP, we minimize the originating incumbent LEC's incentive to engage in this type of activity because the incumbent LEC will receive no compensation for calls blocked at its own switch. In addition, incumbent LECs have compelling incentives to deliver interstate calls to an IXC's POP. As competition develops for local service, it appears doubtful that an incumbent LEC would find it advantageous to block deliberately interstate calls placed by their end user customers. Such practices would encourage entry by new competitors and increase the interest of affected end users in finding a more reliable service provider. We also find it unlikely that either originating or terminating incumbent LECs would intentionally risk the collection of often significant per-minute access charge revenues on a completed long-distance call in order to collect additional, much smaller per-call setup charges. Finally, we know of no significant allegations of degraded service quality attributable to the very similar current regime, under which incumbent LECs collect at least a full minute of originating access revenues on uncompleted calls delivered to the IXC's POP. We are prepared, however, to investigate claims that an incumbent LEC is blocking calls in an intentional or discriminatory manner.

143. Several large business customers that make substantial numbers of short-duration calls, such as those associated with credit card authorization, automatic teller machine operation, or other transaction-oriented data transfers, argue that imposing a call setup charge will be disruptive to their businesses and may force them to use alternatives to the public switched network.¹⁸³ These commenters are the primary beneficiaries of the subsidy that is implicit in the current recovery of call setup costs on a per-minute basis, running from customers that make lengthy calls to those that make many short-duration calls. The existing rate structure may well have encouraged users who make many short duration calls to use the public-switched network in inefficient ways. Rate structures that are aligned with cost causation, on the other hand, should encourage economically-efficient use of the telecommunications network. Transaction-oriented users of the network may be motivated to develop more economically efficient processing methods, with resulting economic benefits. Because this group of IXC customers may need time to adjust to the new rate structure, however, incumbent LECs choosing to impose a per-call setup charge on IXCs may do so, at the earliest, in their access tariff filings effective July 1, 1998. This gives a customer over one year to make any necessary adjustments. This time should be sufficient

¹⁸³ CompuServe/Prodigy Comments at 25-29, Reply at 11-12; Bankers Clearing House Comments at 7-8; Ad Hoc Comments at 19-20, Reply at 3-4.

to mitigate any potential disruptive effects of this rate structure change.¹⁸⁴

144. MCI asserts that there may be costs of call setup in addition to those associated with signalling,¹⁸⁵ such as a portion of the switch central processor costs.¹⁸⁶ We limit the costs that an incumbent LEC may recover through call setup charges, however, to those associated with signalling because we agree with MCI that it would be extremely difficult to separate the costs of the switch CPU and other traffic-sensitive costs into per-message and per-minute portions and to verify that the allocation has been done properly.¹⁸⁷

145. Several commenters caution that, if we permit a call setup charge, we should also ensure that the charge does not overlap with any SS7-related charges now permitted or developed in this proceeding.¹⁸⁸ Because call setup is one function of the SS7 network, some of these costs may already be recovered through the current Part 69 SS7 rate elements.¹⁸⁹ Currently, Section 69.125 of our rules permits LECs to recover from IXCs only (1) a flat-rated signalling link charge for the Dedicated Network Access Line (DNAL); and (2) a flat rated Signal Transfer Point (STP) port termination charge.¹⁹⁰ While these elements recover the costs of some dedicated SS7 facilities, they do not include the usage-based signalling costs of call setup, including the costs incurred to switch messages at the local STP, to transmit messages between an STP and the

¹⁸⁴ Our experience with Ameritech's tariffed unbundled SS7 signalling charges indicates that a call setup charge, if implemented, may in fact be relatively small. For call setup purposes, Ameritech has established separate signalling rate elements for SS7 call setup for both direct-trunked and tandem-switched traffic. The first of these, the "ISDN User Part (ISUP) Signal Formulation Charge," is a "per signalling message charge for the formulation of the ISUP message at end offices and tandems" in the amount of .06¢ (\$0.0006) per message assessed for both direct-trunked and tandem-switched traffic. The second, the "Signal Transport Charge," is a "per-signalling message charge for the transmission of signalling data between the local STP and an end office SP/SSP" in the amount of .012¢ (\$0.00012) per message. The third, the "Signal Switching Charge" is a "per signalling message charge for switching an SS7 message at the local STP" in the amount of .025¢ (\$0.00025) per message. The Signal Transport Charge and the Signal Switching Charge are assessed on direct-trunked traffic only. For tandem switched traffic, the "Signal Tandem Switching Charge" is a "per signalling message charge for the bundled provision of multiple instances of signal switching and signal transport for the situation in which tandem routed facilities are provided to the end office" in the amount of .055¢ (\$0.00055). The Signal Tandem Switching charge incorporates three instances of transport and two instances of switching at the STP. Both the Signal Switching and the Signal Tandem Switching rate elements include the costs of measuring device and billing system changes. See *Ameritech Operating Companies Tariff FCC No. 2*, Tariff Transmittal No. 982, filed July 5, 1996.

¹⁸⁵ MCI Comments at 82.

¹⁸⁶ MCI Comments at 82-83.

¹⁸⁷ *Id.*

¹⁸⁸ *E.g.*, AT&T Reply at 29; Bankers Clearing House Comments at 4-5; Ad Hoc Comments at 23-25; TCI Comments at 12-13.

¹⁸⁹ 47 C.F.R. § 69.125.

¹⁹⁰ 47 C.F.R. § 69.125.

incumbent LEC's end office or tandem switch, and to process or formulate signal information at an end office or tandem switch.¹⁹¹

146. Currently, the setup costs of certain calls may be recovered through database query charges, either for the line information database (LIDB)¹⁹² or the 800 database.¹⁹³ In addition, incumbent LECs recover some costs associated with the provision of certain signalling information necessary for third parties to offer tandem switching through the "signalling for tandem switching" rate element.¹⁹⁴

147. Imposing a call setup charge for interexchange calls should not overlap with any of these existing rate elements. Nevertheless, we clarify that an incumbent LEC choosing to impose a call setup charge may not include in that charge any costs that it continues to recover either through other local switching charges, through charges for dedicated SS7 facilities, or through other signalling charges. In this Order, we also permit incumbent LECs to adopt a more detailed SS7 rate structure, modeled on that currently used by Ameritech under waiver.¹⁹⁵ This SS7 rate structure may permit LECs to recover a significant portion of their call setup costs without an additional call setup charge. Given estimates in the record that SS7 is used to provide signalling for more than 95 percent of the large LECs' customers,¹⁹⁶ we conclude that, in the ordinary case, a price cap LEC will not need to use both the optional SS7 rate structure and a separate call setup charge to recover the costs of call setup. We recognize, however, that some call setup is still performed using in-band, multifrequency (MF) signalling, rather than out-of-band signalling systems. Because SS7 charges will not recover costs of call setup using MF signalling, we do not prohibit the use of both SS7 and call setup charges. We caution LECs adopting both the optional SS7 rate structure and an additional call setup charge, however, that cost support filed with access tariffs must clearly indicate the allocation of individual costs of call setup between these two recovery mechanisms; the same costs cannot be double-recovered using both mechanisms.

¹⁹¹ Neither section 69.125 nor any of our other signalling-related cost recovery rules, discussed below, provide for recovery of the costs of these functions. As a result, these costs are recovered through per-minute charges assessed on completed calls. 47 C.F.R. § 69.106. As discussed below, LECs choosing to adopt a separate SS7 signalling rate elements, similar to those established by Ameritech under waiver, may recover a large part of their call setup costs through that mechanism.

¹⁹² 47 C.F.R. § 69.120.

¹⁹³ 47 C.F.R. § 69.118.

¹⁹⁴ 47 C.F.R. § 69.129.

¹⁹⁵ *Ameritech Operating Companies Petition for Waiver of Part 69 of the Commission's Rules to Establish Unbundled Rate Elements for SS7 Signalling*, Order, 11 FCC Rcd 3839 (Com. Car. Bur. 1996) (*Ameritech SS7 Waiver Order*). See Section III.E.

¹⁹⁶ Ameritech Comments at 16. Ameritech states that, "SS7 technology is currently used for more than 95% of customers in the Ameritech network. This figure is probably comparable for other large [incumbent LECs.]"

b. Peak and Off-Peak Pricing

148. We conclude that we should not now mandate a peak-rate pricing structure for local switching. The record reflects significant practical difficulties that may make it difficult or impossible to establish and enforce a rational, efficient, and fair peak-rate structure as a matter of regulation. For example, the record outlines a variety of difficulties that incumbent LECs will confront in determining peak and off-peak hours with any degree of certainty, based on geographic, user-type, service, and other variations. Moreover, peak usage periods may shift over time as usage patterns change, and as competitors enter the market. Based on these difficulties, some incumbent LECs may find it too costly or too difficult to develop, implement, and maintain a peak-rate structure that will allow them to capture all or most of the benefits this structure could offer.

149. We do recognize the possible efficiency of a peak-rate structure.¹⁹⁷ Accordingly, we will consider whether LECs should have the flexibility to develop such peak and off-peak rate structures for local switching on a permissive basis when we consider other issues of rate structure flexibility in a subsequent Report and Order that we will adopt in this proceeding.

C. Transport

150. Transport service is the component of interstate switched access consisting of transmission between the IXC's point of presence (POP) and LEC end offices.¹⁹⁸ Currently, incumbent LECs offer two basic types of interoffice transport services. The first, direct-trunked transport, uses dedicated circuits for transport between a LEC end office and the LEC serving wire center, or between any other two points the direct-trunked transport customer requests. The second, tandem switched transport, uses common transport facilities to connect the end office to a tandem switch. Common transport circuits may be used to transmit the individual calls of many IXCs and even the incumbent LEC itself. Transport circuits dedicated to a particular access customer connect the tandem switch to the serving wire center. Dedicated entrance circuits carry traffic between the IXC POP and the serving wire center, whether the IXC uses direct-trunked transport or tandem-switched transport.

151. In the NPRM, we expressed concern that some of our current Part 69 rules¹⁹⁹ may require LECs to recover transport costs through rate structures that do not reflect accurately the

¹⁹⁷ *Local Competition Order* at ¶ 755.

¹⁹⁸ *Transport Rate Structure and Pricing*, Third Memorandum Opinion and Order on Reconsideration and Supplemental Notice of Proposed Rulemaking, 10 FCC Rcd 3030, 3033 (1994) (*Third Transport Reconsideration Order*).

¹⁹⁹ *See, e.g.*, 47 C.F.R. §§ 69.110, 69.111, 69.112, 69.124.

way these costs are incurred. We sought comment on possible revisions to many of these rate elements.²⁰⁰

1. Entrance Facilities and Direct-Trunked Transport

a. Background

152. Entrance facilities are dedicated circuits that connect an access customer's POP with the LEC's serving wire center. Direct-trunked transport facilities are dedicated trunks that carry an access customer's traffic from the LEC end office to the serving wire center without switching at the tandem switch. In the *First Transport Order*, we mandated an interim rate structure under which entrance facilities and direct trunked transport are priced on a flat-rated basis, which may be distance sensitive.²⁰¹ Initial rate levels for direct-trunked transport and entrance facilities were presumed reasonable if they were set equal to the rates for corresponding special access service components (special access service and special access channel termination, respectively).²⁰² In the NPRM, we tentatively concluded that, because direct-trunked transport and entrance facilities appear to be dedicated to individual customers, a flat-rated pricing structure accurately reflected the way LECs incur the costs of these facilities.²⁰³ We sought comment on this tentative conclusion and on whether incumbent LECs should be permitted to offer transport services differentiated by whether the LEC or the IXC is responsible for channel facility assignments (CFAs).²⁰⁴ We also sought comment on whether any rules in addition to the interim rules are necessary to govern rate levels for these services.²⁰⁵

b. Discussion

153. We conclude that both entrance facilities and direct-trunked transport services should continue to be priced on a flat-rated basis and that charges for these services may be distance-sensitive. In the *First Transport Order*, we found that such a flat charge would facilitate

²⁰⁰ See NPRM at ¶¶ 80-95.

²⁰¹ *Transport Rate Structure and Pricing*, Report and Order and Further Notice of Proposed Rulemaking, 7 FCC Rcd 7006, 7016-7017 (1992) (*First Transport Order*); see also 47 C.F.R. § 69.110.

²⁰² *Transport Rate Structure and Pricing*, First Memorandum Opinion and Order on Reconsideration, 8 FCC Rcd 5370, 5375 (1993) (*First Transport Reconsideration Order*).

²⁰³ NPRM at ¶ 86.

²⁰⁴ A channel facility assignment is the actual designation of the routing that a circuit takes within the incumbent LEC network. This assignment may be made either by an IXC purchasing a dedicated circuit, or the incumbent LEC itself.

²⁰⁵ NPRM at ¶ 86.

competition in the direct-trunked transport market and encourage incumbent LECs to make efficient network decisions.²⁰⁶ For the same reasons, and because this pricing structure is reflective of the manner in which incumbent LECs incur the costs of provisioning these facilities, we confirm that the interim rate structure the Commission adopted for these facilities should be made final.

154. U S West and Sprint make a persuasive showing that, as carriers expand their use of fiber-optic ring architecture and other modern network designs, transport costs should become less distance sensitive because LECs may transport a call along any one of many paths to its destination based on transient network traffic levels.²⁰⁷ We conclude, however, that we need not amend our Part 69 rules now to reflect the decreasing sensitivity of transport costs to distance. Our rules permit, but do not mandate, the use of distance sensitive transport charges. Therefore, if an incumbent LEC determines that its transport costs have become less distance sensitive, it may reduce or eliminate the distance-sensitivity of its direct-trunked transport rates. For two reasons, we expect that incumbent LECs will adjust their rates to reflect any change in the distance sensitivity of transport costs. First, as U S West states, ring architecture will be most prevalent, and therefore, will reduce the distance sensitivity of rates most dramatically, in densely populated areas.²⁰⁸ When an incumbent LEC obtains authority to deaverage access rates geographically, therefore, it may choose to offer a less distance-sensitive pricing structure in more densely populated areas than it does in less densely populated areas. Such a structure would properly reflect the reduced distance sensitivity of the incumbent LEC's costs in more densely populated areas. Second, as competition develops, incumbent LECs will come under increasing market pressures to maintain rates that reflect the nature of the costs underlying the service. If they choose not to do so, we expect that new market entrants will develop competitive service offerings at prices more reflective of underlying costs.

155. We decline Ameritech's request in its comments for immediate flexibility to offer new technologies to switched access customers without obtaining a Part 69 waiver or passing a public interest test.²⁰⁹ In our Third Report and Order in the *Price Cap Performance Review for Local Exchange Carriers (Price Cap Performance Review Third Report and Order)*, adopted along with the NPRM in this proceeding, we eliminated the need for a Part 69 waiver for new

²⁰⁶ *First Transport Order*, 7 FCC Rcd at 7022.

²⁰⁷ As Sprint explains, LECs are moving toward ring configurations in response to customer demands for the increased service reliability gained from this architecture's route diversity and self-healing qualities. "With the ring configuration, the tandem-routed traffic and direct-trunked traffic will all be moving in the same ring, and the distance traversed will simply be a function of the provisioning path selected by the LEC for individual traffic. Utilization of available bandwidth between two nodes at any point in time will become a higher priority in the economic determinant of cost than the distance between the two nodes." Sprint Comments at 24.

²⁰⁸ See U S West Reply at 30.

²⁰⁹ See Ameritech Comments at 17-18.

services, and instead required incumbent LECs to file a petition demonstrating that introduction of the new service would be consistent with the public interest.²¹⁰ Such petitions will give LECs that desire to do so the opportunity to make their cases and receive the requested flexibility.²¹¹ This procedure significantly streamlined the prior waiver process, and we conclude that the public interest will not suffer if we do not grant incumbent LECs additional immediate flexibility in this area as part of our basic rate structure modifications. We will give further consideration to Ameritech's request for additional flexibility to offer new technologies to switched access customers as part of our assessment of other aspects of pricing flexibility in a subsequent Report and Order in this proceeding.

156. We also will consider whether LECs should be permitted to offer direct-trunked transport services that are differentiated by whether the incumbent LEC or the transport customer is responsible for performing channel facility assignments in connection with our evaluation of other forms of pricing flexibility in a subsequent Report and Order in this proceeding. As MCI argues in its comments, it is unclear whether rates for direct-trunked transport where the LEC controls the CFA should be higher or lower than the rates that apply where the IXC controls the CFA.²¹² Although the LEC may be able to make more efficient use of its network facilities when it controls the CFAs itself, this efficiency benefit may be offset by the additional costs the LEC incurs in performing the CFA function. We agree with MCI that an incumbent LEC may be able to increase its network efficiency by retaining or assuming control of CFAs, particularly if an IXC orders a relatively large amount of transport capacity. In those cases, however, rate differentiation based on CFA control appears to be the functional equivalent of a volume discount. As a result, we will consider this issue, along with other pricing flexibility issues, in a subsequent Report and Order planned in this docket.

157. In its comments, USTA requests that we forbear under Section 10 of the Communications Act²¹³ from regulating services in the interexchange basket, special access, collocated direct-trunked transport, and directory assistance.²¹⁴ We will address USTA's request along with other pricing flexibility issues, in a subsequent Report and Order planned in this docket.

²¹⁰ NPRM at ¶¶ 309-310 (contained within the *Third Report and Order* portion of that item). The rule changes implementing this procedure will become effective on June 30, 1997.

²¹¹ See 47 C.F.R. § 69.4(g).

²¹² MCI Comments at 84-85.

²¹³ 47 U.S.C. § 160.

²¹⁴ USTA Comments at 35-48.

2. Tandem-Switched Transport

a. Background

158. Tandem-switched transport uses trunks that are shared among many IXCs and the LEC itself to carry traffic between the end office and a tandem switch. The tandem switch routes IXC traffic onto an appropriate dedicated trunk that runs between the tandem switch and the serving wire center.²¹⁵ An IXC may use tandem-switched transport either as its primary form of transport in lieu of direct-trunked transport, or to carry traffic that overflows from its direct-trunked transport facilities at peak periods. In 1982, the *Modification of Final Judgment (MFJ)* established an interim rule that required, until September 1, 1991, BOC charges to IXCs to be "equal, per unit of traffic" of a given type transported between end offices and facilities of the IXCs within an exchange area or within reasonable subzones of an exchange area.²¹⁶

159. The Commission replaced the "equal charge" rule in 1993 with an interim rate structure for tandem-switched transport. This interim structure allows IXCs to choose between two rate structures for the purchase of tandem-switched transport. Both options provide for a per-minute tandem switching charge. Under the first option, an IXC may elect to pay "unitary" per-minute charge for transmission of traffic from the end office, through the tandem switching office, to the serving wire center. This charge may be distance sensitive, with distance measured in airline miles from the end office to the serving wire center. Under the second option, the "three-part rate structure," in addition to the charge for the tandem switch, an IXC may elect to purchase transmission on a bifurcated basis, with the end office-to-tandem portion charged on a per-minute basis, and the tandem-to-serving wire center portion charged as direct-trunked transport facilities, *i.e.*, on a flat-rated basis. Under the three-part rate structure, both portions of the transmission charge may be distance sensitive based on the airline mileage to the tandem office.²¹⁷

160. In adopting the interim rate structure, the Commission stated that initial direct-trunked and tandem-switched transport rates would be presumed reasonable if set based on special access rates in effect on September 1, 1992 using a DS3 to DS1²¹⁸ rate ratio of at least 9.6

²¹⁵ An end office local switch may also serve as a tandem switch with certain software upgrades. Therefore, the tandem switching office is also often an end office in its own right. Similarly, an IXC typically uses a large end office, upgraded with additional trunking capacity to handle the IXC's traffic, as its serving wire center.

²¹⁶ *United States v. American Tel. and Tel. Co.*, 552 F. Supp. 131, 233-34 (AT&T Consent Decree, Appendix B, Section B(3)), *aff'd sub nom. Maryland v. United States*, 460 U.S. 1001 (1983).

²¹⁷ See *First Transport Reconsideration Order*, 8 FCC Rcd at 5372.

²¹⁸ A DS1 line is capable of transmitting 24 voice conversations, each digitally encoded at 64 kilobits per second, for a total capacity of 1.544 megabits per second. A DS3 line has 28 times the capacity of a DS1.

to 1.²¹⁹ Per-minute tandem-switched transport rates were presumed reasonable if set using a weighted average of DS1 and DS3 rates reflecting the relative numbers of circuits of each type in use in the tandem-to-end office link, and assuming circuit loading of 9000 minutes of use per month per voice-grade circuit.²²⁰

161. Under the interim rate structure, whether a tandem-switched transport customer elects to purchase tandem-switched transport under the unitary or the three-part rate structure, the LEC imposes a separate, per-minute charge on the tandem-switched transport customer for use of the tandem switch. The Commission set this charge initially to recover only twenty percent of the tandem revenue requirement, in order to: (1) protect small IXCs that use tandem-switched transport as their primary transport mechanism from substantial increases in tandem-switched transport rates;²²¹ (2) ensure that the interim rate structure did not "endanger the availability of pluralistic supply in the interexchange market" that had developed under the equal charge rule;²²² and (3) allow IXCs a transitional period to reconfigure their networks to eliminate inefficiencies that had developed under the equal charge rule and to prepare for a fully cost-based rate structure.²²³ Unlike the direct-trunked and tandem-switched transport rates, which are set using overhead loadings based on special access, the tandem switching rates used higher overhead loadings applicable to switched access.

162. As part of the interim rate structure, the Commission also created the TIC to recover on a per-minute basis from all switched access customers the difference between the Part 69 transport revenue requirement and the revenues projected to be recovered under the interim rate structure.²²⁴ The TIC was explicitly intended to make the transition to the interim rate structure revenue neutral.²²⁵ Among other possible costs, the TIC recovers the remaining 80 percent of the tandem-switching revenue requirement.

163. Portions of the interim transport rate structure were recently remanded to the

²¹⁹ *First Transport Order*, 7 FCC Rcd at 7029. Special access customers use a dedicated trunk running between the customer's premises and the IXC's POP, thereby bypassing the LEC's switched network facilities altogether. This service is primarily used by large volume users in densely populated areas.

²²⁰ *Id.* at 7036-37.

²²¹ See *Competitive Telecommunications Ass'n v. FCC*, 87 F.3d 522, 526-27 (D.C. Cir. 1996) ("*CompTel*").

²²² *First Transport Order*, 7 FCC Rcd at 7008.

²²³ *Id.* at 7016.

²²⁴ *Id.* at 7038.

²²⁵ *Id.*

Commission by the United States Court of Appeals for the District of Columbia Circuit.²²⁶ With respect to tandem-switching rates and the TIC, the Court ordered us either to implement a cost-based rate structure or offer a "rational and non-conclusory analysis in support of [our] determination that an alternative structure is preferable."²²⁷ With respect to overhead loadings, the Court ordered us either to substantiate that our current method of allocating overhead is cost-based, choose a method that is, or provide a reasoned explanation of our decision to pursue a non-cost-based system.²²⁸

164. In the NPRM, we sought comment on several alternative rate structures for tandem-switched transport service facilities, including: (a) maintaining the interim rate structure, which permits the IXC's to choose between the two pricing alternatives above; (b) eliminating the unitary rate option and requiring the IXC's to purchase tandem-switched transport under the three-part rate structure; or (c) developing another, different rate structure.²²⁹ We also sought comment on whether, in conjunction with any of these pricing options, we should apply to tandem switching any of the options for local switching discussed above, including whether we should establish separate flat-rated charges for the dedicated ports on the serving wire center side of the tandem or other NTS components of the tandem switch, and whether usage-based or flat rates more accurately reflect shared tandem-switching costs.²³⁰ We also sought comment on whether, in conjunction with any of these options, we should permit or require peak load pricing for usage-based charges for tandem-switched transport service, and on whether any portion of tandem-switched transport costs should be recovered from direct-trunked transport customers.

b. Overview of Rate Structure and Rate Level Changes

165. In this section, we summarize the changes we make to the tandem-switched transport rate structure and rate levels below. We conclude that we should require incumbent LECs to implement a cost-based rate structure for tandem-switched transport in four stages over a two year transition period. Unlike our previous transition plans, however, we set forth today, for the first time, the details of a final, cost-based transport rate structure. We have long recognized that non-cost based rate structures can, among other dangers, (1) threaten the long-term viability of the nation's telephone systems; (2) distort the decision whether to use alternative telecommunications technologies; and (3) encourage "uneconomic bypass" of the public switched

²²⁶ *CompTel*, 87 F.3d 522.

²²⁷ *Id.* at 536.

²²⁸ *Id.*

²²⁹ NPRM at ¶¶ 87-88, 91.

²³⁰ NPRM at ¶ 89.

telecommunications network, raising rates for all.²³¹

166. Until today, however, we have limited ourselves to interim transport rate structure plans, such as the equal charge rule and the interim rate structure described above. While the interim rate structure increased the cost-based nature of our transport rate structure, it also included significant non-cost-based elements. We have not, until today, laid out a clear transition plan that describes all the steps necessary to achieve cost-based transport rates. As a result, although all carriers have no doubt been aware of our intention to move to a cost-based rate structure, they have been able only to react to our transitional steps, announced piecemeal. Because we have not announced a definite and detailed end state -- a final, cost-based rate structure -- we have afforded carriers little opportunity to plan, adjust, and develop their networks in preparation for such a rate structure, despite our lengthy period of "transition." Accordingly, because of the potential magnitude of the rate impact of these changes, we conclude that a four-step implementation over a two-year period will minimize the risk of rate shock and allow transport customers to adjust while we move as expeditiously as possible to cost-based transport rates as required by the *CompTel* decision.

167. The first step will occur in incumbent LEC access tariffs to become effective on January 1, 1998. In those tariffs, incumbent price cap LECs must establish new rate elements for recovery of the costs of DS3/DS1 and DS1/voice-grade multiplexers used in conjunction with the tandem switch. The rate element for the dedicated multiplexers on the serving wire center side of the tandem will recover these costs on a flat-rated basis, while the rate element for the multiplexers on the end office side of the tandem will be assessed per minute of use. In addition, incumbent price cap LECs must establish in those tariffs a flat-rated charge to recover the costs of dedicated trunk ports on the serving wire center side of the tandem. None of our existing rate elements currently recovers the costs of either these multiplexers or these dedicated trunk ports. Accordingly, we conclude that those costs are currently recovered through the TIC, and that incumbent price cap LECs must reduce the TIC to reflect the recovery of these costs through the new rate elements. Also on January 1, 1998, all incumbent LECs must take the first of three annual steps to reallocate to the tandem-switching rate element tandem switching revenues currently being recovered through the TIC. In tariffs filed to be effective on that date, we require incumbent LECs to reallocate one third of the portion of the tandem switching revenue requirement that they currently recover through the TIC, excluding signalling and dedicated port costs that we reallocate elsewhere, to the tandem switching rate element.

168. The second step will occur in incumbent LEC tariffs to become effective July 1, 1998. At that time, all incumbent LECs must eliminate the unitary pricing option for tandem switched transport. Instead, incumbent LECs will be required to provide tandem-switched transport under a three-part rate structure as follows: (1) a per-minute charge for transport of

²³¹ *MTS and WATS Market Structure*, Third Report and Order, 93 F.C.C.2d at 251-252.

traffic over common transport facilities between the LEC end office and the tandem office; (2) a per-minute tandem switching charge; and (3) a flat-rated charge for transport of traffic over dedicated transport facilities between the serving wire center and the tandem switching office. Incumbent LECs will continue to impose separate multiplexing and port charges established on January 1, 1998, as complementary to the three-part rate structure.

169. The third and fourth steps will consist of the reallocation of the remaining portion of the tandem-switching revenue requirement currently recovered through the TIC to the tandem-switching rate element. All incumbent LECs are to reallocate one half of the remaining portion of tandem-switching revenue requirement recovered through the TIC to the tandem-switching rate element in access tariffs to become effective January 1, 1999, and the final portion of the tandem-switching revenue requirement to the tandem-switching rate element in access tariffs to become effective on January 1, 2000. Before performing this reallocation, price cap incumbent LECs must account for X-factor reductions to the tandem-switching revenues permitted under price caps that have occurred since the TIC was created, as described in Section III.C.2.d, below.

c. Rate Structure

170. *Multiplexing Costs.* As discussed above, we direct incumbent LECs to establish separate rate elements for the multiplexing equipment on each side of the tandem switch. LECs must establish a flat-rated charge for DS1/DS3 multiplexers on the serving wire center side of the tandem, imposed pro-rata on the purchasers of dedicated DS3 trunks on the serving wire center side of the tandem, in proportion to the amount of DS3 trunking capacity purchased by each customer. Unlike DS3 rates, rates for DS1 dedicated trunks already include a portion of the DS1/DS3 multiplexer needed for transport.²³² Multiplexing equipment on the end office side of the tandem shall be charged to users of common end office-to-tandem transport on a per-minute of use basis. These multiplexer rate elements must be included in the LEC access tariff filings to be effective January 1, 1998.

171. We sought comment in the NPRM on the claim that:

The TIC . . . includes the two additional multiplexers needed in order to multiplex a DS3 circuit down to a DS1 level before switching at the tandem, and then back up to DS3 afterward for transmission to an end office. To the extent that analog tandem switches exist, two additional DS1/[voice-grade] multiplexers are needed to achieve the voice-grade interface with the tandem switch.²³³

²³² *First Transport Order*, 7 FCC Rcd at 7028 n.85.

²³³ NPRM at ¶ 106. It is also possible to combine the DS3/DS1 and DS1/voice-grade functions into a single multiplexer.

None of our existing rate elements explicitly recovers the costs of these multiplexers, and we conclude that these costs are currently recovered as part of the TIC. Accordingly, we establish two rate elements for multiplexers used on the serving wire center side of the tandem switch. The first will recover the costs of DS3/DS1 multiplexers used by purchasers of dedicated DS3 transport trunks from the serving wire center to the tandem switch, and may be levied only on purchasers of such DS3 transport. The second will recover the costs of DS1/voice-grade multiplexers used on the serving wire center side of analog tandem switches, and should be levied on purchasers of DS1 or greater capacity dedicated transport from the tandem switch to the serving wire center in proportion to the transport capacity purchased on that route. Like serving wire center-side trunks and trunk ports, both DS3/DS1 and DS1/voice-grade multiplexers on the serving wire center side of the tandem switch are dedicated to individual customers. Accordingly, flat-rated NTS charges for these multiplexers are appropriate.

172. On the end office side of the tandem switch, we establish two additional rate elements. The first will recover the costs of DS3/DS1 multiplexers used on the end office side of the tandem switch. This rate element will be a per-minute charge imposed on each IXC purchasing common transport on the end office-to-tandem link. This charge will be calculated based on actual minutes of use of the common transport circuits and will be assessed on IXCs in a 1:1 ratio with minutes of use of common transport. As with common transport trunks, because these multiplexers are shared among all users of common transport, traffic-sensitive, per-minute charges are appropriate. The second rate element should be assessed only at analog tandems, to recover in a similar manner the costs of DS1/voice-grade multiplexers needed at these analog tandems.

173. Price cap LECs must reallocate revenues currently being recovered through the TIC to these rate elements and begin recovery of multiplexing costs using these rate elements in their access tariffs to become effective January 1, 1998.

174. *Dedicated Tandem Switch Trunk Port Costs.* Price cap incumbent LECs must establish a separate rate element for dedicated trunk ports used to terminate dedicated trunks on the serving wire center side of the tandem switch. LECs incur the costs of these ports on an NTS basis, but currently must recover their costs through per-minute charges for the tandem switch. Because we have allocated 80 percent of tandem-switching costs to the TIC, these port costs may currently be recovered through either per-minute tandem-switching charges, or the per-minute TIC. We now take this opportunity to establish a separate rate element for these costs. Price cap LECs must establish a flat-rated element for dedicated trunk ports on the serving wire center side of the tandem, assessed on the purchaser of the dedicated trunk terminated at that port. This rate element shall be a flat-rated charge assessed on the carrier purchasing the dedicated trunk terminated at that port, and must be also be included in tariff filings to become effective January 1, 1998.

175. *Three-Part Rate Structure.* We also direct all incumbent LECs to discontinue the

unitary rate structure option for the transmission component of tandem-switched transport, effective July 1, 1998. In their access tariffs that take effect on July 1, 1998, incumbent LECs will be required to provide tandem-switched transport under a three-part rate structure as follows: (1) a per-minute charge for transport of traffic over common transport facilities between the LEC end office and the tandem office; (2) a per-minute tandem switching charge; and (3) a flat-rated charge for transport of traffic over dedicated transport facilities between the serving wire center and the tandem switching office. This three part rate structure reflects the manner in which the incumbent LEC incurs the costs of providing each component of tandem-switched transport. By establishing a per-minute, traffic-sensitive rate for the shared common transport trunks and the tandem switch, incumbent LECs will recover these costs from each IXC in proportion to its use. The incumbent LEC, in contrast, incurs the costs of the dedicated serving wire center-to-tandem trunk on an NTS basis because, like other dedicated trunks, the LEC must provision the trunk for the exclusive use of one IXC. Once this capacity is dedicated, the cost of the trunk does not vary with the amount of traffic transmitted by the IXC.

176. The three-part rate structure may cause some tandem-switched transport customers to increase their use of direct-trunked transport relative to tandem-switched transport. As discussed above, making this rate structure change effective on July 1, 1998, will provide tandem-switched transport customers that currently take service under the unitary rate structure with notice of this change sufficient to enable them to adjust their networks to provide service in the most efficient way possible, and to mitigate any sudden effect on rates such a change could have if implemented on shorter notice. In order to encourage transport customers to increase the efficiency of their transport networks quickly, we will require incumbent LECs to waive certain nonrecurring charges until six months after the three-part rate structure becomes mandatory. Therefore, from the effective date of this Order until six months after the effective date of tariffs eliminating the unitary pricing option for tandem-switched transport, the incumbent LECs shall not assess any nonrecurring charges for service connection when a transport customer converts trunks from tandem-switched to direct-trunked transport or orders the disconnection of overprovisioned trunks.²³⁴

177. When we replaced the equal charge rule in 1991, we stated three principles that would guide our efforts to develop the transport rate structure: (1) to encourage efficient use of transport facilities by allowing pricing that reflects the way costs are incurred; (2) to avoid interference with the development of interstate access competition; and (3) to facilitate full and fair interexchange competition.²³⁵ In 1991, we stated that the interim rate structure was a reasonable first step toward achieving these goals, because it was more cost-based than the equal

²³⁴ This waiver is similar to the one we ordered when we adopted the interim rate structure. *First Transport Order*, 7 FCC Rcd at 7038.

²³⁵ *First Transport Order*, 7 FCC Rcd at 7009. We reiterated these principles in the *First Transport Reconsideration Order*, 8 FCC Rcd at 5372, and the *Third Transport Reconsideration Order*, 10 FCC Rcd at 3035.

charge rule.²³⁶ Even from its inception, however, we have recognized that the interim rate structure represents significant compromises that cause it to fall substantially short of these goals in many ways.²³⁷

178. First, the unitary rate option does not accurately reflect the manner in which LECs incur costs in providing tandem-switched transport and, therefore, does not provide maximum incentive for IXCs to use transport facilities efficiently. IXCs may order, and LECs must provide, dedicated transport links with NTS costs on the serving wire center-to-tandem route with no assurance that the traffic-sensitive, per-minute revenues collected will cover the NTS costs of the link. As we stated at the time, the unitary rate structure was intended as an interim measure to allow IXCs time to prepare for a fully cost-based transport rate structure.²³⁸ IXCs have now had well over a decade since divestiture to so prepare. We agree with the *CompTel* decision that it is time to bring this period of preparation to a close as expeditiously as possible without causing severe disruption to carriers.²³⁹

179. Second, by bundling the dedicated and common portions of the transmission component of tandem-switched transport into a single, end-to-end per-minute charge, the unitary rate structure inhibits the development of competitive alternatives to incumbent LEC tandem-switched transport. While we have required incumbent LECs to provide the collocation, signalling, and unbundled network elements necessary for new entrants to compete with incumbent LECs without having to replicate the incumbent LEC's interoffice transport network,²⁴⁰ we have not corrected the non-cost based aspects of our tandem-switched transport rate structure that reduce incumbent LEC rates for tandem-switched transport services. Several commenters have noted that the tandem-switched transport market, despite our efforts, is subject only to limited competition.²⁴¹ Moreover, several competitive entrants have stated that they have the capability and desire to offer some or all of the components of tandem-switched transport on a competitive basis, but that the present, unitary rate structure inhibits the development of

²³⁶ *First Transport Order*, 7 FCC Rcd at 7016.

²³⁷ *See First Transport Order*, 7 FCC Rcd at 7016, 7021-22; *Third Transport Reconsideration Order*, 10 FCC Rcd at 3047-48.

²³⁸ *Third Transport Reconsideration Order*, 10 FCC Rcd at 3048.

²³⁹ *CompTel*, 87 F.3d at 530.

²⁴⁰ *See Local Competition Order; Expanded Interconnection with Local Telephone Company Facilities*, Memorandum Opinion and Order, 9 FCC Rcd 5154 (1994); *Expanded Interconnection with Local Telephone Company Facilities*, Transport Phase II, Third Report and Order, 9 FCC Rcd 2718 (1994).

²⁴¹ *E.g.*, Letter from David Sieradzki, Counsel for WorldCom, Inc., to William F. Caton, Acting Secretary, FCC, February 25, 1997, Encl. at 4.

competition in this area.²⁴² In addition, each component of tandem-switched transport is not equally susceptible to competitive entry; it is relatively easier for a new entrant to compete to provide the dedicated serving wire center-to-tandem link than it would be to compete to provide either the tandem switch itself or the myriad common transport end office-to-tandem links. Thus, in order to permit the fullest development of competitive alternatives to incumbent LEC networks, we need to unbundle reasonably segregable components of incumbent LEC transport services and price them in the manner in which costs are incurred.

180. Third, the interim rate structure does not best promote "full and fair" interexchange competition. The unitary rate structure has facilitated the growth of small IXCs to compete with larger carriers. It has achieved this, however, by requiring incumbent LECs to price facilities with NTS costs on a per-minute, traffic sensitive basis, in order to allow small IXCs to offer interexchange services at rates comparable to those offered by larger carriers without regard to whether the charges paid by the small IXCs cover the costs of the facilities that they use. While this structure has protected "pluralistic supply in the interexchange market,"²⁴³ our rules should promote competition, not protect certain competitors. We have recently concluded that no carrier is dominant with respect to domestic, interexchange services.²⁴⁴ Therefore, to the extent that we designed the interim rate structure to facilitate the growth of small IXCs in competition with AT&T, we find that such protective rules are no longer necessary. In a competitive market,

²⁴² E.g., Teleport Comments at 13-14; ALTS Reply at 22. After the comment period closed in this proceeding, Teleport and CompTel proposed a compromise tandem-switched transport rate structure that would (1) retain the unitary rate structure for the transmission component of tandem-switched transport; (2) prohibit incumbent LECs from deaveraging TIC charges within a state for a five year transition period; and (3) provide that IXCs and CLECs that do not use transport facilities supplied by the incumbent LEC would be exempt from paying the TIC for any switched access traffic carried over those facilities. See *Ex Parte* Letter from James M. Smith and Robert C. Atkinson to Hon. Reed E. Hundt, April 16, 1997. Teleport and CompTel characterize this third element of their proposal as the "most important." Exempting IXCs and CLECs that do not use transport facilities supplied by the incumbent LEC from paying the TIC for any switched access traffic carried over those facilities would be consistent with a recent Colorado Commission arbitration ruling. See *TCG Colorado Petition for Arbitration Pursuant to § 252(b) of the Telecommunications Act of 1996 to Establish an Interconnection Agreement with U S West*, Docket No. 96A-329T, Decision Regarding Petition for Arbitration, Decision No. C96-1186 (adopted Nov. 5, 1996). In that decision, the Colorado Commission stated that,

[I]f [U S West] provides all or part of the transport of an interstate call from the end office to the IXC, then [U S West] is entitled to collect its interstate rates, including [TIC]. If, however, [U S West] is not providing the transport of a call from an end-office switch to an IXC, then [U S West] may not apply its switched access transport rates, including the [TIC], to those calls. We reject arbitrary splits of revenues. In jointly provisioned switched access services, each company will develop and apply its tariffed rates to the portion of service it provides.

Id. at ¶ I.O.7. Clarifying this position on reconsideration, the Colorado Commission stated, "[t]he [TIC] shall be applied on a pro rata basis determined from the proportional distance between the [Teleport] tandem and the end-office of [U S West]." *TCG Colorado Petition for Arbitration Pursuant to § 252(b) of the Telecommunications Act of 1996 to Establish an Interconnection Agreement with U S West*, Docket No. 96A-329T, Order Denying Applications for Rehearing, Reargument, or Reconsideration, Decision No. C96-1344 (adopted Dec. 18, 1996), at ¶ I.B.1.4.

²⁴³ See *First Transport Order*, 7 FCC Rcd at 7007.

²⁴⁴ *Motion of AT&T to be Reclassified as a Non-Dominant Carrier*, Order, 11 FCC Rcd 3271 (1995).

we believe that we should strive to make our rate structure rules consistent with cost-causation principles, so long as those principles do not conflict with other statutory obligations, such as universal service. As the *CompTel* decision stated, "attempt[ing] to recover costs from IXCs that did not cause those costs to be incurred would impart the wrong incentives to both actual and potential providers of local transport, thereby inducing them to offer an inefficient mix of dedicated, [direct-trunked transport], and tandem-switched service."²⁴⁵ Because rules that do not reflect cost-causation may cause IXCs to order an inefficient mix of transport services, such rules artificially raise the costs of providing interexchange services. Rules properly reflecting cost-causation, in contrast, will benefit LECs, IXCs, and consumers alike by encouraging competitors to provide service using facilities efficiently. In adopting the interim rate structure, we cited AT&T's estimate that the efficiency benefit to consumers of cost-based pricing and competition could reach \$1 billion annually.²⁴⁶ Our adoption of the three-part rate structure is intended to permit consumers the benefits of even greater service efficiency.

181. We therefore adopt the three-part structure as the final tandem-switched transport rate structure because this structure most closely reflects the manner in which LECs incur the costs of each component of the overall tandem-switched transport service. When combined with our actions with respect to the TIC, our adoption of actual minutes of use as the appropriate factor for determining per-minute rates for common transport circuits, and our allocation of the full cost of the tandem-switch to the tandem-switching rate elements, we expect that this structure will benefit LECs, IXCs, competitive providers of access services, and consumers. Tandem-switched transport facilities are sized to accommodate peak traffic loads, including overflow traffic from IXCs using direct-trunked transport facilities. Several commenters have stated that, until now, these overflow customers have not borne the full costs of these facilities because overflow customers pay only the same per-minute transmission charges applicable to other IXCs.²⁴⁷ The three-part rate structure will require the IXC purchasing tandem-switched transmission facilities to pay the full NTS costs of the dedicated serving wire center-to-tandem link, without regard for the amount of traffic transported. This benefit, in turn, will substantially increase IXC incentives to use tandem-switched transport efficiently for overflow traffic.

182. Some commenters argue that we should retain the unitary rate structure because tandem-switched transport, as a service, has traditionally been offered on an end-to-end basis. We agree that the transmission component of tandem-switched transport has in fact been *offered*

²⁴⁵ *CompTel*, 87 F.3d at 530-531. Even though directly addressing the TIC and not the unitary rate structure, the Court's remarks are apposite because the unitary rate structure does not recover the costs of tandem-switched transport in the way that those costs are incurred and therefore results in the recovery of some costs of the transmission component of tandem-switched transport through the TIC.

²⁴⁶ *First Transport Order*, 7 FCC Rcd at 7016.

²⁴⁷ *E.g.*, TCI Comments at 16, Reply at 13-14. *See also* ACC Long Distance Comments at 14-15; Telco Communications Group Comments at 6-7.

on an end-to-end basis, but only pursuant to the requirements of the MFJ and our interim rate structure rules as part of a transition to cost-based rates. We find, however, that the transmission component of tandem-switched transport is not, in fact, *provisioned* by the incumbent LEC on an end-to-end basis. Purchasers of direct-trunked transport purchase an end-to-end service; they purchase from the incumbent LEC transport capacity between two end points. Tandem-switched transport customers, in contrast, purchase use of the tandem switch to route traffic to their POP. By virtue of their decision to choose tandem-switched transport, these customers specifically obligate the LEC to transport their traffic between the serving wire center and the tandem serving a particular end office or group of end offices and to perform the tandem switching function. Because they cause the incumbent LEC to incur the costs of transmitting their traffic between the serving wire center and the tandem, tandem-switched transport customers should, as a matter of cost-causation, pay the costs of reaching the tandem. In providing tandem-switched service, incumbent LECs must provision two separate circuits with distinctly different cost characteristics -- one dedicated, and one shared. Tandem-switched service, therefore, is not provisioned on an end-to-end basis between the end office and serving wire center, but in three parts: (1) transmission from one "end," the end office, to the tandem; (2) the tandem switching function itself; and (3) transmission from the tandem to the other "end," the serving wire center. Just as the tandem-switched transport customer pays a separate charge for the tandem switch, the tandem-switched transport customer should pay separately for the two distinct transmission components.

183. Other commenters argue that the three-part rate structure will create LEC incentives to engage in inefficient network reconfiguration, placing tandems far from end offices and serving wire centers simply to increase tandem-switched transport revenues.²⁴⁸ These commenters further argue that, if we adopt the three-part rate structure, we need to control this incentive by establishing a process for review of the incumbent LECs' tandem deployment decisions. Based on this record, we conclude that these commenters' fears are not well founded. An incumbent LEC would likely incur substantial costs to reconfigure placement of its tandem switches specifically to disadvantage IXC users of tandem switched transport. Because we expect the three part rate structure to catalyze the development of competition, we conclude that the incumbent LEC would not be likely to incur such costs. Although the incumbent LEC might be able to increase its tandem-switched transmission revenues in the short term to reflect inefficient routing, as more efficiently configured competitors enter the market, the LEC would not be able to sustain such artificially inflated rates and would then need to incur additional costs to reconfigure its network efficiently. Because, under our new competitive paradigm, a multitude of investment opportunities, including wireless services, video, and interLATA toll, may emerge for incumbent LECs, we agree with Ameritech that "[s]uch misspent capital outlays and inefficient

²⁴⁸ E.g., Sprint Comments at 22.

network configuration simply would not make good business sense."²⁴⁹

184. Moreover, the redeployment of tandem switches affects network efficiency with respect to both the incumbent LEC's own local and toll traffic, as well as intrastate and interstate access.²⁵⁰ Therefore, inefficient network reconfiguration would cause harm both to tandem-switched transport customers and to the incumbent LEC itself. Any additional transport revenues that the incumbent LEC generated through inefficient network reconfiguration would be at least partially offset by the additional costs of transporting the LEC's own traffic in similarly inefficient ways. As discussed above, as competition develops in the local market, we expect that a LEC would be reluctant to take steps to decrease its own efficiency.

185. Some commenters argue that we should retain the unitary rate structure because direct-trunked transport and tandem-switched transport circuits often travel along the same routes using the same physical facilities. These commenters argue, therefore, that it would be unfair or discriminatory to require tandem-switched transport users to purchase transmission based on airline mileage from the end office to the tandem to the serving wire center, while users of direct-trunked transport are permitted to purchase the same route on the basis of airline mileage from end office to the serving wire center directly. Other commenters argue that we should require the LECs to offer both types of transport based on actual route miles, revealing actual LEC network efficiencies and inefficiencies.

186. We disagree with both of these proposed modifications. An IXC purchasing direct-trunked transport requires the incumbent LEC to provide transport service between the end office and the serving wire center. Because the LEC must route direct-trunked transport traffic between only these two points, our rate structure requires the IXC to pay only for the airline mileage between those two points, reflecting the direct mileage route between the locations in the incumbent LEC network designated by the access customer. In contrast, an IXC purchasing tandem-switched transport purchases use of the access tandem switch and therefore requires the incumbent LEC to provide service between the serving wire center and the tandem, and between the tandem and the end office. Under the three part rate structure, the tandem-switched transport customer, like the direct-trunked transport customer, pays for the direct mileage between the locations in the incumbent LEC network designated by the customer -- for tandem-switched transport, the serving wire center to tandem, and the tandem to the end office. Because the IXC has chosen to make use of the LEC tandem switching facilities, it should pay explicitly for the transport necessary to reach the tandem. The direct-trunked transport customer, in contrast, does not make use of the tandem switching facilities; even if the LEC routes direct-trunked transport traffic through the tandem office, this traffic is not switched at the tandem. While the incumbent

²⁴⁹ Ameritech Reply at 29.

²⁵⁰ See Ameritech Reply at 29.

LEC may choose to route direct-trunked traffic through the tandem office based on its own assessment of whether it is economically efficient to do so, the direct-trunked transport customer pays only for direct mileage between the locations it designated in the network.

187. We are not persuaded by arguments that we should retain the unitary pricing structure because the incumbent LEC, and not the tandem-switched transport customer, has selected the tandem location and, consequently, the tandem-switched transport customer should not pay for the direct mileage to and from the tandem location. The incumbent LEC equally chooses the locations of the serving wire center and end office, and yet access customers routinely pay mileage charges to and from those locations, rather than between the end points of the access service -- the POP and the end user location. Similarly, we find that the three-part rate structure does not discriminate against IXCs using tandem-switched transport. As discussed above, the tandem-switched transport customer, unlike the direct-trunked transport customer, *requires* the incumbent LEC to route its traffic to the tandem, and so should pay the costs of reaching the tandem. In addition, an IXC operating efficiently often may choose to locate its POP at or close to the tandem, if the tandem-switching office also can function as the serving wire center, thus eliminating virtually all of the dedicated transport costs of the tandem-to-serving wire center link. While such an arrangement may be the most efficient transport architecture for tandem-switched transport, our current unitary pricing structure does not reflect the underlying costs of tandem-switched transport transmission facilities and so does not encourage efficient transport architectures.

188. The introduction of more modern network architectures, such as Synchronous Optical Network (SONET) rings, does not alter our conclusion that the three-part rate structure most closely approximates the nature of costs associated with each component of tandem-switched transport. WorldCom, for instance, asserts that the "pyramid" diagram included in the NPRM as Figure 1 is outdated²⁵¹ and submits a diagram illustrating interoffice tandem-switched transport in a ring-based network.²⁵² WorldCom states that the multiple routing options and the reduced distance sensitivity of transport costs in a SONET environment compel retention of the unitary rate structure.²⁵³ We conclude, however, that the differences WorldCom identifies do not support retention of the unitary rate structure because, even in a ring-based network, the three-part rate structure treats direct-trunked and tandem-switched transport consistently. In a fiber-optic or ring-based network, dedicated, direct-trunked transport circuits are given a constant, and exclusive, time slot assignment on a large, time-division multiplexed fiber-optic cable. The incumbent LEC routes traffic for the IXC purchasing the direct trunk into the dedicated circuit or time slot, where it is received elsewhere on the ring or in the network at the serving wire center.

²⁵¹ NPRM at ¶ 24 (diagram follows the paragraph).

²⁵² WorldCom Reply at iii.

²⁵³ WorldCom Reply at 29-31.

The direction or precise routing of the signal around the ring is irrelevant for purposes of the rate structure because the transport is priced on an airline-mileage basis between the two end points. Capacity dedicated to a particular IXC, however, is not available to the LEC for other purposes.

189. SONET ring architecture offers the LEC the capability to transport large traffic volumes with redundant routing options, but it does not alter the fundamental nature of tandem-switched transport. Tandem-switched transport is functionally very different from direct-trunked transport because, by definition, the incumbent LEC must route an IXC's tandem-switched traffic through the tandem switch serving a particular end office. Whether using a SONET ring or not, the LEC must route its tandem-switched traffic into one of many shared common transport circuits or time slots allocated for transport between the end office and the tandem switch, and onto a *second* dedicated circuit or time slot for transport between the serving wire center and the tandem. Despite parties' arguments to the contrary, the precise routing of the traffic to the tandem, including the direction it may take around a SONET ring, is irrelevant to the rate structure because IXCs purchase transport under the three-part rate structure based on airline mileage to the tandem.

190. As discussed in connection with direct-trunked transport, above, ring network architectures may cause incumbent LECs transport costs to become less distance sensitive. Because our rate structure permits, but does not require, transport rates to be distance sensitive, LECs remain free to establish less distance sensitive transport rates to reflect the changing nature of these costs.

191. We also decline Teleport's suggestion to establish a flat-rated charge for the tandem switch, tied to the amount of dedicated capacity each IXC's serving wire center-side trunk ports provide. While the costs of these dedicated trunk ports are NTS, the record before us does not reflect that all of tandem-switching costs are similarly NTS. Rather, we conclude at this time that the costs of tandem switching likely vary, as do those of local switching, on a traffic-sensitive basis. In light of this conclusion, we find that it would be unreasonable to permit the incumbent LEC to recover all of its tandem-switching costs through flat-rated charges. As with the local switch, until we gain more experience with rate structures for unbundled network elements that are implemented pursuant to Sections 251 and 252 and that segregate switching costs into traffic-sensitive and NTS components, we will continue to adhere to the current, per-minute rate structure for shared switching facilities.

192. We also decline to adopt in full suggestions that we (1) retain the unitary pricing structure for tandem-switched transport, while (2) exempting IXCs and competing LECs that do not use the transport facilities supplied by the incumbent LEC from paying the TIC and (3) preventing the incumbent LEC from deaveraging the TIC within a state during a five year

transition period.²⁵⁴ We are modifying our rules to prohibit incumbent LECs from assessing any per-minute residual TIC charge on any switched minutes of CAPs that interconnect with the incumbent LEC switched access network at the end office.²⁵⁵ In doing so, we adopt a position substantially similar to the second enumerated point, above, which Teleport and CompTel characterize as the "most important" feature of this proposal.²⁵⁶ In addition, we are also taking other measures that will reduce substantially or eliminate the TIC in an expeditious manner. We decline, however, to adopt the other two suggestions. As explained in more detail above, the unitary rate structure is not cost-based in that it requires incumbent LECs to recover costs incurred on an NTS basis through per-minute charges and inhibits the development of competition by bundling reasonably segregable components of tandem-switched transport together and pricing them in a manner that does not reflect cost causation. We conclude that our new paradigm of promoting efficient competition requires that incumbent LECs adopt a cost-based transport rate structure and that entrants providing transport facilities in competition with the incumbent LEC not pay the TIC.

193. Although in their comments in this proceeding the incumbent LECs virtually unanimously favor the three-part rate structure as most consistent with principles of cost-causation, we recognize that incumbent LECs may face competition from competitors that are not limited to the three-part rate structure we adopt for incumbent LECs today. As such competition develops, the incumbent LEC may wish to respond by offering tandem-switched transport on a unitary pricing basis. We will address issues relating to when incumbent LECs should have the flexibility to offer a unitary tandem-switched transport rate structure in connection with our discussion of other pricing flexibility issues in a subsequent Report and Order that we will adopt in this proceeding.

194. *Peak and Off-Peak Pricing.* As with the local switch, we conclude that we should not mandate a peak-rate pricing structure for the tandem switch or common transport at this time. Many of the same practical difficulties with establishing, verifying, and enforcing a rational, efficient, and fair peak-rate structure exist in the context of the tandem switch. We will consider whether incumbent LECs should have the flexibility to develop such peak and off-peak rate structures for local switching on a permissive basis when we consider other issues of rate structure flexibility in a subsequent Report and Order that we will adopt in this proceeding.

²⁵⁴ See Letter from James M. Smith, President, CompTel, and Robert C. Atkinson, Senior Vice President, Teleport Communications Group Inc., to Hon. Reed E. Hundt, Chairman, FCC, April 16, 1997.

²⁵⁵ Section III.D.2.b.

²⁵⁶ See Letter from James M. Smith, President, CompTel, and Robert C. Atkinson, Senior Vice President, Teleport Communications Group Inc., to Hon. Reed E. Hundt, Chairman, FCC, April 16, 1997.

d. Rate Levels

195. *Allocation of 80 Percent of the Tandem Switching Revenue Requirement to the TIC.* In establishing the interim transport rate structure, we required incumbent LECs to base their initial tandem switching charge on 20 percent of the interstate tandem-switching revenue requirement. In remanding this portion of the interim rate structure to us, the D.C. Circuit directed us either to implement a cost-based tandem switching rate or offer a rational and non-conclusory analysis in support of our determination that an alternative structure is preferable.

196. Based on the record in this proceeding, we reallocate much of the remaining 80 percent of the tandem switch revenue requirement back to the tandem switching rate elements in three steps. We conclude that this action is most consistent with cost-causation, and with the general approach we are taking in this Order regarding pricing issues. We do not require all of the 80 percent to be reallocated to tandem switching rates because the tandem-switching revenue requirement includes, not only the costs of the tandem switch, but other costs, such as SS7 signalling costs and tandem port costs, which we are requiring to be reallocated elsewhere.

197. Furthermore, if we required the price cap LECs to reallocate, dollar-for-dollar, the entire portion of the tandem switching revenue requirement that we reallocated to the original TIC in the *First Transport Order*, we would deny tandem-switched transport customers the continuing benefits of past X-factor reductions in the revenues permitted under price caps. Therefore, in order to preclude recovery of tandem switching costs in excess of the current revenues permitted under price caps, we direct price cap incumbent LECs first to account in the following manner for the effects of "GDP-PI minus X-factor" reductions to the original portion of the tandem switching revenue requirement allocated to the TIC in the *First Transport Order*. Each price cap LEC first should calculate the percentage of its total original TIC that represented the 80 percent reallocation of its tandem switching costs when the TIC was created. It should then calculate this percentage of its current TIC, which represents the extant portion of the reallocated tandem switching costs. It is this extant portion that the price cap LECs should reallocate to tandem switching as described in the next paragraph.

198. In access tariff filings to become effective on January 1, 1998, incumbent LECs must identify the portion of the tandem-switching revenue requirement currently in the TIC that they reallocate to each rate element, including, as applicable, SS7 signalling, tandem port costs, or other rate elements. They must then reallocate one third of the tandem switching revenue requirement remaining in the TIC to the tandem switching rate element. Effective January 1, 1999, incumbent LECs shall reallocate approximately one half of the remaining amount of the tandem switching revenue requirement in the TIC to the tandem switching rate elements. Effective January 1, 2000, incumbent LECs shall reallocate any portion of the tandem switching revenue requirement remaining in the TIC to the tandem switching rate element. This three-step implementation of this change permits IXCs time to adjust their use of various incumbent LEC transport services, but sets a definite end date in the near future, thus responding to the *CompTel*

decision's concerns regarding the length of the transition to a cost-based transport rate structure.

199. Some commenters argue that, rather than reallocating revenues from the TIC to other rate elements, we should reinitialize tandem-switched transport rates to levels reflecting long run incremental costs, making reallocation of TIC revenues to other transport rate elements unnecessary. We have decided in this Order, however, not to reinitialize access rates based on forward-looking cost principles. We have instead determined that the first step in access reform is to make the current system as economically efficient as is possible within the limits of current ratemaking practices. Thus, the focus of this portion of this proceeding is on the development of cost-causative rate structure rules. While we are taking several prescriptive steps using existing ratemaking methods to reduce initial baseline rates, we are generally adopting a market-based approach, with a prescriptive backdrop, to move rates over time to levels reflecting forward-looking economic costs. We disagree with those commenters that argue that the *Local Competition Order* requires us immediately to prescribe rate levels for access elements based on long-run incremental costs. The *Local Competition Order* addressed, *inter alia*, the pricing of unbundled network elements. While unbundled network elements may be used to provide interstate access services, their availability at TELRIC-based prices does not compel adoption of similar rates for access services. We intend instead to rely on the availability of unbundled network elements to place market-based downward pressures on access rates, subject to a prescriptive backstop. We will further address questions related to reinitialization to TELRIC rate levels in connection with our discussion of the prescriptive approach to access reform.²⁵⁷

200. *Use of Switched Access Overhead Loadings for Initial Tandem Switching Rates.* In setting rates, the interim transport rate structure derived both direct-trunked transport rates and tandem-switched transmission rates using relatively low overhead loadings applicable to special access. Tandem switching rates, in contrast, were set using relatively higher switched access overhead loadings. As a result, the tandem switching revenue requirement became relatively high, in comparison to other transport rate elements.

201. Several commenters in this proceeding contend that our use of special access overheads in setting direct trunked transport rates was inappropriate because, while special access is used almost exclusively in high density, generally urban areas, direct-trunked transport and, to an even greater extent, tandem-switched transport are used in less dense areas.²⁵⁸ In these less dense areas, overhead costs associated with transport may be higher than those associated with special access in urban areas. Some commenters have argued that we should either (1) equalize the overhead loading factors for all transport options by directing that the difference in transport rates is equal to the difference in the long run incremental cost of each transport option (DS3,

²⁵⁷ See Section IV.B.2.

²⁵⁸ See, e.g., BellSouth Comments at 77, 80.

DS1, and tandem-switched transport); or (2) otherwise ensure that transport customers pay an equal dollar amount of overhead per unit of traffic transported.²⁵⁹

202. We conclude that we need to make no change to the overheads attributed to tandem switching. As discussed above, we have decided not to base access prices directly at this time on incremental cost studies, but instead to make significant changes in existing ratemaking practices as the first step in access reform. Our current methods allocate overhead in a reasonable, cost-based manner. In consultation with the Joint Board on Jurisdictional Separations, the Commission established procedures for allocating overhead expenses between the state and interstate jurisdictions.²⁶⁰ Our Part 69 cost allocation rules in turn allocated interstate direct investment to broad categories, including Central Office Equipment (with respect to both local switching and tandem switching) and Carrier Cable and Wire Facilities (with respect to special access, direct-trunked transport, and tandem-switched transport transmission facilities).²⁶¹ Other investment, including overhead, was allocated among these categories in proportion to the dollar amounts of net direct investment allocated to these categories.²⁶² Similarly, direct expenses, where possible, were allocated to the category to which the expenses are related.²⁶³ Other expenses, including overheads, are allocated on the same basis as other investment, according to relative dollar amounts allocated to the various categories.²⁶⁴ The Commission has stated that initial allocation of overheads based on relative costs closely approximates an economically efficient method assuming that the elasticity of demands for the various outputs is not too dissimilar.²⁶⁵

203. Our Part 69 cost allocation rules, therefore, established category revenue requirements that included overheads allocated generally based on relative costs. Once these initial revenue requirements were established, our Part 69 rules permitted incumbent LECs to recover all costs assigned to each category through the rate elements established for that

²⁵⁹ Cable & Wireless Comments at 19.

²⁶⁰ See, e.g., 47 C.F.R. § 36.192, separating Corporate Operations Expenses, USOA Accounts 6710 and 6720, on the basis of the separation of the Big Three Expenses: Plant Specific Expenses, Plant Non-Specific Expenses, and Customer Operations Expenses.

²⁶¹ 47 C.F.R. §§ 69.305 - 69.306.

²⁶² 47 C.F.R. § 69.309.

²⁶³ E.g., 47 C.F.R. § 69.401.

²⁶⁴ 47 C.F.R. § 69.411.

²⁶⁵ See, e.g., *First Transport Order*, 7 FCC Rcd at 7030 n.91.

category.²⁶⁶ The incumbent LECs were permitted to assign overhead costs among the category rate elements in any way that is just and reasonable and not unreasonably discriminatory.²⁶⁷ We find that it is reasonable to have set overhead loadings for tandem switching consistently with the overhead loadings for local switching, and disagree with those parties that argue that there is no cost justification for the current allocation of overheads to the tandem switch. The direct costs of both kinds of switching are fundamentally the same in that both types of switches are comprised of ports and a switching matrix. By contrast, the direct costs of transmission consist of outside plant and circuit equipment and certain central office equipment. So long as consistent overhead loading methodologies were used across switching functions, and across transmission functions, we find that a reasonable cross-over is established for access customers between direct-trunked transport and tandem-switched transport. As competition develops, we can also rely on market forces to pressure incumbent LECs to allocate overheads among rate elements in economically efficient ways. We address issues concerning the use of special access prices to initialize direct-trunked transport rates in the interim rate restructure below in our discussion of the TIC.

204. We also decline to adopt a requirement for equalized overhead loadings. Overhead loadings are used to assign costs that do not qualify as the direct costs of a particular service. Reasonable definitions of direct costs often leave in the overhead category costs that might reasonably be deemed attributable to a given service. Thus, if all of a carrier's costs are classified as either "direct costs" or "overheads," the overhead category will likely include costs that should not necessarily apply uniformly to all services. As a result, we think it desirable not to adopt a policy that is too specific and too rigid, and that might not permit recognition of legitimate differences in costing definitions. Furthermore, in a competitive market, it would be mere happenstance if different products or services of a single company recovered uniform amounts of overhead. If we were to require equalized overhead loadings, we would be interfering with the market discipline on which we are primarily relying. We might, for example, prevent an entrant from realizing a reasonable profit opportunity based on a rigid overhead loading requirement.

205. In determining that our existing cost allocation rules reasonably allocated overhead to the initial tandem switching rate element and that we thus need not change the overheads currently attributed to tandem switching, we recognize that the D.C. Circuit in *CompTel* remanded the overhead issue to the Commission for further explanation and stated that the "cost allocation to the tandem switch" under the existing allocation rules "is, by the Commission's own estimation, grossly excessive."²⁶⁸ The court did not provide a cite for its characterization of the

²⁶⁶ Since 1991, of course, the amounts recovered by price cap LECs have been subject to the price cap formulae. For all incumbent LECs, however, the relative allocation of overheads was originally established under cost-of-service regulation by the Part 69 cost allocation rules.

²⁶⁷ 47 U.S.C. §§ 201-202.

²⁶⁸ *CompTel*, 87 F.3d at 533.

Commission's "estimation," but the court may have been referring to the agency's finding in the *First Transport Order* that "most, *but not all*, of the interstate tandem revenue requirement is attributable to tandem-switched transport."²⁶⁹ The Commission in that order also identified only one category of costs -- having to do with SS7 technology -- that appeared to be misallocated to tandem switching.²⁷⁰ Elsewhere in this Order, we have taken steps to address that misallocation of SS7 costs.²⁷¹ That correction having been made, we find that our existing rules reasonably allocate overhead to tandem switching for the reasons discussed above.

206. *Use of actual minutes of use rather than an assumed 9000 minutes of use.* For tandem-switched transport rates to be presumed reasonable, the interim rate structure requires incumbent LECs to set per-minute tandem-switched transport rates using a weighted average of DS1 and DS3 rates reflecting the relative numbers of circuits of each type in use in the tandem-to-end office link, and assuming circuit loading of 9000 minutes of use per month per voice-grade circuit.²⁷² Based on the record before us, we find that continued use of this 9000 minutes of use assumption is no longer reasonable. Many commenters state that their actual traffic levels are substantially lower than 9000 minutes of use per month. Some incumbent LECs, particularly smaller LECs in rural areas, indicate that their actual traffic levels may be as low as 4000 minutes of use per month per voice-grade circuit. Accordingly, we conclude that rates for the common transport portion of tandem-switched transport must be set using a weighted average of DS1 and DS3 rates reflecting the relative numbers of DS1 and DS3 circuits in use in the tandem-to-end office link, and using the actual voice-grade switched access common transport circuit loadings, measured as total actual minutes of use, geographically averaged on a study-area-wide basis, that the incumbent LEC experiences based on the prior year's annual use. Incumbent LECs that deaverage their transport rates under our existing zone-based deaveraging rules²⁷³ may similarly deaverage the actual minutes of use figures that they use to calculate per-minute common transport rates.

207. Our assumption that voice-grade common transport circuits experience uniform loadings of 9000 minutes of use was initially based on 1983 data submitted in the original *MTS and WATS Market Structure* proceeding.²⁷⁴ In using this assumption as part of the interim rate structure, we stated that, "[t]he 9000 minutes per circuit per month standard serves as a

²⁶⁹ 7 FCC Rcd at 7062 (emphasis added).

²⁷⁰ *Id.*

²⁷¹ See Section III.D.2.

²⁷² *First Transport Order*, 7 FCC Rcd at 7036-37.

²⁷³ See 47 C.F.R. § 69.123.

²⁷⁴ *MTS and WATS Market Structure*, Memorandum Opinion and Order, 97 F.C.C.2d at 862.

convenient starting point in the context of a short-term, interim rate structure."²⁷⁵ We rejected at that time requests to develop a loading factor for small LECs that would reflect their actual, substantially lower circuit loading levels, stating that, "the benefits to be obtained from use of more individualized loading factors are outweighed by the benefits of the administrative convenience of a uniform loading factor and of avoiding verification difficulties."²⁷⁶ Given the new competitive paradigm embodied in the 1996 Act, we conclude that this assumption must give way to charges based on actual usage levels. The same conversion factor is not appropriate for each incumbent LEC.²⁷⁷ Because the 9000 minute assumption appears to have substantially overstated the actual traffic levels on many circuits, we now conclude that the current rate structure is unlikely to recover the full costs of common transport. Costs that properly should be recovered from common transport rate elements may currently be recovered through TIC revenues. Because the 9000 minutes of use loading factor has contributed, possibly significantly, to the level of the non-cost-based TIC, we find that continued use of this factor is no longer reasonable.

208. We therefore direct incumbent LECs to develop common transport rates based on the relative numbers of DS1 and DS3 circuits in use in the tandem-to-end office link, and using actual voice-grade circuit loadings, geographically averaged on a study-area-wide basis, that the incumbent LEC experiences based on the prior year's annual use. As discussed above, incumbent LECs that deaverage their transport rates under our existing zone-based deaveraging rules may similarly deaverage the actual minutes of use figures that they use to calculate per-minute common transport rates. As they develop transport rates based on actual minutes of use, we require incumbent LECs to use any increase in common transport revenues to decrease the TIC. These rates must be included in the LEC access tariff filings effective January 1, 1998.

209. We disagree with commenters arguing that the actual number of minutes a circuit is in use is irrelevant in a rate-setting context.²⁷⁸ These commenters argue that rates should be set based on forward-looking cost studies using Commission-determined "efficient" traffic levels, which they argue may be far higher than either the actual traffic levels, or the 9000 minutes of use assumption. As explained elsewhere, we are not taking the general approach of prescribing rates at forward looking economic costs, and we decline to make an exception in this instance. We are instead reforming access charges so that they more closely reflect the costs imposed by individual access customers. We also do not find it necessary to employ different principles here to ensure that incumbent LECs face sufficient incentives to design their networks to achieve efficient usage

²⁷⁵ *First Transport Reconsideration Order*, 8 FCC Rcd at 5377.

²⁷⁶ *Id.*

²⁷⁷ U S West Reply at 32.

²⁷⁸ *See, e.g., WorldCom Reply* at 35.

levels. LECs subject to price cap regulation already have only limited ability to raise rates to cover the costs of inefficient network designs, and are able to benefit from increased profits as their efficiency improves. In addition, as competition develops for local service, all incumbent LECs will face increasing pressure to provide service as efficiently as possible.

D. Transport Interconnection Charge (TIC)

1. Background

210. Under our Part 36 separations rules, certain costs of the incumbent LEC network are assigned to the interstate jurisdiction. The Part 69 cost allocation rules allocate these costs among the various access and interexchange services, including transport. In the *First Transport Order*,²⁷⁹ we restructured interstate transport rates for incumbent LECs. The restructure created facility-based rates for dedicated transport services based on comparable special access rates as of September 1, 1991, derived per-minute tandem-switched transport transmission rates from those dedicated rates, established a tandem switching rate, and established a TIC that initially recovered the difference between the revenues from the new facility-based rates and the revenues that would have been realized under the preexisting "equal charge rule." Under the equal charge rule, which arose from the AT&T divestiture of the BOCs,²⁸⁰ the BOCs were required to charge a per-minute, distance-sensitive rate for their transport offerings, regardless of how the underlying costs were incurred. The TIC was intended as a transitional measure that initially made the transport rate restructure revenue neutral for incumbent LECs and reduced any harmful interim effects on small IXCs caused by the restructuring of transport rates.²⁸¹ Approximately 70 percent of incumbent LEC transport revenues are generated through TIC charges, or approximately \$3.1 billion, according to USTA.²⁸²

211. The TIC is a per-minute charge assessed on all switched access minutes, including those of competitors that interconnect with the LEC switched access network through expanded interconnection. In the NPRM, we sought comment on how to reduce and eliminate the TIC in a manner that fosters competition and responds to the D.C. Circuit's *CompTel* remand. We sought comment on different methods of recovering the costs currently recovered by the TIC, including: (1) giving the incumbent LECs significant pricing flexibility and allowing market forces to discipline the recovery of the TIC, either alone or in conjunction with a phase-out of the TIC; (2) quantifying and correcting all identifiable cost misallocations and other practices that result in

²⁷⁹ *First Transport Order*, 7 FCC Rcd 7006.

²⁸⁰ *United States v. American Tel. and Tel. Co.*, 552 F. Supp. 131.

²⁸¹ *First Transport Order*, 7 FCC Rcd at 7038-40.

²⁸² USTA Comments, Attachment 11.

costs being recovered through the TIC; (3) combining the above approaches, for example, by addressing directly the most significant and readily-corrected misallocations, and then relying on a market-based approach to reduce what remains of the TIC; (4) providing for the termination of the TIC over a specified time, such as three years. We specifically sought comment on the possible reassignment of costs based on several explanations for the amounts in the TIC. The NPRM also sought comment on how the resolution of the issues surrounding the TIC would be affected by decisions on universal service, by the level of any residual costs, and by the adoption of either the market-based or prescriptive approach to access reform.

2. Discussion

212. As a per-minute charge assessed on all switched access minutes, including those of competing providers of transport service that interconnect with the LEC switched access network through expanded interconnection, the TIC adversely affects the development of competition in the interstate access market. First, as discussed more fully below, some of the revenues recovered through the TIC should be recovered through other switched access elements, including transport rates other than the TIC. The TIC, as currently structured, provides the incumbent LECs with a competitive advantage for some of their interstate switched access services because the charges for those services do not recover their full costs. At the same time, the incumbent LECs' competitors using expanded interconnection²⁸³ must pay a share of incumbent LEC transport costs through the TIC. Second, all other things being equal, the usage-rated TIC increases the per-minute access charges paid by IXC and long-distance consumers, thus artificially suppressing usage of such services and encouraging customers to explore ways to bypass the LEC switched access network, particularly through the use of switched facilities of providers other than the incumbent LEC that may be less economically efficient than incumbent LECs.

213. As we noted in the NPRM, our goal is to establish a mechanism to reduce and eliminate the TIC in a manner that fosters competition and responds to the D.C. Circuit's remand. To that end, we below identify several costs included in the TIC that should be reallocated to other access elements. We conclude, however, that on the present record, we cannot immediately eliminate the TIC entirely through these reassignments. We establish a mechanism that should substantially reduce the remaining TIC over a short, but reasonable period. In addition, we will in the near future refer a broad range of separations issues to a Joint Board for purposes of determining whether certain costs currently allocated to the interstate jurisdiction and recovered through the TIC more properly should be allocated to the intrastate jurisdiction. Finally, we establish the means by which the remaining TIC amounts are to be recovered.

²⁸³ Under our expanded interconnection rules and policies, competitors may interconnect with the incumbent LEC's facilities at the end office and supply their own transport. For a more detailed discussion of expanded interconnection, see *Expanded Interconnection with Local Telephone Company Facilities*, Memorandum Opinion and Order, 9 FCC Rcd at 5157.

a. Reallocation of costs in the TIC

214. The record in response to the NPRM clearly establishes that some costs in the TIC should be reallocated to other access elements. USTA, in conjunction with the incumbent LECs, submitted extensive comments setting forth an incumbent LEC consensus explanation of the causes for the sums in the TIC and estimates of the amounts associated with each explanation.²⁸⁴ While the current rulemaking record will not permit us to prescribe specific amounts that individual incumbent LECs must shift from the TIC to specific access rate elements, it does permit us to direct incumbent LECs to make certain cost reallocations and to require them to calculate the appropriate level of the reallocation in the supporting materials filed with the tariffs implementing the changes. Below, we discuss each of the identified causes of costs being included in the TIC and the extent to which costs should be reallocated to other access elements or categories.

215. In this Order, we do not address certain rate structure issues relating to incumbent LECs subject to rate-of-return regulation. These LECs account for relatively few access lines.²⁸⁵ In some instances we direct price cap LECs to allocate costs to new rate elements that do not currently exist for rate-of-return LECs. We anticipate that we will propose similar rate elements in the forthcoming notice of proposed rulemaking addressing rate structure issues for incumbent LECs subject to rate-of-return regulation. Recognizing the expense and difficulties of modifying billing systems, we conclude that, until the rate structure issues are resolved for rate-of-return companies, the costs allocated to new elements and any residual TIC revenues may continue to be recovered by the incumbent LECs that are not subject to price cap regulation through per-minute TIC rates assessed on both originating and terminating access.

216. As their primary challenge to the incumbent LEC proposals to reallocate costs from the TIC, several parties argue that we should use forward-looking cost principles, or TELRIC, in determining how much to shift from the TIC to other access categories. Some parties advocating the use of such forward-looking cost standards assert that any costs not meeting these forward-looking cost standards should be eliminated from the TIC, and the incumbent LECs should not be permitted to recover those amounts. One group of consumer advocates proposes that we need not complete TELRIC studies before substantially reducing the TIC because BA/NYNEX has already proposed, as part of their access charge reform compromise plan, to eliminate up to 80

²⁸⁴ USTA Comments, Attachments 10 and 11.

²⁸⁵ As of December 31, 1995, larger, reporting local exchange carriers (*i.e.*, those with revenues of at least \$100 million) account for 92.6 percent of the total presubscribed lines. Federal Communications Commission, CCB, Industry Analysis Division, *Preliminary Statistics of Common Carriers*, Tbl. 2.3, Total Presubscribed Lines for all Local Exchange Companies (July 1996). Thus, small local exchange carriers account for 7.4 percent of the presubscribed lines.

percent of the TIC pending a determination of "service related" costs by the Commission.²⁸⁶ We conclude, however, that immediate, widespread, prescriptive action is not necessary to pressure access rates toward market-based levels. Instead, we have determined that the most appropriate first step towards access reform is to make the current rate structure as economically efficient as possible within the limits of past ratemaking practices. These practices include setting rates based on interstate-allocated costs, subject to price cap constraints for most large carriers.²⁸⁷ As we discuss more fully in Section IV, below, we intend in the future to rely primarily on market forces, with a prescriptive backdrop, to move rates toward forward-looking economic cost. Therefore, because we currently are not prescribing a forward-looking cost method for access reform, we will require reassignment of certain TIC revenues based on an analysis of the separated, booked costs already recovered through the TIC.

217. *SS7 costs.* Based on the record before us, we conclude that SS7 costs that are recovered by the TIC should be removed from the TIC and allocated to the traffic-sensitive basket. The record demonstrates that these costs are related to the signalling function and should be recovered through local switching or signalling rate elements. The costs to be removed are the costs of signal transfer points (STPs) that were included in the tandem-switching category for jurisdictional separations purposes and the cost of the link between the end office and the STP that is used only for SS7 signalling. The incumbent LECs shall distribute the STP costs reallocated from the TIC to local switching or, if the incumbent LEC has established an unbundled signalling rate structure, to appropriate SS7 elements, in tariffs filed to be effective January 1, 1998. The incumbent LEC shall distribute the costs of the link between the local switch and the STP that are included in the TIC to local switching or, if provided, to the call-setup charge. This change means that the incumbent LECs' SS7 prices will reflect the full cost of providing SS7 signalling and provide the proper price signals to developers of new services utilizing SS7. We decline to adopt the suggestion of US West that we reallocate SS7 costs to services in the trunking basket. As we conclude below in conjunction with our consideration of the SS7 rate structure, the costs being reallocated are appropriately included in the traffic-sensitive basket.

218. *Tandem switching costs.* Several parties argue that the tandem switching rate must be set to reflect the cost of providing the service. In the preceding section, we modified the existing tandem-switched transport rate structure and revised certain of the pricing rules applicable to elements of tandem-switched transport to establish a cost-based structure and to respond to the court remand in *CompTel v. FCC*. The revised pricing rules applicable to tandem switching include two separate elements -- a flat-rated port charge to be assessed when a port is dedicated to a single customer and a per minute charge to be assessed for the traffic-sensitive

²⁸⁶ See Letter from Brian R. Moir, Esq., Counsel to the International Communications Association, to William F. Caton, Acting Secretary, FCC, April 16, 1997; Letter from G.R. Evans, Vice President, Federal Regulatory Affairs, NYNEX, to William Caton, Acting Secretary, FCC, April 4, 1997.

²⁸⁷ See Section I, above.

portion of the tandem switch. In three approximately equal annual steps, beginning January 1, 1998, we require reallocation of all tandem-switching revenues currently allocated to the TIC to the tandem-switching rate element. As a result of this modification, the total revenues recovered through the tandem switching rates will, subject to price cap limits, increase to the level of costs assigned to the interstate jurisdiction by the separations process at the end of our plan. Equivalent changes to the amounts recovered through the TIC must be made to ensure that over-recovery does not occur. After this adjustment, in accordance with the *CompTel* remand, and to facilitate the development of economically-efficient competition for tandem-switching services, the TIC will not recover any costs that are attributable to tandem switching.

219. *DS1/voice-grade multiplexer costs.* We conclude that the costs of DS1/voice-grade multiplexing²⁸⁸ associated with analog local switches should be reassigned to the newly created trunk ports category within the traffic sensitive basket. Analog switches require a voice-grade interface on the trunk-side of the end office switch. Our separations rules assign the costs of DS1/voice-grade multiplexers to the cable and wire category. The costs of these multiplexers associated with switched access were originally included in the Part 69 transport revenue requirement. The revised transport rules adopted in 1992 established transport rates based on DS1 switch interfaces, and thus the rates did not include the costs of DS1/voice-grade multiplexers. The costs of the DS1/voice-grade multiplexers are, therefore, included in the TIC. Therefore, the costs associated with DS1/voice-grade multiplexing associated with analog local switches should be reassigned to the trunk ports category within the traffic sensitive basket, to be considered in conjunction with the development of appropriate rates for trunk ports, in tariffs filed to become effective January 1, 1998. This will make recovery of the costs necessary to use an analog switch port equivalent to the recovery of digital switch port costs, in which the multiplexing function is included in the port itself.

220. *Host/remote trunking costs.* We agree with the parties that allege that the costs of host/remote links not recovered by the current tandem-switched transport rates should be included in the tandem-switched transport category. The record reflects that the rates for carrying traffic between the host and a remote switch, for which the tandem-switched transport rates, both fixed and per mile, are assessed, do not recover the full costs of this transmission service. These charges for host/remote service are in addition to charges that an IXC is assessed for either direct-trunked transport, or tandem-switched transport, between the serving wire center and the host end office. This reassignment will ensure that these transmission costs will be recovered from those using the transmission facilities, and must be included in tariff filings to become effective January 1, 1998. We reject NECA's suggestion that we include these costs in local switching on the theory that remote facilities are installed when it is more cost effective to do that than it is to install a new switch at the remote location. That would require all users of local switching to pay

²⁸⁸ DS1 transport trunks need to be demultiplexed into individual voice-grade circuits before being switched at analog end office switches. DS1/voice-grade multiplexers perform this function.

for these host/remote transmission facilities. Imposing the host/remote transmission cost on the users of host/remote facilities is more cost causative and will facilitate the development of access competition.

221. *Additional multiplexers associated with tandem switching.* Based on the record before us, we conclude that an IXC's decision to utilize tandem-switched transport imposes the need for additional multiplexing on each side of the tandem switch. The revised tandem-switched transport rate structure provides for these multiplexers. For price cap LECs, recovery of the costs associated with the multiplexers should, therefore, be shifted from the TIC to the tandem-switched transport category as of January 1, 1998, as explained in Section III.C. This realignment of costs helps ensure that tandem-switched transport rates are cost based, as required by the *CompTel* decision, and facilitates competitive entry for those services.

222. *Use of actual minutes of use rather than an assumed 9000 minutes of use.* The data in the record provided by USTA and other incumbent LECs support a finding that for many incumbent LECs, especially those serving less densely populated areas, the assumed 9000 minutes of use per circuit is far higher than actual minutes of use. A tandem-switched transport rate derived by dividing the cost of a circuit by an assumed usage level does not recover the costs of the circuit when the actual usage is below that level. The costs not recovered through tandem-switched transport rates based on our current 9000 minutes of use assumption are being recovered through the TIC. In the preceding section, we conclude that the pricing of tandem-switched transport transmission should be based on the actual average minutes of use on the shared circuits and that such pricing would produce a cost-based rate. Accordingly, costs should be removed from the TIC equal to the additional revenues realized from the new tandem-switched transport rates when it is implemented in accordance with the rate structure established in Section III.C.

223. *Central Office Equipment (COE) Maintenance Expenses.* The record in this proceeding demonstrates that allocating COE maintenance expenses on the basis of combined COE investment produces misallocations of these expenses among access services. USTA correctly traces this problem to the Part 36 separations rules; the problem is then tracked in our Part 69 cost allocation rules. Under our current rules, COE maintenance expenses are allocated among separations categories, and then access services, based on the *combined* investment in the three categories of the COE plant being maintained -- Central Office Switching, Operator Systems, and Central Office-Transmission -- rather than on the *individual* investment in each of those categories. As a result, a portion of the expense of maintaining local switches and operator systems is recovered in rates for common line, transport, and special access even though those do not utilize any local switching or operator systems.²⁸⁹ Correcting this misallocation through changes to Part 36 would require referral to a Federal-State Joint Board and therefore could not

²⁸⁹ BellSouth Comments at 78.

be done in this proceeding. The misallocation can, however, be corrected by modifying section 69.401 of our rules to provide that the COE expenses assigned to the interstate jurisdiction should be allocated on the basis of the allocation of the specific type of COE investment being maintained, and we make the correction here. This will shift some costs to local switching from common line and transport, and result in more cost-based rates. This shift must be reflected in tariff filings to be effective January 1, 1998. We also plan to refer the underlying separations issue to a Joint Board for its recommendation.

224. *Separations-related causes.* Several incumbent LECs argue that a substantial portion of the TIC can be traced to decisions separating costs between the interstate and intrastate jurisdictions. As explained by USTA and incumbent LECs, the largest portion of the amounts recovered by the TIC results from the differences in the jurisdictional separations allocation procedures for message (*i.e.*, switched) services and special access services, and from the consequent effects of the Commission's decision to use special access rates to establish transport transmission rates when the Commission restructured transport rates. The current jurisdictional separations process separates the costs of message services based on average cost factors; costs of DS1 and DS3 special access services, in contrast, are separated using unit costing methods. Because of the differences in these separations methodologies, special access-derived rates reflect the costs of transport in areas in which special access services are most often offered (urban, higher density areas), and do not reflect the costs of transport in rural, less dense areas. Another alleged separations-related cause of the amounts in the TIC is the use of circuit termination counts in the separations process to allocate costs between special access and switched services before they are allocated between federal and state jurisdictions. This practice appears to allocate costs disproportionately to switched services. The incumbent LECs assert that the use of direct costing methods would assign many of these costs to local and intrastate services and to interstate services other than transport.²⁹⁰

225. We find that some of the remaining costs recovered by the TIC result from at least two different causes: (1) the separations process assigned costs differently to private line and message (*i.e.*, switched) services, resulting in costs allocated to special access being lower than those allocated to the message category, even though the two services use comparable facilities -- rates for direct-trunked transport and the transmission component of tandem-switched transport, which are switched services, therefore, do not recover the full amount of separated costs; and (2) the cost of providing transport services in less densely populated areas is higher than that reflected by transport rates derived from those special access rates. The existing record is inadequate to permit us to identify more costs that could clearly be reallocated to interstate services. Furthermore, the record indicates that some residual TIC costs may be appropriately allocated to intrastate services. Because we will soon be considering a Notice of Proposed Rulemaking to

²⁹⁰ If the Joint Board on Jurisdictional Separations takes action to address this issue, we will then consider what corresponding reallocations should be made.

refer to a Joint Board questions regarding separations, we will leave the determination of the ultimate allocation of the remaining costs recovered by the TIC until the conclusion of that proceeding.

226. Incumbent LEC parties generally contend that special access rates provided an acceptable initializing pricing level for transport transmission services in geographic areas where significant amounts of special access services are provided, but do not reflect the cost of providing transport service in low-density areas in which special access services are not as widespread.²⁹¹ We recognize that rates for direct-trunked transport and for the transmission component of tandem-switched transport, because they were established based on special access rates, do not reflect the full cost of providing transport services in higher-cost, rural areas. Because none of our other facilities-based rate elements recover costs reflecting this differential, we conclude that the additional costs of rural transport currently are recovered through the TIC. On the basis of the current record, however, we are unable to quantify these cost differentials. Moreover, based on differences in network architectures, population density variations, topography, and other factors that vary among LECs, we find that transport cost differentials are also likely to vary greatly among incumbent LECs and among study areas served by the same incumbent LEC. We do not believe, however, that we need to quantify these differences in this Order to ameliorate this distortion caused by the current rate structure, because the requirements set forth in the next paragraph will address this issue.

227. If an incumbent LEC deaverages its transport rates, either by implementing zone-density pricing under our rules²⁹² or by waiver, the underlying predicate is that the costs in low-density areas are higher than those in higher-density areas. The rates it sets for the different areas should reveal a cost differential of at least that magnitude between low-density and high-density areas served by that LEC. When an incumbent LEC deaverages transport rates, therefore, we require it to reallocate additional TIC amounts to facilities-based transport rates, reflecting the higher costs of serving lower-density areas. The reallocation we require here will permit incumbent LECs, in deaveraging their transport rates, to achieve cost-based transport rates while ensuring that a significant portion of costs reflecting the geographic cost difference are removed from the TIC. Each incumbent LEC must reallocate costs from the TIC each time it increases the deaveraging differential. We find that any incumbent LEC that has already deaveraged its rates must move an equivalent amount from the TIC to its transport services. Under any of these scenarios, the costs shall be reassigned to direct-trunked transport and tandem-switched transport categories or subcategories in a manner that reflects the way deaveraging is being implemented by the incumbent LEC. We do not require incumbent LECs that average their transport rates to make a similar reallocation at this time, because of the difficulty in determining the amount to be

²⁹¹ See, e.g., USTA Comments at 65; GTE Comments at 38; Aliant Comments at 3. See also Cable & Wireless Comments at 21-22.

²⁹² 47 C.F.R. § 69.123.

reallocated.

228. *Price Cap Implementation issues.* For purposes of phasing out the TIC, we are keeping the TIC in its own service category in the trunking basket. The reallocation of costs from the TIC to other access elements will require price cap LECs to adjust their price cap indices (PCIs) and service band indices (SBIs) to reflect the new revenue streams. To accomplish these reallocations, price cap LECs shall make exogenous adjustments to their PCIs and SBIs that are targeted to the indices in question, rather than applying the exogenous adjustment proportionately across all categories in the affected price cap basket. Thus, when a reallocation occurs within a price cap basket, only the affected SBIs will be adjusted. When the reallocation affects service categories in more than one basket, however, the affected PCIs and SBIs must be adjusted. The upward or downward adjustment to the PCIs and upper SBIs shall be calculated as the percentage of the revenues being added or subtracted from a basket or category, divided by the total revenues recovered through the basket or category at the time of the adjustment. For example, if ten percent of the revenues are being reallocated from a service category, the category upper SBI will be reduced by ten percent. If that revenue amount is only three percent of the PCI for the basket, the PCI is reduced by three percent.

b. Treatment of Remaining Costs Recovered by the TIC

229. *Residual TIC reduction plan.* After the costs identified above have been reallocated to other access services, some costs will continue to be recovered by the TIC. While it is desirable to eliminate the TIC as soon as possible by shifting the costs recovered by the TIC to facilities-based rates, referring separations questions to a Joint Board is the best means of reaching that ultimate objective, as we noted earlier. Even as we make this referral, we will require incumbent LECs to target to the TIC price cap reductions arising in any price cap basket as a result of the application of the "GDP-PI minus X-factor" formula until the per-minute TIC is eliminated, as many parties have suggested.²⁹³ These parties submit that this targeting will permit incumbent LECs to manage the reduction in revenues recovered by the TIC, while reducing the amount at issue in the TIC. Sprint states that, using a targeting approach, we would not need to address the cost allocation issues raised by Part 36 and Part 69.²⁹⁴ Targeting these price cap reductions to the TIC reduces the TIC over a reasonable period, thereby ultimately substantially reducing what is widely recognized to be an inefficient aspect of the access rate structure. We require price-cap LECs to begin these targeted X-factor reductions to the TIC in tariff filings to become effective July 1, 1997.

230. Targeting PCI reductions to the per-minute TIC will not change the overall revenue

²⁹³ See, e.g., PacTel Comments at 72; Sprint Comments at 29,52; Ameritech Reply at 32-33; BA/NYNEX Comments at 38.

²⁹⁴ Sprint Reply at 17-18.

levels that our price cap mechanisms permit incumbent LECs to receive. We have reallocated those costs that the record shows are clearly related to other facilities-based elements. The upcoming separations proceeding may provide additional data that will permit us to reallocate more costs to facilities-based rate elements, or to the intrastate jurisdiction. The approach we take is a reasonable response to the D.C. Circuit's remand directive, and establishes a plan that should substantially reduce the TIC within a reasonable period, pending review of the jurisdictional separations process.

231. We reject ALTS' allegation that targeting the productivity factor to the TIC undercuts the rationale for the "just and reasonable" status of all price-cap rates, which ALTS contends is dependant on the widespread application of the X-factor. The targeting approach that we adopt will eliminate anticompetitive aspects of the TIC, which promotes inefficient entry into the transport market by imposing some transport costs on IXCs that do not cause the costs to be incurred. In addition, by spreading current TIC revenues across all price cap PCIs and SBIs, our targeting method does not offer TIC revenues special insulation against the pressures of the competitive marketplace, as would some proposals to bulk-bill the TIC to IXCs. We also decline to adopt the approach of spreading the remaining costs recovered by the TIC proportionately among all transport services, as proposed by State Consumer Advocates.²⁹⁵ That approach might, because of the unknown nature of the costs that will remain in the TIC, result in an excessive reallocation to transport.

232. The D.C. Circuit instructed us to revise our transport rate structure rules to be more consistent with cost-causation principles. There is conflicting evidence in the record concerning the nature of the costs contained within the residual TIC; these costs may be traffic sensitive or NTS and may be associated with common line, transport or switching services. BA/NYNEX states, without explanation, that the costs in the TIC are NTS in nature.²⁹⁶ To the extent that some portion of the residual TIC has its origin in the methods used to separate cable and wire facilities between the regulatory jurisdictions, it seems likely that BA/NYNEX is partially correct in this assertion. The evidence, however, does not clearly resolve this issue.

233. If the costs remaining in the residual TIC are NTS, as BA/NYNEX suggests, then traffic-sensitive recovery could artificially raise per-minute rates for interstate access. These higher per-minute access rates could distort the market for interstate toll services by artificially suppressing demand for interstate toll services and by encouraging users that efficiently could make use of the network to instead seek other alternatives. Conversely, if costs remaining in the

²⁹⁵ State Consumer Advocates Comments at 34-37.

²⁹⁶ BA/NYNEX Reply at 39-40. USTA and many incumbent LECs proposed recovering the remaining TIC costs through a bulk billing mechanism based on an IXC's share of presubscribed lines or revenues. *See, e.g.*, USTA Comments at 66; BA/NYNEX Comments at 38; PacTel Comments at 72; SNET Reply at 27-28. This proposal to use presubscribed lines is consistent with treating the remaining costs recovered by the TIC as NTS costs.

residual TIC are usage-sensitive, flat-rating may also create a distortion by encouraging inefficient overuse of interstate toll services. Because the limited evidence in the record suggests that at least some amount of the residual TIC represents NTS costs, and because we wish to see that consumers enjoy the benefits of usage of the network to the greatest extent possible, we find that we should err, if at all, on the side of NTS recovery of these costs. For elements not demonstrably reflecting usage-sensitive costs, therefore, we find, on balance, compelling policy arguments in favor of flat-rated pricing because usage-sensitive recovery of any NTS costs artificially suppresses demand for interexchange calling by inflating per-minute rates. In the absence of definitive evidence as to the nature of the residual TIC amounts, we conclude that the public interest would be better served by imposing these costs on IXCs on a flat per-line basis, rather than on a per-minute basis.

234. Accordingly, we seek to migrate the current usage-based charges into flat-rated charges as quickly as possible consistent with avoiding short-term market distortions. We do that by: (1) on July 1, 1997, drawing down the per-minute-of-use residual TIC charge by targeting the price cap productivity (X-factor) adjustment to the trunking PCI and, specifically, the TIC SBI, thus effectively spreading those residual TIC revenues, which otherwise would be recovered exclusively on a minute of use basis, among the universe of (both traffic-sensitive and NTS) access services and moving TIC recovery closer to flat-rated recovery; (2) starting in January 1998, recovering remaining residual TIC revenues through PICC charges each year, subject to the PICC cap; and (3) drawing down any remaining residual per-minute TIC revenues each July by targeting the annual X-Factor adjustments to those revenues.

235. The targeting of price cap productivity reductions to the TIC will be accomplished in the following manner. Because the price cap LECs will not have reallocated facilities-based costs contained in the TIC before they file tariffs to be effective July 1, 1997, we first direct the price cap LECs to compute their anticipated "residual" TIC amount by excluding revenues that are expected to be reassigned on a cost-causative basis to facilities-based charges in the future, pursuant to the transition plan described in this Order. To determine TIC amounts so excluded, NYNEX, BellSouth, U S West, and Bell Atlantic shall use the residual TIC percentage estimates contained in USTA's *ex parte* letter filed May 2, 1997, to compute their respective anticipated residual TICs.²⁹⁷ SBC Communications shall use the cost data for SWBT, Pacific Bell, and Nevada Bell contained in its *ex parte* letter filed April 24, 1997 to estimate its residual TICs.²⁹⁸ Each remaining price cap LEC shall estimate a "residual" TIC in an amount equal to 55 percent of its current TIC revenues. For these remaining price cap LECs, we find that this 55 percent level

²⁹⁷ These percentages are as follows: NYNEX, 77.63 percent; BellSouth, 56.93 percent; U S West, 59.14 percent; and Bell Atlantic, 63.96 percent. *See* Letter from Linda Kent, Associate General Counsel, USTA, to William F. Caton, Acting Secretary, filed May 2, 1997.

²⁹⁸ These percentages, calculated from TIC data supplied, are: SWBT, 69.11 percent; Pacific Bell and Nevada Bell combined, 53.52 percent. *See* Letter from Todd F. Silbergeld, Director -- Federal Regulatory, SBC Communications, Inc., to William F. Caton, Acting Secretary, April 24, 1997.

represents a reasonable, but conservative estimate. The 55 percent level corresponds approximately to the lowest residual TIC percentage identified in the record, and three of the price cap LECs that submitted data on the record are within a few percentage points of this level. We therefore find that residual TIC estimates at the 55 percent level for companies that have not developed actual percentage estimates on the record will be reasonable, but will also minimize the risk that we will eliminate facilities-based TIC costs with targeted X-factor price cap reductions.

236. The "GDP-PI minus X" adjustments LECs ordinarily would apply to each of their price cap indices (i.e. revenues) for the July 1, 1997, annual filing shall be applied by LECs to reduce their calculated anticipated "residual" TIC revenues. For tariffs to become effective July 1, 1997, the price cap LECs shall calculate the annual price cap reduction resulting from the application of the productivity adjustment to each basket other than the interexchange basket, and shall sum the dollar effects of the adjustment. If the effect is to reduce PCIs, the dollar amount shall be targeted completely to the trunking basket PCI and the TIC SBI, without changing the PCIs or SBIs for any other basket or service category. The percentage reduction in the PCI and SBI shall equal the ratio of the total dollar effect of the price cap annual adjustment to the dollar value of the PCI and SBI, respectively. If the effect of the productivity adjustment would increase the PCIs, the PCIs shall be adjusted in their usual fashion, and no targeting to the TIC shall occur. This avoids exacerbating an already inefficient aspect of the access rate structure.

237. Price cap LECs will begin reallocation of facilities-based TIC components on January 1, 1998. At that time, the price cap LECs should all have actual cost data reflecting the facilities-based components of the TIC. If, at that time, any price cap incumbent LEC determines that its use of the applicable residual TIC estimate, above, resulted in more PCI reductions being targeted to the interconnection charge in its tariff filing to become effective on July 1, 1997, than were required to eliminate the per-minute interconnection charge, then that price cap LEC shall make necessary exogenous adjustments to its PCIs and SBIs to reverse the effects of the excess targeting.

238. For tariff filings to become effective July 1, 1998, and annually in July thereafter, all price cap LECs will have actual cost data reflecting the facilities-based components of the TIC and will be able to target reductions to actual anticipated residual per-minute TIC amounts without resort to the percentage estimates prescribed above. For these filings, "GDP-PI minus X" adjustments similar to those described above shall be targeted to the trunking basket PCI and the TIC SBI to reduce residual per-minute TIC amounts recovered through per-minute originating and terminating access charges.

239. To avoid the adverse effects of per-minute pricing of costs that may be NTS, we require price cap LECs to recover residual TIC amounts not otherwise eliminated by targeted X-factor reductions, described above, through the flat-rated PICC to the extent the PICC is below its ceiling. In order to ensure that primary residential and single line business subscribers do not pay more than their fair share of the residual TIC, however, we prohibit price cap LECs from

charging a PICC on primary residential or single-line business lines that recovers TIC revenues that exceed residual TIC revenues permitted under our price cap rules divided by the total number of access lines. As the PICC caps increase each year, more of the residual TIC charge can be included in the flat-rated PICC. Any residual TIC amounts that cannot be recovered through the PICC shall be recovered on a per-minute basis from originating traffic, subject to a cap on per-minute originating access charges, as explained in Section III.A, above.²⁹⁹ If this cap is exceeded, the residual TIC shall be recovered through per-minute terminating switched access rates. Although a portion of the residual TIC will be recovered through PICC charges, the TIC will remain in the trunking basket. Therefore, to ensure that excess headroom is not created in the trunking basket, price cap LECs shall include the TIC revenues received from the flat-rated PICC in calculating the API for the trunking basket and the SBI for the TIC.

240. The policies adopted when the TIC was created require incumbent LECs to assess the TIC on all minutes that interconnect with the incumbent LEC switched access network, including minutes that transit a CAP's transport network without using any incumbent LEC transport facilities. As we noted in the NPRM,³⁰⁰ and as some commenters assert,³⁰¹ if the incumbent LEC's transport rates are kept artificially low and the difference is recovered through the TIC, competitors of the incumbent LEC pay some of the incumbent LEC's transport costs. In a recent arbitration between Teleport and US West, the Colorado Commission has precluded US West from imposing the TIC on competitors for the portion of transport that U S West does not provide.³⁰² We find that our current policy, which requires competitive entrants to pay the TIC even in cases where it provides its own transport, is inconsistent with the procompetitive goals of the 1996 Act. We therefore modify our rules to permit incumbent LECs to assess any per-minute residual TIC charge only on minutes that utilize incumbent LEC transport facilities, and not on any switched minutes of CAPs that interconnect with the incumbent LEC switched access network at the end office.

241. *Other Approaches.* We reject alternative methods for recovering the TIC that were proposed in the record. The majority of the incumbent LEC parties supported recovering any remaining costs in the TIC by bulk billing such amounts to IXCs based on each IXC's share of

²⁹⁹ See para. 100, above.

³⁰⁰ NPRM at ¶ 97.

³⁰¹ See, e.g., Teleport Comments at 30-32; Time Warner Comments at 12-13, 15.

³⁰² See *TCG Colorado Petition for Arbitration Pursuant to § 252(b) of the Telecommunications Act of 1996 to Establish an Interconnection Agreement with U S West*, Docket No. 96A-329T, Decision Regarding Petition for Arbitration, Decision No. C96-1186 (adopted Nov. 5, 1996); *TCG Colorado Petition for Arbitration Pursuant to § 252(b) of the Telecommunications Act of 1996 to Establish an Interconnection Agreement with U S West*, Docket No. 96A-329T, Order Denying Applications for Rehearing, Reargument, or Reconsideration, Decision No. C96-1344 (adopted Dec. 18, 1996), at ¶ I.B.1.4; Letter from Judith Herrman, Manager, Federal Regulatory Affairs, Teleport Communications Group, to Richard Lerner, Competitive Pricing Division, FCC, April 11, 1997.

revenues, or presubscribed lines.³⁰³ Other incumbent LECs proposed establishing "public policy" elements to recover the residual TIC.³⁰⁴ These approaches would insulate TIC costs from the pressures of the competitive market and guarantee incumbent LECs the recovery of these amounts, even where such costs have resulted from inefficiencies that the competitive market -- but not regulators -- detected and otherwise would eliminate. This would be inconsistent with the development of an efficient competitive market. Our resolution of the TIC will allow LECs a reasonable opportunity to recover their costs, without providing a guarantee. We also reject the idea of spreading the remaining costs recovered by the TIC proportionately over all transport services, as suggested by AARP, *et al.* As we noted earlier, some of the remaining costs in the TIC may implicate certain Commission decisions separating costs between the federal and state jurisdictions and thus may be related to services other than transport. We, therefore, believe that awaiting further consideration by a Joint Board is a more practical means of ultimately resolving the TIC issue.

242. Some parties have requested that a portion of the costs recovered by the TIC should be considered to be universal service costs.³⁰⁵ We do not find this argument persuasive. Elsewhere in this Order, we have reallocated the TIC's identifiable cost components. On the basis of the record before us, we cannot clearly associate the remaining TIC revenues with any particular facilities or services. The parties arguing that these costs are related to universal service have not made any clear showing as to the source of these costs or demonstrated why they believe that these TIC revenues are either costs of universal service that should be recovered from the universal service fund or constituent costs of supported services.

243. We have analyzed the effect of the reallocation of TIC costs and the new recovery procedures on small business entities, including small LECs and new entrants, and find that the changes will facilitate the development of a competitive marketplace by moving incumbent LEC rates toward cost-based levels and by eliminating the ability of incumbent LECs to assess the TIC on switched access minutes that do not use incumbent LEC transport facilities. These pricing revisions may create new opportunities for small entities wishing to enter the telecommunications market.

³⁰³ See, e.g., USTA Comments at 66; BellSouth Comments at 13-14; PacTel Comments at 72.

³⁰⁴ See, e.g., U S West Comments at 71-73; SWBT Reply at 11; GTE Comments at 39, 41-44.

³⁰⁵ See, e.g., WITA Comments at 8; Texas Public Utility Counsel Comments at 21.

E. SS7 Signalling

1. Background

244. SS7 is a network protocol used to transmit signalling information over common channel signalling networks. As described in greater detail in the NPRM, signalling networks like SS7 establish and close transmission paths over which telephone calls are carried.³⁰⁶ Signalling networks are also used to retrieve information from remote data bases to enable credit card and collect calling. SS7 systems are also used to transmit information needed to provide custom local area signalling services like automatic call back.³⁰⁷

245. An SS7 network consists of several primary components -- signalling points, signal transport links, and dedicated lines used for access to an incumbent LEC's signalling network (signal links). Signalling points are nodes in an SS7 network that originate, transmit, or route signalling messages. There are three principal types of signalling points: service switching points (SSPs), service control points (SCPs), and signalling transfer points (STPs). An SSP is a switch that can originate, transmit, and receive messages for call setup and database transactions. An SCP serves as a database that stores and provides information used in the routing of calls, such as the line information database (LIDB) used to validate calling cards or the database that identifies the designated long-distance carrier for toll-free service. An STP is a specialized packet switch that performs screening and security functions and switches SS7 messages within the signalling network.

246. Signal transport links are facilities dedicated to the transport of SS7 messages within the incumbent LEC's signalling network. Finally, dedicated network access lines (DNALs) consist of dedicated circuits that transmit queries between the incumbent LEC's signalling network and the signalling networks of other individual carriers, such as IXCs. A carrier's DNAL is connected to an incumbent LEC's signalling network through a port on an incumbent LEC's STP.

247. Under the interim transport rate structure, incumbent LECs charge IXCs and other access customers a flat-rated charge (dedicated signalling transport) under Part 69 for the use of dedicated facilities used to connect to the incumbent LEC's signalling network. This rate element has two subelements -- a flat-rated signalling link charge for the dedicated network access line (dedicated signalling line) and a flat-rated STP port termination charge.³⁰⁸ Most other signalling costs, such as costs for switching messages at the STP and transmitting messages within the signalling network, are not recovered through facility-based charges and thus most, if not all, of

³⁰⁶ NPRM at ¶¶ 123-25.

³⁰⁷ See *Ameritech SS7 Waiver Order*, 11 FCC Rcd at 3841 (1996).

³⁰⁸ 47 C.F.R. § 69.125.

these costs are embedded in the TIC or in the local switching charge and recovered through per-minute-of-use charges. Retrieval of information from databases for toll-free calls and LIDB databases, however, is charged on a per-query basis.³⁰⁹

248. In the NPRM, we solicited comment on whether the Commission should revise its rate structure for SS7 services to reflect the SS7 rate structure implemented by Ameritech.³¹⁰ In March, 1996, the Commission granted a waiver to Ameritech, allowing it to restructure its recovery of SS7 costs through four unbundled charges.³¹¹ These charges correspond to various functions performed by signalling networks: signal link, STP port termination, signal transport, and signal switching.

249. The Ameritech waiver was granted to allow Ameritech to realign its charges for SS7 services more closely with the manner in which such costs are incurred. Unbundling of SS7 services from transport and local switching ensures that transport and local switching customers do not pay for SS7 services they do not use. Unbundling also enables Ameritech to offer SS7 services to competing providers of local exchange and exchange access services without requiring the purchase of other elements that the competitors do not need.³¹² In support of its waiver petition, Ameritech noted that it had received numerous customer requests for such unbundling. It also explained that it had deployed equipment necessary for measuring third-party usage of its SS7 networks, enabling the company to bill its SS7 services separately from its switched access services.³¹³

250. The NPRM also requested comment on whether incumbent LECs should be allowed to impose separate charges for ISDN User Part (ISUP) messages and Transaction Capabilities Application Part (TCAP) messages.³¹⁴ ISUP messages are used to set up and take down calls. For example, ISUP messages include the initial address message used to establish and close the transmission path used to carry a telephone call.³¹⁵ TCAP messages, on the other hand, are used to carry information between SSPs that support particular services, such as toll free services, LIDB services and certain custom local area signalling services (CLASS) like automatic call

³⁰⁹ 47 C.F.R. § 69.120.

³¹⁰ NPRM at ¶ 127.

³¹¹ *Ameritech SS7 Waiver Order*, 11 FCC Rcd 3839 (1996).

³¹² 11 FCC Rcd at 3853.

³¹³ 11 FCC Rcd at 3848.

³¹⁴ NPRM at ¶ 135.

³¹⁵ 11 FCC Rcd at 3841-42.

back.³¹⁶ We noted that differentiation between charges for ISUP and TCAP messages may be economically justified because TCAP messages tend to be shorter in average length and place lower demands on the signalling network than ISUP messages.³¹⁷

251. The NPRM also requested comment regarding the appropriate placement of SS7 signalling elements in price cap baskets. Currently, STP port termination rates and charges for the signalling link, or DNAL, are placed in the trunking basket.³¹⁸ Because both services are dedicated to particular SS7 customers, rates for these elements are flat-rated. We requested comment on whether the STP port termination charge should be placed in its own service category in the traffic-sensitive basket. We noted that interconnectors can provide their own signalling link, exposing that service element to some measure of competition. The STP port termination, on the other hand, is relatively insulated from competitive pressures because it is part of the incumbent LEC's STP and must be purchased from the incumbent LEC under existing network architecture.

2. Discussion

252. As we noted in the *Ameritech SS7 Waiver Order*, the removal of SS7 costs from the local switching and transport interconnection charge rate elements would benefit access customers that pay for these services but do not actually use an incumbent LEC's signalling services. It would also benefit alternative local service providers by enabling them to purchase separate SS7 services from incumbent LECs to support their provision of competing local exchange or exchange access services.³¹⁹ Unbundling the individual SS7 components into separate charges would further promote efficiency by ensuring that signalling charges more accurately reflect the costs of providing such services. Competitive service providers could limit their signalling costs by purchasing only the signalling elements they need.³²⁰ Despite these benefits, however, we are reluctant to impose on incumbent LECs the cost burden of installing metering or other equipment needed to measure third party usage of signalling facilities.³²¹ In granting Ameritech a waiver to implement its unbundled SS7 rate structure, we noted that

³¹⁶ *Id.*

³¹⁷ NPRM at ¶ 135.

³¹⁸ 47 C.F.R. § 61.42(d)(3); NPRM at ¶¶ 128, 130.

³¹⁹ 11 FCC Rcd at 3853.

³²⁰ *Id.*

³²¹ Bell Atlantic and NYNEX estimate the cost of installing facilities to measure SS7 usage ranges between \$15 million and \$40 million. BA/NYNEX Comments at 40. Sprint estimates that the cost would run between \$15 million and \$20 million. Sprint Comments at 31.

Ameritech had previously installed the equipment and other facilities needed to meter independent signalling usage.³²² Although we encourage actions that would promote disaggregation and unbundling of SS7 services, we will not require incumbent LECs to implement such an approach and incur the associated equipment costs of doing so. The record indicates that, as a general matter, the costs of mandating the installation of metering equipment may well exceed the benefits of doing so.³²³

253. Instead, we will permit incumbent LECs to adopt unbundled signalling rate structures at their discretion and acquire the appropriate measuring equipment as needed to implement such a plan. Specifically, incumbent LECs may implement the same unbundled rate structure for SS7 services that we approved in the *Ameritech SS7 Waiver Order*.³²⁴ We recognize, however, that other signalling rate structures may achieve the same benefits that are available under the Ameritech rate structure. Hence, an incumbent LEC may implement an unbundled signalling rate structure that varies from the approach implemented in the *Ameritech SS7 Waiver Order* by filing a petition demonstrating that the establishment of new rate elements implementing such a service is consistent with the public interest.³²⁵ We note, however, that variations in signalling rate structures among incumbent LECs could impose burdens on IXC's if IXC's must adapt to a diverse range of unbundled signalling rate structures.³²⁶ We anticipate that, if incumbent LECs choose to adopt unbundled rate structures for their SS7 network services, they will evaluate how the implementation of these plans will affect their prospective customers.³²⁷

254. With respect to rate differentiation between ISUP and TCAP messages, the NPRM expressed the concern that imposing rate differentiation may be inconsistent with rate structure simplicity.³²⁸ Several commenters indicate that the costs of implementing rate differentiation would exceed the benefits of such an approach.³²⁹ We further note that commenters offered little, if any, general support for the adoption of rate differentiation. Accordingly, to avoid unnecessary

³²² 11 FCC Rcd at 3844-45.

³²³ USTA Comments at 37; BA/NYNEX Comments at 40; PacTel Comments at 73; GTE Comments at 53.

³²⁴ A carrier could adopt the Ameritech rate structure pursuant to 47 C.F.R. 69.4(g), which permits a carrier to implement rate structures previously approved by the Commission for other carriers.

³²⁵ 47 C.F.R. § 69.4(g).

³²⁶ See Sprint Comments at 31.

³²⁷ Sprint suggests that an industry forum may be appropriate to develop an optimum rate structure for unbundled signalling services. Sprint Comments at 31.

³²⁸ NPRM at ¶ 135.

³²⁹ MCI Comments at 89; Time Warner Comments at 17; CompTel Comments at 31-32.

complexity and to avoid the imposition of unnecessary regulatory costs, we will not impose a rate differential between ISUP and TCAP messages.

255. With respect to the placement of SS7 rate elements in price cap baskets, we have previously recognized that the signalling link and the STP port termination are not subject to the same level of competition. As noted in the *Ameritech SS7 Waiver Order*, STP port termination is provided only by incumbents while the signalling link can be provided by SS7 customers themselves or by other alternative providers.³³⁰ Comments filed in this proceeding also acknowledge this competitive disparity.³³¹ Although Ameritech discounts the risk that STP port termination charges would be used to offset price reductions for the signal link, it nevertheless acknowledges the existence of the competitive differential we suggested in the NPRM. Other commenters argue that the competitive disparity is sufficient to justify concerns that price cap LECs would adjust their rates to account for the competitive differential. Accordingly, we will establish a new STP port termination rate element in the traffic-sensitive basket. Placing these SS7 services in different price cap baskets will ensure consistency with the Commission's general approach of maintaining elements with similar competitive characteristics in the same service baskets.

F. Impact of New Technologies

256. The NPRM requested comment regarding the rate structure treatment of new technologies that enable new telecommunications services and, by enhancing the productivity of telecommunications facilities, lower prices for services in the future. These technologies, which we describe in greater detail in the NPRM, include synchronous optical networks (SONET), Asynchronous Transfer Mode (ATM) switching, and advanced intelligent networks (AIN). We invited commenters to recommend specific rate structure rules that would reflect the manner in which incumbent LECs incur costs when providing services utilizing such new technologies.³³²

257. As a general matter, the Commission is reluctant to adopt detailed rules governing rate structures for recovering the cost of deploying advanced technologies. We note that, in the *Price Cap Third Report and Order*, we adopted rules that permit price cap LECs to petition the Commission for the establishment of one or more switched access rate elements to accommodate new services.³³³ Under these rules, petitioners must demonstrate either of the following: 1) that the new rate elements would be in the public interest; or 2) that another LEC has previously

³³⁰ 11 FCC Rcd at 3859. NPRM at ¶ 130.

³³¹ MCI Comments at 87-88; AT&T Reply at 33-34.

³³² NPRM at ¶ 139.

³³³ *Price Cap Third Report and Order* at ¶ 309-10.

obtained approval to establish identical rate elements and that the original petition did not rely upon a competitive showing as part of its public interest justification.³³⁴ Because technological advancements emerge rapidly, the adoption of uniform rate structures corresponding to particular technologies may slow investment in the development of newer technologies or improvements in current technologies. Indeed, as a general matter, incumbent LECs oppose the adoption of uniform rate structures for new technologies, suggesting that strict uniform rules in this regard could inhibit development of such technologies. Accordingly, we will refrain from adopting in this Order specific rate structures with respect to SONET, AIN, or other new technologies. As noted above, however, our rules already accommodate rate element adjustments that may be needed on an ad hoc basis when technological advancements justify such modifications. As particular new technologies become used on a widespread basis, we can always consider whether there is a need for a uniform rate structure at that point.

IV. BASELINE RATE LEVELS

A. **Primary Reliance on a Market-Based Approach With A Prescriptive Backdrop and the Adoption of Several Initial Prescriptive Measures**

1. **Background**

258. In the NPRM, we established a goal of encouraging efficient competitors to enter local exchange access markets so that incumbent LECs would face substantial competition for the entire array of interstate access services.³³⁵ As a particular service becomes subject to substantial competition from new providers, we proposed to remove that service from price cap and tariff regulation.³³⁶ We sought comment on two general approaches for a transition to reliance on substantial competition to ensure that interstate access charges are closely related to forward-looking economic costs: a "market-based" approach and a "prescriptive" approach. Under a market-based approach, we would permit market forces to operate as competition emerges, allowing an incumbent to change its prices in response to competitive entry. To that end, we proposed a two-phase approach in which incumbent LECs would be permitted certain pricing flexibility upon a showing that meaningful competitive entry is possible within a particular local exchange and exchange access market, followed by a further relaxation of price cap regulation when meaningful actual competition developed within the market.³³⁷ We did not propose,

³³⁴ 47 C.F.R. § 69.4(g).

³³⁵ NPRM at ¶ 140.

³³⁶ NPRM at ¶ 149.

³³⁷ NPRM at ¶ 140.

however, to abandon the possibility of using the prescriptive tools at our disposal in the event that competition does not develop in some places.

259. As an alternative to the proposed market-based approach, we also sought comment on a prescriptive approach, under which incumbent LECs would be required to change their prices for some or all exchange access services using specific measures adopted by the Commission to more accurately ensure that access charges are closely related to the economic costs of providing interstate access services.³³⁸ We also invited comment whether the two approaches could be merged in some fashion.³³⁹ We emphasized that our ultimate goal under any approach, whether market-based, prescriptive or combined, is to remove from price cap regulation LEC services that are subject to substantial competition. Instead of price cap regulation, we expect eventually to rely on the operation of competitive local markets to prevent incumbent LECs from exercising market power, and thereby to protect consumers.

260. In this section, we endorse the use of a market-based approach generally. Our market-based approach will retain the protection afforded by price cap regulation, while relaxing particular restrictions on incumbent LEC pricing as competition emerges, thereby permitting the development and operation of competitive markets, which will maximize the efficient allocation of telecommunications services and promote consumer welfare. This section also explains how, if competition fails to emerge over time for certain access services in particular geographic areas, we will ensure that the rates for those services reflect the forward-looking economic costs of providing the services. In the NPRM, we sought comment on a number of specific issues concerning the timing and degrees of pricing flexibility and ultimate deregulation. We recognize that we must attend carefully to this task of granting incumbent LECs increased pricing flexibility commensurate with competitive developments, and we will resolve these issues of timing and degree in detail in a subsequent report and order in this docket, where we can more fully discuss these matters.

261. Elsewhere in this Order, we adopt or propose several measures that work within our current price cap structure to lower baseline access charge rate levels consistent with evidence that the revised rate levels better reflect the underlying costs of providing interstate access services. In Section IV.C below, we order an exogenous cost reduction to reflect the completion of the amortization of equal access costs. In Section IV.D, we order reallocation of certain marketing and retail expenses and discuss the reallocation of GSF costs. We issue a further notice on GSF costs in Section VII. In the companion *Price Cap Fourth Report and Order*, which we also adopt today, we modify our current price cap plan by adopting a single productivity offset (X-Factor) of 6.5 percent and eliminating sharing while maintaining the low-end adjustment.

³³⁸ NPRM at ¶ 141.

³³⁹ NPRM at ¶ 144.

2. Discussion

262. The Commission's objective is the one set forth in the 1996 Act -- "opening all telecommunications markets to competition."³⁴⁰ Therefore, we must ensure that our own regulations do not unduly interfere with the development and operation of these markets as competition develops. If we successfully reform our access charge rules to promote the operation of competitive markets, interstate access charges will ultimately reflect the forward-looking economic costs of providing interstate access services. This is so, in part, because Congress established in the 1996 Act a cost-based pricing requirement for incumbent LECs' rates for interconnection and unbundled network elements, which are sold by carriers to other carriers. As we have recognized, interstate access services can be replaced with some interconnection services or with functionality offered by unbundled elements.³⁴¹ Because these policies will greatly facilitate competitive entry into the provision of all telecommunications services, we expect that interstate access services will ultimately be priced at competitive levels even without direct regulation of those service prices.

263. We decide that adopting a primarily market-based approach to reforming access charges will better serve the public interest than attempting immediately to prescribe new rates for all interstate access services based on the long-run incremental cost or forward-looking economic cost of interstate access services. Competitive markets are superior mechanisms for protecting consumers by ensuring that goods and services are provided to consumers in the most efficient manner possible and at prices that reflect the cost of production. Accordingly, where competition develops, it should be relied upon as much as possible to protect consumers and the public interest. In addition, using a market-based approach should minimize the potential that regulation will create and maintain distortions in the investment decisions of competitors as they enter local telecommunications markets. Finally, under the 1996 Act, implicit universal service subsidies, wherever possible, are to be made explicit and supported by all carriers on an equitable and non-discriminatory basis.³⁴² To the extent that any implicit subsidies remain in interstate access charges because it was not feasible to identify them or make them explicit, our market-based approach will have the effect of making those implicit subsidies subject to being competed away as competitors offer comparable services at prices that do not include the subsidies. In addition, we note that the rate structure changes we adopt today go a long way towards achieving such ends because the inefficiency produced by distortions in markets "rises as a quadratic function of

³⁴⁰ *Joint Explanatory Statement.*

³⁴¹ *E.g., NPRM ¶¶ 8-9, 170.*

³⁴² 47 U.S.C. § 254.

the relative price distortion."³⁴³ Therefore, the first steps made toward removing distortions caused by our regulations will produce the greatest benefits.

264. The market-based approach to access charge reform that we adopt will not, as some parties assert, expose customers of interstate access services to the unfettered exercise of market power.³⁴⁴ We will continue to maintain the current mechanisms upon which we rely to ensure that rates for these services are "just and reasonable,"³⁴⁵ and not unjustly or unreasonably discriminatory.³⁴⁶ Instead of exposing customers to harm, we expect that permitting incumbent LECs certain kinds of pricing flexibility in response to the development of competition will allow prices for interstate access services to adjust in ways that reflect the underlying economic costs of providing those services without moving outside the range of rates that are just and reasonable. This process of relaxing regulation as competition develops, and ultimately deregulating services subject to effective competition, is well established. For example, many of the types of pricing flexibility discussed in the NPRM are similar to forms of pricing flexibility we have in the past accorded incumbent LECs and IXC's facing increased competition in markets for particular services.³⁴⁷

265. Economic teaching also leads to the conclusion that rates for interstate access services will generally move toward the forward-looking economic cost of providing such services in response to increased competition in local exchange and exchange access markets.³⁴⁸ In addition, competition will do a better job of determining the true economic cost of providing such services. As competitive entry becomes increasingly possible, IXC's that now purchase interstate switched access services from incumbent LEC's will be able to bypass those services where the prices (interstate access charges) do not reflect the economic costs of providing the underlying services. Those IXC's can do this by entering the local markets themselves as local exchange service providers, thereby self-providing interstate access services for their new local exchange service customers. They can also seek out competitive providers of comparable services. As customers choose providers other than incumbent LEC's as their local providers, interstate access services will come to be priced competitively. Incumbent LEC's will have to

³⁴³ Scherer & Ross, *supra.*, at 662.

³⁴⁴ Appendix B, Section IV.A., *infra.*

³⁴⁵ 47 U.S.C. § 201.

³⁴⁶ 47 U.S.C. § 202.

³⁴⁷ See, e.g., *Expanded Interconnection with Local Telephone Company Facilities*, CC Docket No. 91-141, Report & Order & Notice of Proposed Rulemaking, 7 FCC Rcd 7369 (1992) (geographic deaveraging); *AT&T Communications (Revisions to Tariff FCC No. 12)*, CC Docket No. 87-568, Memorandum Opinion & Order, 4 FCC Rcd 4932 (1989).

³⁴⁸ See, e.g., Dennis W. Carlton & Jeffrey M. Perloff, *Modern Industrial Organization* 92-93 (2d ed. 1994)

respond to competitors' offerings with lower-priced access services of their own in order to retain customers that would otherwise switch to competitors' networks, further increasing the effect of competition on overall access charge payments.

266. The 1996 Act has created an unprecedented opportunity for competition to develop in local telephone markets. It also has provided this Commission with tools for opening markets to competition, and for implementing our market-based relaxation of regulation so that interstate access charges reflect forward-looking economic costs. We recognize, however, that competition is unlikely to develop at the same rate in different locations, and that some services will be subject to increasing competition more rapidly than others.³⁴⁹ Accordingly, we anticipate that competition will drive rates for some interstate access services toward more economically efficient levels more rapidly in some areas than rates for other services or in other areas. Where competition develops, we will provide incumbent LECs with additional flexibility, culminating in the removal of incumbent LECs' interstate access services from price regulation where they are subject to sufficient competition to ensure that the rates for those services are just and reasonable, and are not unjustly or unreasonably discriminatory.

267. We also recognize, however, that there will be areas and services for which competition may not develop. Therefore, we shall retain many of the existing safeguards afforded by our price cap regulation, including the productivity offset (X-Factor), which requires incumbent LECs to adjust their access charges to reflect changes in the economic cost of providing service. In addition, we also adopt a prescriptive "backstop" to our market-based approach that will serve to ensure that all interstate access customers receive the benefits of more efficient prices, even in those places and for those services where competition does not develop quickly. To implement our backstop to market-based access charge reform, we require each incumbent price cap LEC to file a cost study no later than February 8, 2001, demonstrating the cost of providing those interstate access services that remain subject to price cap regulation because they do not face substantial competition. The Commission will require submission of such studies before that date if competition is not developing sufficiently for our market-based approach to work. Studies should identify and quantify forward-looking costs, short-run and long-run, that are incremental to providing each such service, and also costs that are common as between various services. These studies are required only for non-competitive services; as stated above, we do not intend to regulate prices of services that are subject to substantial competition.

³⁴⁹ The observation that competitive entry will occur in some places, and for some services, more rapidly than others is a corollary to the rule that firms in competitive markets seek to maximize their profits. *See, e.g.,* Carlton & Perloff, *supra*, at 89. To maximize profits, firms naturally seek out those customers and services on which they can generate the most profits. Therefore, some customers are naturally more desirable than others at any given point in time. As competitors attempt to gain the patronage of the customers offering the greatest profit opportunities, they offer lower-priced or more desirable services. These actions have the effect of reducing over time the profitability of serving those particular customers and, as this occurs, the relative profitability of serving other customers or offering other services increases. Therefore, competitors begin seeking to serve these other customers, and entry occurs in new places, or for new services.

268. We have chosen this date in order to give competition sufficient time to develop substantially in the various markets for interstate exchange access services. We have also chosen this date to permit us and all interested parties to take into account the effects of implementing the substantial changes that we adopt in this Order and that we will be adopting elsewhere to satisfy the universal service goals in section 254. By this date, we also expect to have additional regulatory tools by which to assess the reasonableness of access charges. We may, for example, be able to establish benchmarks based on prices for the interstate access services for which competition has emerged, and use the prices actually charged in competitive markets to set rates for non-competitive services and markets. Carriers could be required either to set their rates in accordance with the benchmarks or to justify their rates using their cost studies.

269. We anticipate that the pro-competitive regime created by the 1996 Act, and implemented in the *Local Competition Order* and numerous state commission decisions, will generate competition over the next few years. Further, it would be imprudent to prejudge the effectiveness of those measures at creating competitive local markets. Rather than ignore or interfere with the effects of this developing competition on prices for interstate access services, we find that the public interest is best served by permitting emerging competition to affect access charge rate levels. In addition, the experience we gain from observing the effects of emerging competition on interstate access services will permit us more effectively and efficiently to implement any prescriptive measures that may be needed in the future to ensure that interstate access services remaining subject to regulation are priced in accordance with the forward-looking economic cost of providing those services.

270. Economic logic holds that giving incumbent LECs increased pricing flexibility will permit them to respond to competitive entry, which will allow prices to move in a way that they would not have moved were the pricing restrictions maintained.³⁵⁰ This can lead to better operating markets and produce more efficient outcomes. Deregulation before competition has established itself, however, can expose consumers to the unfettered exercise of monopoly power and, in some cases, even stifle the development of competition, leaving a monopolistic environment that adversely affects the interests of consumers.³⁵¹ Therefore, it is important that we design our market-based approach carefully. We must, among other things, decide which, if any, of the rules setting forth specific competitive triggers and corresponding flexibility as proposed in the NPRM we should adopt. We will resolve these issues in the subsequent report and order in this docket.

271. As set forth in the summary of comments appended to this order, AT&T cites to

³⁵⁰ E.g., Jean-Jaques Laffont & Jean Tirole, *Creating Competition Through Interconnection: Theory and Practice*, 10 J. Reg. Econ. 227-56 (1996).

³⁵¹ See, e.g., Jean Tirole, *The Theory of Industrial Organization* 230 (1988).

*Farmers Union Central Exchange, Inc. v. FERC*³⁵² for the proposition that "[r]eliance on competitive forces to constrain exchange access rates, particularly in the presence of strong indications that market forces will not produce the intended results, would be arbitrary and capricious and contravene the Commission's statutory duty to ensure just, reasonable, and nondiscriminatory rates."³⁵³ We disagree with AT&T's assertion. In *Farmers Union*, FERC had stated in its relevant order that ratemaking for oil pipelines should be used solely to prevent price gouging, and had interpreted the Congressional mandate of "just and reasonable" rates as requiring that rates be kept within the zone of commercial reasonableness, not public utility reasonableness.³⁵⁴ Under this interpretation, FERC had concluded that it would rely primarily on market forces to keep rates reasonable.³⁵⁵

272. The court in *Farmers Union* recognized that "[m]oving from heavy to lighthanded regulation . . . can be justified by a showing that . . . the goals and purposes of the statute will be accomplished through substantially less regulatory oversight," but objected to FERC's failure to establish that its new approach would satisfy the "just and reasonable" standard.³⁵⁶ The court rejected FERC's position that oil pipeline ratemaking should protect only against "egregious exploitation and gross abuse" as being inconsistent with the mandate that Congress had established for FERC.³⁵⁷ The court concluded that FERC had not shown that market forces were sufficient to rely upon in setting reasonable rates.³⁵⁸

273. We reject AT&T's argument that our market-based approach to access charge reform is analogous to FERC's conduct at issue in *Farmer's Union*. Our access charge and price cap rules are designed to ensure that access charges remain within the "zone of reasonableness"³⁵⁹ defining rates that are "just and reasonable,"³⁶⁰ and our market-based approach will also be designed to implement this statutory requirement. It will not remove incumbent LECs from

³⁵² 734 F.2d 1486, 1508 (D.C. Cir.) (*Farmers Union*), cert. denied, *Williams Pipe Line Co. v. Farmers Union Central Exchange, Inc.*, 469 U.S. 1034 (1984).

³⁵³ Appendix B, Sec. IV.A., *infra*.

³⁵⁴ *Farmers' Union*, 734 F.2d at 1492.

³⁵⁵ *Id.*

³⁵⁶ *Id.* at 1510.

³⁵⁷ *Id.* at 1502.

³⁵⁸ *Id.* at 1508.

³⁵⁹ *Id.* at 1502.

³⁶⁰ 47 U.S.C. § 201(b).

regulation immediately, but will implement deregulation in steps, as competitive conditions warrant. Throughout the transition to deregulation in the face of substantial competition, we will maintain many safeguards against unjust or unreasonable rates, such as the price cap indices. We will deregulate incumbent LEC services only when it is reasonable to conclude that competition has developed to such an extent that the market will ensure just and reasonable rates.³⁶¹

274. Second, our market-based approach is an eminently reasonable method for pursuing our goal of promoting competition and ensuring the economically efficient pricing of interstate access services. As competition emerges, the market-based approach will permit access charges to move towards the levels that will prevail in competitive markets. During the transition to competitive markets, access services not subject to competition will remain subject to price cap regulation, and we will eventually prescribe rates for those services at forward-looking economic cost levels, to ensure that all consumers reap the benefits of economically-efficient prices. Unlike the FERC regulation at issue in *Farmers Union*, our market-based approach to promoting the development of competitive markets and economically-efficient pricing will not be based on "largely undocumented reliance on market forces" ³⁶² Instead, we will design our approach so that deregulation occurs only when the reliability of market forces can be fully determined with respect to a particular service. Finally, we observe that FERC's mandate in *Farmers Union* was one of rate regulation due to market failure and concern over monopoly power.³⁶³ In light of the 1996 Act, our mandate is no longer strictly or solely one of rate regulation. Congress has stated its desire to establish "a pro-competitive, deregulatory national policy framework."³⁶⁴ Our market-based approach will be designed to coincide with and promote this objective.

275. *Price Squeeze Concerns Are Adequately Addressed.* Several parties have argued that current access charge rate levels create the conditions for an anticompetitive price squeeze when a LEC affiliate offers interexchange services in competition with IXCs.³⁶⁵ A price squeeze, as the term is used by these parties, refers to a particular, well-defined strategy of predation that would involve the incumbent LEC setting "high" prices for interstate exchange access services, over which the LEC has monopoly power (albeit constrained by regulation), while its affiliate is offering "low" prices for long-distance services in competition with the other long-distance carriers. Because interstate exchange access services are a necessary input for long-distance

³⁶¹ Such market-based regulation of prices has been upheld where the market being relied upon is sufficiently competitive and the regulator maintains its authority to step in to ensure that rates remain just and reasonable. *Elizabethtown Gas Co. v. FERC*, 10 F.3d 866, 870-71 (D.C. Cir. 1993).

³⁶² AT&T Comments at 48 (citing *Farmers Union*, 734 F.2d at 1508).

³⁶³ *Farmers' Union*, 734 F.2d at 1508.

³⁶⁴ *Joint Explanatory Statement*.

³⁶⁵ Appendix B, Section IV.A, *infra*.

services, these parties argue that an incumbent LEC can create a situation where the relationship between the LEC's "high" exchange access prices and its affiliate's "low" prices for long-distance services forces competing long-distance carriers either to lose money or to lose customers even if they are more efficient than the LEC's affiliate at providing long-distance services. It is this nonremunerative relationship between the input prices and the affiliate's prices, and not the absolute levels of those prices, that defines a price squeeze. In the most extreme case, a price squeeze involves a monopolist setting input prices that are actually higher than its prices in the output market.

276. Price cap regulation of access prices limits the ability of LECs to raise the prices of the input services. Commenters raising price squeeze concerns argue, however, that a LEC's interexchange affiliate will still be in a position to implement a price squeeze by setting long-distance rates close to the rates for access services, thereby forcing IXCs to charge below-cost rates to retain customers. They argue that LECs' interexchange affiliates have lower costs of providing interexchange services because of their affiliation with monopoly providers of interstate access services, and not as a result of being more efficient. According to these commenters, the relevant economic costs of providing interstate interexchange services will be lower for the LEC affiliate offering interexchange services than for competing IXCs because it only has to recover the true economic cost of providing the interstate access services (since the owners of the LEC and its interexchange affiliate will want the two entities to maximize their joint profits), whereas the IXCs will be forced to pay interstate access charges that are above the true economic cost of providing the underlying services.

277. Absent appropriate regulation, an incumbent LEC and its interexchange affiliate could potentially implement a price squeeze once the incumbent LEC began offering in-region, interexchange toll services. Although no BOC affiliate may offer such services at this time, GTE, SNET, Sprint and other incumbent LECs do have affiliates offering such services. The incumbent LEC could do this by raising the price of interstate access services to all interexchange carriers, which would cause competing in-region carriers to either raise their retail rates to maintain their profit margins or to attempt to maintain their market share by not raising their prices to reflect the increase in access charges, thereby reducing their profit margins. If the competing in-region, interexchange providers raised their prices to recover the increased access charges, the incumbent LEC's interexchange affiliate could seek to expand its market share by not matching the price increase. The incumbent LEC affiliate could also set its in-region, interexchange prices at or below its access prices. Its competitors would then be faced with the choice of lowering their retail rates for interexchange services, thereby reducing their profit margins, or maintaining their retail rates at the higher price and risk losing market share.

278. We conclude that, although an incumbent LEC's control of exchange and exchange access facilities may give it the incentive and ability to engage in a price squeeze, we have in place

adequate safeguards against such conduct. The *Fifth Competitive Carrier Report and Order*³⁶⁶ requirements aid in the prevention and detection of such anticompetitive conduct. In our recent *In-Region Interexchange Order* we decided to retain the *Fifth Competitive Carrier Report and Order* separation requirements for incumbent LEC provision of in-region interLATA services.³⁶⁷ These requirements apply both to BOCs and to other incumbent LECs. In addition, as discussed in that order, BOC interexchange affiliates are subject to the safeguards set forth in section 272 of the Act.³⁶⁸

279. The *Fifth Competitive Carrier Report and Order* separation requirements have been in place for over ten years, and independent (non-BOC) incumbent LECs have been providing in-region, interexchange services on a separated basis with no substantiated complaints of a price squeeze. Under these separation requirements, incumbent LECs are required to maintain separate books of account, permitting us to trace and document improper allocation of costs and/or assets between a LEC and its long-distance affiliate, as well as to detect discriminatory conduct. In addition, we prohibit joint ownership of facilities, which further reduces the risk of improper allocations of the costs of common facilities between the incumbent LEC and its interexchange affiliate, as discussed at length in the *In-Region Interexchange Order*³⁶⁹ and the *Non-Accounting Safeguards Order* (addressing the Act's prohibition of BOC joint ownership with its interexchange affiliate pursuant to Section 272).³⁷⁰ As we also discussed at length in those orders, the prohibition on jointly-owned facilities also helps to deter any discrimination in access to the LEC's transmission and switching facilities by requiring the affiliates to follow the same procedures as competing interexchange carriers to obtain access to those facilities. Finally, our requirement that incumbent LECs offer services at tariffed rates, or on the same basis as

³⁶⁶ *Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor*, CC Docket No. 79-252, Fifth Report & Order, 98 FCC 2d 1191, 1198 ¶ 9 (1984) (*Fifth Competitive Carrier Report and Order*).

³⁶⁷ *Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area and Policy and Rules Concerning the Interstate, Interexchange Marketplace*, Second Report and Order in CC Docket No. 96-149 and Third Report and Order in CC Docket No. 96-61, ___ FCC Rcd ___, FCC 97-142 (Apr. 18, 1997) (*Dom/Nondom R&O*)

³⁶⁸ *Id.*

³⁶⁹ *Id.* ¶¶ 163-69.

³⁷⁰ *Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended*, First Report and Order and Further Notice of Proposed Rulemaking, FCC 96-489 ¶¶ 159-62 (Dec. 24, 1996) (*Non-Accounting Safeguards Order*), *on recon.*, FCC 97-52 (Feb. 19, 1997), *recon. pending*, CC Docket No. 96-149, *petition for summary review in part denied and motion for voluntary remand granted sub nom.*, *Bell Atlantic v. FCC*, No. 97-1067 (D.C. Cir. filed Mar. 31, 1997), *petition for review pending sub nom.*, *SBC Communications v. FCC*, No. 97-1118 (D.C. Cir. filed Mar. 6, 1997) (held in abeyance pursuant to court order filed May 7, 1997).

requesting carriers that have negotiated interconnection agreements pursuant to section 251³⁷¹ reduces the risk of a price squeeze to the extent that an affiliate's long-distance prices would have to exceed their costs for tariffed services.

280. Current conditions in markets for interexchange services give us comfort that an anticompetitive price squeeze is unlikely to occur as a result of our decision not to prescribe immediately access charge rates at forward-looking economic cost levels. If an incumbent LEC does attempt to engage in an anticompetitive price squeeze against rival long-distance providers, the provisions of the Act should permit new entrants or other competitors to seek out or provide competitive alternatives to tariffed incumbent LEC access services. For example, under the provisions of section 251,³⁷² a competitor will be able to purchase unbundled network elements to compete with the incumbent LEC's offering of local exchange access. Therefore, so long as an incumbent LEC is required to provide unbundled network elements quickly, at economic cost, and in adequate quantities, an attempted price squeeze seems likely to induce substantial additional entry in local markets. Accordingly, there should be a reduced likelihood that an incumbent LEC could successfully employ such a strategy to obtain the power to raise long-distance prices to the detriment of consumers.

281. Furthermore, even if a LEC were able to allocate improperly the costs of its affiliate's interexchange services, we conclude that it is unlikely that the LEC's interexchange affiliate could engage successfully in predation.³⁷³ At least four interexchange carriers -- AT&T, MCI, Sprint, and LDDS WorldCom -- have nationwide, or near-nationwide, network facilities that cover every LEC's region.³⁷⁴ These are large, well-established companies with millions of customers throughout the nation. It is unlikely, therefore, that one or more of these national companies can be driven from the market with a price squeeze, even if effectuated by several LECs simultaneously, whether acting together or independently. Even if it could be done, it is doubtful that the LECs' interexchange affiliates would later be able to raise, and profitably sustain, prices above competitive levels. As Professor Spulber has observed, "[e]ven in the unlikely event that [LECs' interexchange affiliates] could drive one of the three large interexchange carriers into bankruptcy, the fiber-optic transmission capacity of that carrier would remain intact, ready for another firm to buy the capacity at distress sale and immediately undercut the [affiliates']

³⁷¹ *Id.* ¶ 164.

³⁷² 47 U.S.C. § 251(c)(3).

³⁷³ See *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 589 (1986) ("[P]redatory pricing schemes are rarely tried, and even more rarely successful.").

³⁷⁴ *Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier*, 11 FCC Rcd 3271, 3304 ¶¶ 60-61 (1996).

noncompetitive prices."³⁷⁵

282. Finally, in addition to our regulations and the provisions of section 251 of the Act, the antitrust laws also offer a measure of protection against a possible price squeeze.³⁷⁶ Although we believe it would not serve the public interest for us knowingly to permit a price squeeze to occur, and to rely entirely on the adequacy of antitrust law remedies to protect the public, we take comfort in the fact that such remedies exist should an anticompetitive price squeeze occur in spite of the safeguards we have adopted.³⁷⁷ In particular, although a price squeeze engaged in by several LECs, particularly if it involved more than one of the BOCs or GTE, could have a significant impact on interexchange competitors, we believe that the antitrust laws will act as a strong backstop to our own enforcement process so that the risk of such concerted activity is sufficiently limited.³⁷⁸

283. *Other Concerns Raised by Commenters.* Several commenters raised concerns that our market-based approach to access charge reform might permit incumbent LECs to engage in cross subsidization, either between competitive and non-competitive services, or between interstate access services and other services such as video distribution.³⁷⁹ No evidence has been presented, however, indicating any likelihood that current price cap regulation, which is designed, in part, to prevent cross subsidization, might become less effective under a market-based approach to access charge reform. Those price cap regulations will remain in place until there is

³⁷⁵ Daniel F. Spulber, *Deregulating Telecommunications*, 12 Yale J. Reg. 25, 60 (1995).

³⁷⁶ Beginning with Judge Learned Hand's opinion in *United States v. Aluminum Co. of America (Alcoa)*, 148 F.2d 416, 437-38 (2d Cir. 1945), a specific body of precedent has developed under federal antitrust law defining situations where a price squeeze can be actionable as a form of monopolization or attempted monopolization under Section 2 of the Sherman Act. 15 U.S.C. § 2. Under this precedent, a price squeeze can violate the antitrust laws where (1) a firm has monopoly power with respect to an "upstream" product; (2) it sells that product at "higher than a 'fair price,'" (3) the product is a necessary input for the product being sold by other firms in competition with the monopoly or its affiliate in a "downstream" market; and (4) the monopolist offers the "downstream" product at a price so low that (equally-efficient) competitors cannot match the price and still earn a "living profit." *Alcoa*, 148 F.2d at 437-38. Over time, courts have developed several tests for determining when the relationship between the two prices is sufficiently adverse to competitors that it constitutes an anticompetitive price squeeze. See, e.g., *Bonjorno v. Kaiser Aluminum & Chem. Corp.*, 752 F.2d 802, 808-09 (3d Cir. 1984), *cert.denied*, 477 U.S. 908 (1986); *Ray v. Indiana & Mich. Elec. Co.*, 606 F. Supp. 757, 776 (N.D. Ind. 1984), *aff'd*, 758 F.2d 1148 (7th Cir. 1985).

³⁷⁷ Because the rates charged by LEC interexchange affiliates will not be regulated, we do not believe that a court would reject a price squeeze claim under the antitrust laws on the grounds that "'normally' a price squeeze will not constitute an exclusionary practice in the context of a fully regulated monopoly." *Town of Concord v. Boston Edison Co.*, 915 F.2d 17 (1st Cir.1990) (J. Breyer), *cert. denied*, ___ U.S. ___, 111 S. Ct. 1337 (1991). Indeed, the court in that case explicitly declined to address the "special problem" posed by a price squeeze allegation against a firm regulated in the input market and undercutting rivals' prices in the unregulated market where inputs are used. *Id.* at 29.

³⁷⁸ See *Non-Accounting Safeguards Order* FCC 97-142 ¶ 70.

³⁷⁹ See Appendix B, Section IV.A, *infra*.

sufficient competition to prevent an incumbent LEC from charging rates that are not just and reasonable. Therefore, we find that the record does not contain substantial evidence that a market-based approach to access charge reform is any less likely than current regulation to permit incumbent LECs to engage in unreasonable cross subsidization with their interstate access charges.

284. Finally, several commenters based their support for a market-based approach, in part, on arguments that it would reduce, or minimize, administrative burdens. Other commenters, on the other hand, opposed a market-based approach on the grounds that it would increase administrative burdens. Based on the record before us, however, we cannot reach a conclusion as to the relative administrative burdens of the two approaches. Some parts of our proposed market-based approach, such as grants of increased pricing flexibility as competitive conditions warranted, were modeled on waivers that we have granted within the context of our current price cap plan and would likely be necessary even if we had adopted a primarily prescriptive approach to access charge rate level reform. Similarly, some parts of a prescriptive approach, such as annual changes in price cap calculations, will necessarily be a part of our market-based approach. Accordingly, we can see no basis in this record for concluding that a market-based approach to access charge reform will be any more or less burdensome than any other alternative.

B. Prescriptive Approaches

1. Prescription of a New X-Factor

a. Background

285. In the NPRM, we observed that the Commission had initiated a rulemaking proceeding in the *Price Cap Fourth Further NPRM* to examine a number of proposals for revising the productivity offset component of the X-Factor, and to consider related issues such as eliminating sharing obligations and the low-end adjustment mechanism.³⁸⁰ We invited parties to discuss in this proceeding whether the record developed pursuant to the *Price Cap Fourth Further NPRM* justified increasing the productivity offset, and specifically invited comment on the effects of a forward-looking cost of capital and economic depreciation on total factor productivity (TFP) measurement.³⁸¹

³⁸⁰ NPRM at ¶ 233. With respect to the productivity offset, we invited comment on, among other things, basing it on total factor productivity (TFP). TFP is the ratio of an index of a firm's total outputs to an index of its total inputs. NPRM at ¶ 233 n.300, citing *Price Cap Fourth Further NPRM*, 10 FCC Rcd at 12663-71. With respect to sharing, we noted that, although sharing tends to blunt the efficiency incentives otherwise created by the price cap plan, it also serves beneficial functions, and we invited comment on eliminating sharing and establishing other mechanisms to serve those functions. NPRM at ¶ 233 n.301, citing *Price Cap Fourth Further NPRM*, 10 FCC Rcd at 12676-80.

³⁸¹ NPRM at ¶ 233. GTE notes that, while the X-Factor received considerable attention in the *Price Cap Fourth Further NPRM* proceeding, the discussion did not focus on the effects of the 1996 Act. GTE Comments at 57.

b. Discussion

286. The commenters generally repeat arguments made in the *Price Cap Fourth Further NPRM* proceeding. For reasons explained in detail in our companion *Price Cap Fourth Report and Order*, we conclude that we should prescribe an X-Factor on the basis of total factor productivity studies, the difference between LEC input price changes and input price changes in the economy as a whole, and the 0.5 percent consumer productivity dividend (CPD). In the companion order we find that this results in an X-Factor prescription of 6.5 percent.

2. Other Prescriptive Approaches

a. Background

287. In the NPRM, we sought comment on four options for a prescriptive approach: reinitializing price cap indices (PCIs) to economic cost-based levels;³⁸² reinitializing PCIs to levels targeted to yield no more than an 11.25 percent rate of return, or some other rate of return;³⁸³ adding a policy-based mechanism similar to the CPD to the X-Factor;³⁸⁴ or prescribing economic cost-based rates.³⁸⁵ We have decided above to rely primarily on a market-based approach, and impose prescriptive requirements only when market forces are inadequate to ensure just and reasonable rates for particular services or areas. We will determine the details of our market-based approach in a future Order. In that Order, we will also discuss in more detail what prescriptive requirements we will use as a backstop to our market-based access charge reform.³⁸⁶ In this Section, we explain why we have decided not to adopt any specific prescriptive mechanism in this Order.

³⁸² NPRM at ¶¶ 223-27.

³⁸³ NPRM at ¶¶ 228-30.

³⁸⁴ NPRM at ¶¶ 231-32.

³⁸⁵ NPRM at ¶¶ 236-38.

³⁸⁶ In Section IV.A of this Order, we state that we will require incumbent price cap LECs to file forward-looking economic cost studies on or before February 8, 2001.

b. Rate Prescription

288. *Background.* We sought comment on prescribing new interstate access rates because simply reinitializing PCIs would not necessarily compel incumbent LECs to establish reasonable rate structures.³⁸⁷ We also noted, however, that prescribing access rates on a TSLRIC basis could raise common cost allocation issues to a much greater extent than did TELRIC pricing for unbundled network elements.³⁸⁸

289. *Discussion.* In Section IV.A, above, we explain why we can and should rely primarily on market forces to cause interstate access rates to move toward economic cost levels over the next several years. Prescribing TSLRIC-based access rates would be the most direct, uniform way of moving those rates to cost. But, precisely because of its directness and uniformity, rate regulation can only be, at best, an imperfect substitute for market forces. Regulation cannot replicate the complex and dynamic ways in which competition will affect the prices, service offerings, and investment decisions of both incumbent LECs and their competitors. A market-based approach to rate regulation should produce, for consumers of telecommunications services, a better combination of prices, choices, and innovation than can be achieved through rate prescription. A market-based approach, with continued price cap regulation of services not subject to substantial competition and with the prescriptive backstop described in Section IV.A, is thus consistent both with the pro-competitive, deregulatory goals of the 1996 Act and with our responsibility under Title II, Part I of the Communications Act to ensure just and reasonable rates.

290. Furthermore, immediate prescription of TSLRIC-based rates would not necessarily move rates to those levels faster than the market-based approach and prescriptive backstop developed in Section IV.A. Some parties that favor a prescriptive approach have asserted that setting access rates immediately at TSLRIC levels would reduce incumbent LEC revenues by \$10 billion or more.³⁸⁹ Were we to make such a rate prescription, we would consider phasing in rate reductions of that magnitude over a period of years, in order to avoid the rate shock that would accompany such a great rate reduction at one time.³⁹⁰ Finally, because we have adopted a more efficient rate structure for interstate switched access services, it is not necessary to prescribe new rates in order to achieve efficient rate structures, as TRA and TCI recommend. Accordingly, we will not prescribe TSLRIC-based access rates at this time.

³⁸⁷ NPRM at ¶ 236.

³⁸⁸ NPRM at ¶ 237.

³⁸⁹ See NPRM at ¶ 7 and sources cited therein.

³⁹⁰ See *Investigation of Special Access Tariffs of Local Exchange Carriers*, CC Docket No. 85-166, Phase I and Phase II, Part 1, FCC 84-524, 57 Rad.Reg. 2d 188, 209 (released Nov. 9, 1984).

c. Reinitialization of PCIs on a Rate-of-Return Basis

291. *Discussion.* We reject reinitialization on the basis of any rate of return at this time. As a general matter, the parties advocating a rate-of-return based reinitialization do not provide any persuasive reason for adopting that particular approach. They favor reinitialization largely because they believe interstate access charges should be lower than they are now. As explained above, however, we are adopting a primarily market-based approach to rate level adjustments. The prescriptive backstop to that approach will be based on TSLRIC cost studies and, most likely, applied to geographically deaveraged rates. That approach is more likely to result in rates that are aligned with economic costs than would reinitialization to a particular rate of return on an embedded cost rate base.

292. Moreover, because the basic theory of our existing price cap regime is that the prospect of retaining higher earnings gives carriers an incentive to become more efficient, we believe that rate of return-based reinitialization would have substantial pernicious effects on the efficiency objectives of our current policies.³⁹¹ In this regard, we have often expressed concern in past price cap orders that maintaining links between rate levels and a carrier's achieved rate of return would undercut the efficiency incentives price cap regulation was designed to encourage. In the *LEC Price Cap Order*, we rejected a so-called "automatic stabilizer" adjustment to the price cap index that -- like reinitialization -- would have permanently adjusted index levels downward in the event that carriers achieved earnings above a certain rate of return.³⁹² Similarly, in our 1995 *LEC Price Cap Performance Review Order*, we cited as a disadvantage of AT&T's "Direct Model" method of determining the PCI formula's "X-Factor" the fact that "a target rate of return is a critical factor in measuring productivity."³⁹³ And although we sought comment in the *Access Reform NPRM* on the question of rate of return-based reinitialization of the price cap indices, we once again expressed concern that such action "could have a negative effect on the productivity incentives of the LEC price cap plan."³⁹⁴ We, of course, have authority to change

³⁹¹ Ad Hoc's suggestion that we require a PCI reinitialization based on the currently-authorized 11.25 percent rate of return -- while administratively simpler than some other ways of changing rate levels -- would undermine productivity incentives by imposing the greatest penalties (rate reductions) on those carriers that had improved their efficiency the most. Reinitialization to another rate of return level, as API suggests, could, in addition, require resolution of complex and time-consuming issues. *See, e.g.*, Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 89-624, 5 FCC Rcd 7507 (1990) (taking about a year to resolve all relevant issues raised in prescribing the currently-authorized 11.25 percent rate of return).

³⁹² *LEC Price Cap Order*, 5 FCC Rcd at 6803. We adopted instead a sharing mechanism that made one-time earnings-related adjustments to PCI levels to ensure that carriers would "share" significant productivity gains in a given year with ratepayers, but would not be penalized by permanent downward adjustments to the track that the PCI otherwise would have taken. We have found that even the sharing mechanism tends to blunt efficiency incentives, and, in part for that reason, we are removing the sharing mechanism as well in Section IV of our companion *Price Cap Fourth Report and Order*.

³⁹³ *LEC Price Cap Performance Review Order*, 10 FCC Rcd at 9034.

³⁹⁴ NPRM at ¶ 230.

our methods and theories of regulating LEC rates when we believe the purposes of the Communications Act would be better served by doing so. However, we find that, given our consistently critical past statements about rate of return-based adjustments to price caps, a decision now to reinitialize PCIs to any specified rate of return would further undermine future efficiency incentives by making carriers less confident in the constancy of our regulatory policies.

293. In declining to reinitialize PCIs on the basis of carriers' rates of return, we reject GSA/DOD's suggestion that access rates have been excessive merely because the earnings of most price cap carriers have exceeded 11.25 percent, and, in some cases, by substantial amounts. When the Commission adopted price cap regulation, it specifically permitted price cap carriers to earn in excess of 11.25 percent in order to encourage them to become more productive.³⁹⁵ The Commission also concluded that complaints alleging excessive earnings relative to costs will not lie as long as the carrier is in compliance with the sharing mechanism.³⁹⁶ In addition, we found in the *LEC Price Cap Performance Review Order* that access rates declined substantially under price cap regulation from 1991 to 1994, in spite of the increases in earnings to which GSA/DOD alluded.³⁹⁷ Furthermore, the vastly different results among companies³⁹⁸ show that the incentive plan we have for cost reduction (price caps) largely is working as predicted, whereas a rate-of-return-based scheme would have cost much in terms of inefficiency.

d. Reinitialization of PCIs on a TSLRIC Basis

i. Background

294. In the NPRM, we sought comment on reducing price cap PCIs by an amount equal to the difference between the incumbent LECs' PCIs and the revenues that would be produced by rates set at TSLRIC levels. We noted that a TSLRIC-based PCI reinitialization might be preferable to a TSLRIC-based rate prescription because it would not require us to prescribe common cost allocations.³⁹⁹ We also sought comment on whether or to what extent we could rely on TELRIC studies developed for pricing unbundled network elements, and whether we should initiate joint board proceedings to rely on state commissions to evaluate the incumbent

³⁹⁵ *LEC Price Cap Order*, 5 FCC Rcd at 6787.

³⁹⁶ *LEC Price Cap Order*, 5 FCC Rcd at 6836.

³⁹⁷ We found that the cumulative effect of price cap regulation from 1991 to 1994 was approximately \$5.9 billion. *LEC Price Cap Performance Review Order*, 10 FCC Rcd at 8986-87. We do not know for certain, but believe that the benefits to access customers would have been smaller under rate-of-return regulation.

³⁹⁸ See, e.g., 1996 Annual Access Filings, 11 FCC Rcd 7564 (Com.Car.Bur. 1996).

³⁹⁹ NPRM at ¶ 223.

LECs' TELRIC studies.⁴⁰⁰

ii. Discussion

295. We have decided not to require incumbent LECs to reinitialize PCIs on a TSLRIC basis at this time. As we discuss in Section IV.A above, we expect market forces to develop as a result of the 1996 Act and to drive access rate levels to forward-looking economic costs. Furthermore, the record in this proceeding is unclear on whether there is an accurate and convenient method for determining TSLRIC for purposes of reinitializing PCIs at this time. Specifically, it is unclear whether the TELRIC studies used to develop unbundled network element prices can be used for access services.⁴⁰¹

e. Policy-Based X-Factor Increase

i. Background

296. In the NPRM, we observed that we adopted a consumer productivity dividend (CPD) to assure that some portion of the benefits of the incumbent LECs' increased productivity growth under price cap regulation would flow to ratepayers in the form of reduced rates. We sought comment on establishing a policy-based mechanism similar to the CPD to force access rates to cost-based levels.⁴⁰²

ii. Discussion

297. *Discussion.* We do not require a policy-based X-Factor increase at this time for the same reason we do not require a TSLRIC-based PCI reinitialization; we expect market forces to control access charges effectively in a less intrusive manner.

298. BellSouth and GTE oppose increasing the CPD as an arbitrary and confiscatory measure.⁴⁰³ SNET claims that increasing the X-Factor merely because the price cap LECs have earned too much, or simply to drive rates down, is essentially an abandonment of price cap regulation, because it would punish incumbent LECs for their efficiency gains made under the

⁴⁰⁰ NPRM at ¶¶ 224-25.

⁴⁰¹ *Universal Service Order* at ¶ 245.

⁴⁰² NPRM at ¶¶ 231-32.

⁴⁰³ BellSouth Comments at 49; GTE Comments at 77-78.

price cap regime.⁴⁰⁴ BA/NYNEX and GTE contend that the X-Factor should be chosen to reflect reasonably expected incumbent LEC productivity growth rather than to achieve a specific rate reduction.⁴⁰⁵ We emphasize that we have done nothing in this Order to increase the X-Factor. In our companion *Price Cap Fourth Report and Order*, we prescribe a new X-Factor of 6.5 percent, but this prescription is based on detailed studies of LEC productivity growth and input price changes.⁴⁰⁶ We decline to increase the CPD,⁴⁰⁷ and we reject a proposal to set the X-Factor to target an industry average rate of return of 11.25 percent.⁴⁰⁸ Thus, none of our actions in either this Order or our companion Order can properly be characterized as an abandonment of price cap regulation, or as motivated merely by a desire to drive rates down.

C. Equal Access Costs

1. Background

299. In the NPRM, we solicited comment on whether to require incumbent price cap LECs to make an exogenous cost decrease to one or more of their PCIs to account for the completion of the amortization of equal access costs on December 31, 1993.⁴⁰⁹

300. Under court order, the BOCs and GTE were required to provide equal access.⁴¹⁰ This conversion, estimated at more than \$2.6 billion, was largely completed by 1990, and involved both capital and non-capital expenditures. Under the *Equal Access Cost Order*, incumbent LECs were required to identify separately the incremental capital investments and the incremental non-capital-related expenses associated with the implementation of equal access. The *Equal Access*

⁴⁰⁴ SNET Reply at 23-24. *See also* BA/NYNEX Reply at 32-33.

⁴⁰⁵ BA/NYNEX Reply at 30; GTE Reply at 26-27.

⁴⁰⁶ *Price Cap Fourth Report and Order*, Section III.E.

⁴⁰⁷ *Price Cap Fourth Report and Order*, Section III.D.5.

⁴⁰⁸ *Price Cap Fourth Report and Order*, Section III.B.

⁴⁰⁹ NPRM at ¶ 293. We note that through the years, this issue has been referred to as "equal access network reconfiguration" or EANR costs. This is a misnomer, which we correct today. "Equal access" is the provision of exchange access to all interexchange carriers on an unbundled, tariffed basis that is equal in type, quality, and price to that provided to AT&T and its affiliates. *Equal Access and Network Reconfiguration Costs, Memorandum Opinion and Order*, 50 Fed. Reg. 50910 (rel. Dec. 9, 1985) at ¶ 18 (*Equal Access Cost Order*). "Network Reconfiguration" costs are those investments and expenses incurred in connection with structurally conforming the pre-divestiture AT&T network with the LATA boundaries mandated by the MFJ. *Id.* Issues underlying network reconfiguration costs were resolved in the *Equal Access Cost Order* and have not been raised since. *See Id.* at ¶ 22.

⁴¹⁰ *See United States v. AT&T*, 552 F. Supp. 131, 233 (D.D.C. 1982); *United States v. GTE Corp.*, 603 F. Supp. 730, 745 (D.D.C. 1984).

Cost Order directed that the capital investments, which it estimated to comprise approximately 55 percent of the \$2.6 billion, be treated pursuant to ordinary accounting and ratemaking principles.⁴¹¹ The Commission determined that the remaining 45 percent of the expenditures -- which were non-capitalized equal access expenses -- required special treatment:

[W]e are concerned that these expenditures will cause irregular and substantial fluctuations in revenue requirements associated with equal access. Because they are extraordinary, are for the greatest part expected to be incurred over the next few years, and, therefore, are likely to be distortive of financial results and rate requirements, we find that these equal access expenses should be deferred and amortized.⁴¹²

The Commission ordered that these equal access expenses be separately identified and recorded, and that they be written off over a period of eight years, ending December 31, 1993.⁴¹³ In the reconsideration of the *Equal Access Cost Order*, the Commission found that the specific termination date of the eight year amortization of these expenses would "shorten the period during which the unamortized balances are entitled to earn a rate of return."⁴¹⁴ It is clear that the LECs' rate-of-return (ROR) rates included revenue recovery for both capitalized expenditures (recovered through the ordinary depreciation process) and non-capitalized expenses (recovered through the special amortization process).⁴¹⁵ It is also clear that at the time the amortization was imposed, the Commission envisioned an end to the recovery for the amortized expenses and a subsequent decrease in ROR rates.⁴¹⁶

301. In converting to price cap regulation, the Commission found that equal access conversion was, in large part, completed and that the associated costs, which included both the capitalized expenditures and the amortized expenses, were embedded in the existing rates. As such, the Commission refused to grant LECs an exogenous increase for equal access costs,

⁴¹¹ *Equal Access Cost Order*, 50 Fed. Reg. at 50914, ¶ 32 ("[W]e believe that the capital cost of equal access service is best measured in the traditional manner whereby the cost of investments are recovered over their useful lives. This is best accomplished by using FCC prescribed depreciation lives for the classes of property associated with equal access.").

⁴¹² *Equal Access Cost Order*, 50 Fed. Reg. at 50914-15, ¶ 33.

⁴¹³ *Equal Access Cost Reconsideration Order*, at 437 ¶ 25.

⁴¹⁴ *Equal Access Cost Reconsideration Order*, at 437 ¶ 25.

⁴¹⁵ *LEC Price Cap Order*, 5 FCC Rcd at 6808, ¶ 180.

⁴¹⁶ *Equal Access Cost Reconsideration Order*, at 437 ¶ 25.

finding that these costs were already accounted for in the existing rates.⁴¹⁷ The Commission also based its decision to deny an exogenous increase on its concern that exogenous treatment of equal access expenditures would create inappropriate incentives for the LECs to inflate the amounts spent on equal access. The Commission noted the difficulty of reviewing equal access costs, as well as the risk that incumbent LECs might willfully or inadvertently shift switched access costs into the proposed equal access category in order to benefit from the requested exogenous increase.⁴¹⁸

2. Discussion

302. We find that an exogenous cost decrease to account for completion of the amortization of equal access non-capitalized expenses is necessary and appropriate. Although we have addressed this issue in the past and declined to act, we now find that an exogenous decrease is merited. We recognize our decision departs from our past decisions that have declined to impose an exogenous decrease for the completed recovery of these costs. As discussed below, our decision today reverses those decisions and is based on an extensive record from this, and prior proceedings.⁴¹⁹ Our decision today aligns our treatment of the completion of the amortization of equal access costs with two other similar amortizations that were ordered under ROR regulation and carried over into price cap regulation, namely, the exogenous decrease imposed for the completion of the amortization of depreciation reserve deficiencies,⁴²⁰ and the exogenous decrease imposed for the completion of the amortization of inside wire costs.⁴²¹ We are convinced that this treatment is the proper method to ensure that ratepayers are not paying for costs that have already been completely recovered.

303. The need for an exogenous adjustment to account for the expiration of the equal access expense amortization stems from the different ways in which rates are established under ROR regulation, on the one hand, and price cap regulation, on the other hand, and from the Commission's decision to establish initial price cap levels at the outset of price cap regulation on

⁴¹⁷ *LEC Price Cap Order*, 5 FCC Rcd at 6808, ¶ 180.

⁴¹⁸ *LEC Price Cap Order*, 5 FCC Rcd at 6808, ¶ 180.

⁴¹⁹ In addition to the comments received in this proceeding, our record is supplemented by commentary from interested parties in a number of prior proceedings, including comments filed in connection with the following orders: *LEC Price Cap Order*, 5 FCC Rcd 6786 (1990); *LEC Price Cap Reconsideration Order*, 6 FCC Rcd 2637 (1991); *Commission Requirements for Cost Support Material To Be Filed with 1994 Annual Access Tariffs*, 9 FCC Rcd 1060; *1994 First Annual Access Tariff Order*, 9 FCC Rcd 3705; *Second 1994 Annual Access Order*, 9 FCC Rcd 3519; *1993-1996 Annual Access Tariff Filings*, CC Docket Nos. 93-193 and 94-65, Memorandum Opinion and Order, FCC 97-139 (rel. April 17, 1997).

⁴²⁰ *LEC Price Cap Order*, 5 FCC Rcd at 6808, ¶ 173.

⁴²¹ *LEC Price Cap Reconsideration Order*, 6 FCC Rcd at 2673-2674, ¶¶ 78-82 (imposing exogenous cost decrease for the completion of amortization of inside wire costs).

the basis of existing ROR-derived rates.⁴²² When converting from ROR regulation to price cap on regulation January 1, 1991, the Commission needed to select a set of "baseline" rate levels to which the price cap index of incremental cost changes would be tied. For that purpose, we chose the ROR-developed rates that were in effect on July 1, 1990.⁴²³ The Commission found that, in general, those rates served as an appropriate starting point for measuring subsequent incremental cost changes under price cap regulation, because they "reflect[ed] the reasonable operation of ROR regulation."⁴²⁴

304. In two respects, however, the Commission recognized that existing rates did not reflect equilibrium ROR-derived rates, but rather reflected special corrective adjustments that we had ordered previously. In particular, the Commission noted that existing rates had embedded within them costs associated with Commission-ordered "one-time" amortizations of depreciation reserve deficiencies and inside wiring costs.⁴²⁵ Had ROR regulation continued, the rates subject to these amortizations would have been reduced when the amortizations were completed. To ensure that ratepayers under price caps would not be required permanently to bear these temporary Commission-ordered, ROR-derived rate adjustments, we directed LECs to make downward exogenous cost adjustments to their price cap indices upon the expiration of those amortizations.⁴²⁶

305. Similarly, the Commission ordered amortization of equal access expenses, which also were reflected in baseline rates at the outset of price cap regulation. Under normal ROR

⁴²² Under ROR regulation, rates for a particular service are determined annually by a calculation from the ground up of the company-specific costs associated with the provision of that service. Expenses generally are recovered in their entirety through rates in the year in which they are incurred. Asset costs generally are capitalized and recovered over the assets' useful lives through rates that are designed to reflect the annual depreciation expenses associated with the assets and a return on the undepreciated (remaining) portion of the assets. Under price caps, rates are not developed each year through a "ground up" calculation of company-specific costs. Instead, rates are set according to a formula that measures the incremental change in costs each year -- as reflected (a) in the movement of surrogates (*i.e.*, GDP-PI minus X) for so-called "endogenous" costs over which the carrier can exercise some control, and (b) in the company-specific measurement of certain "exogenous" cost changes that are not reflected in the "GDP-PI minus X" variable and are beyond the carriers' control.

⁴²³ *LEC Price Cap Order*, 5 FCC Rcd at 6814, ¶ 230.

⁴²⁴ *Id.* at ¶ 232.

⁴²⁵ See *Price Cap Further Notice of Proposed Rulemaking*, 3 FCC Rcd at 3419-23 ¶¶ 413-420. The depreciation reserve deficiency amortization was a "one-time correction device" ordered by the Commission to address the fact that the depreciation rates prescribed by the Commission had significantly overstated the useful lives of LEC assets. The Commission temporarily raised LEC rates to recover that deficiency. *Price Cap Further Notice*, 3 FCC Rcd at 3421-22, ¶¶ 417-18. The inside wiring amortizations provided a mechanism for LECs to recover from regulated ratepayers investments in activities that were regulated at the time the investments were made, but which the Commission had deregulated on a going-forward basis. *Id.*, 3 FCC Rcd at 3422-23, ¶¶ 419-420.

⁴²⁶ *LEC Price Cap Order*, 5 FCC Rcd at 6808, ¶ 173; *LEC Price Cap Reconsideration*, 6 FCC Rcd at 2673-74, ¶¶ 78-80.

ratemaking principles, those expenses -- which, for the most part, already had been incurred before price cap regulation was initiated -- would have been recovered in the BOCs' rates the same year they were incurred and would no longer have been reflected in rates at the time price caps were instituted. However, as explained *supra*, the Commission required the carriers to amortize these extraordinary expenses over eight years because of the potential fluctuations in revenue requirements associated with equal access.⁴²⁷ Thus these expenses remained embedded within BOC rates at the outset of price caps even though, for the most part, the extraordinary expenses themselves were no longer being incurred.

306. The specific question of whether the completely amortized equal access expenses should be treated exogenously has been presented to the Commission on a number of occasions.⁴²⁸ In the past, procedural impediments arising from our rules, as well as the lack of an adequate record, convinced us to decline to impose such treatment at that time. For example, when AT&T raised the issue of downward adjustment for completed amortization of equal access expenses in an annual access charge tariff proceeding, the Common Carrier Bureau found that the issue was beyond the scope of the proceeding because it would require a substantive change to the price cap rules.⁴²⁹ Similarly, in response to AT&T's and MCI's revisiting the question in both the *First 1994 Annual Access Charge Order* and the *Second 1994 Annual Access Charge Order*, the Commission found that exogenous treatment would require a rule change to section 61.45(d) of the Commission's rules. Because no LEC had filed for a waiver of section 61.45(d), the Common Carrier Bureau found that the issue was not properly presented for investigation.⁴³⁰

307. In denying the requests for procedural reasons, the Commission supported its decisions with various rationales. In some instances, these rationales appear now not to have been considered to a sufficient degree. In addressing equal access costs in the orders adopting price cap regulation, the Commission focused primarily on the question of whether future equal access investments and expenses should be treated exogenously because equal access had been

⁴²⁷ *Equal Access Cost Order*, 50 Fed. Reg. at 50914-15, ¶ 33 (1985).

⁴²⁸ See, e.g., *LEC Price Cap Reconsideration*, 6 FCC Rcd at 2667, ¶ 66 n.77; *Commission Requirements for Cost Support Material To Be Filed with 1994 Annual Access Tariffs*, 9 FCC Rcd 1060, 1063, ¶¶ 21-22 (rel. Feb. 18, 1994) (*1994 Annual Access TRP*); *First 1994 Annual Access Charge Order*, 9 FCC Rcd 3705, 3730-37311 at ¶¶ 54-56 (rel. June 24, 1994); *Second 1994 Annual Access Charge Order*, 9 FCC Rcd 3519, 3535-3536 at ¶¶ 36-38 (rel. June 24, 1994).

⁴²⁹ *1994 Annual Access TRP*, 9 FCC Rcd at 1063, ¶¶ 21-22.

⁴³⁰ See *First 1994 Annual Access Charge Order*, 9 FCC Rcd at 3731; *Second 1994 Annual Access Charge Order*, 9 FCC Rcd at 3536. See also *1993-1996 Annual Access Tariff Filings*, CC Docket Nos. 93-193 and 94-65, Memorandum Opinion and Order, FCC 97-139 (rel. April 17, 1997), at ¶ 82.

compelled by regulatory (or judicial) order.⁴³¹ We concluded, subject to consideration of waiver requests, that we should not accord exogenous cost treatment to such future equal access conversion costs, because of concerns that exogenous cost treatment would create disincentives to implement equal access in an efficient manner.⁴³² We did not focus in detail on the logically distinct question of whether equal access expenses that were already embedded within baseline BOC rates pursuant to the temporary "one-time" amortizations (and thus raised no question with respect to future incentives) should be removed through exogenous adjustments when the amortizations expired.⁴³³ Instead, we relegated that issue to a footnote, which denied exogenous cost treatment on the basis of a skeletal analysis that makes no reference to our treatment of the depreciation reserve deficiency and inside wiring amortizations. In the footnote, it is clear that the Commission was not distinguishing between capitalized costs, which were properly treated as depreciated expenses, and non-capitalized expenses, which were actually amortized per the Commission's own requirement.⁴³⁴ The Commission framed the issue of a downward adjustment in terms of whether the completion of depreciation required a downward adjustment, querying "whether the BOCs will experience any cost change in 1994 [at the completion of the amortization] that stems from factors beyond their control." In support of its implicitly negative answer, the Commission analogized to the absence of a price cap index change when a piece of equipment is fully depreciated, or when a carrier increased or decreased the speed with which it recovered investments.⁴³⁵ The Commission found that, "[b]ased on a meager factual record presented on the issue of equal access expense, we are reluctant to depart from our practice of not adjusting PCI levels to reflect levels of cost recovery."⁴³⁶

308. The Commission's analysis at that time was incomplete. The *Equal Access Cost*

⁴³¹ *LEC Price Cap Order*, 5 FCC Rcd at 6808 ¶¶ 180-181. The amortization requirement had applied only to court-ordered conversion to equal access by the BOCs. The Commission, however, had also had required independent LECs to convert to equal access upon bona fide request.

⁴³² See *LEC Price Cap Reconsideration*, 6 FCC Rcd at 2666-67, ¶ 66.

⁴³³ See *LEC Price Cap Reconsideration*, 6 FCC Rcd at 2667 n.77. In several subsequent orders addressing BOC tariff filings implementing our price cap rules, we rejected contentions that we order downward exogenous cost adjustments to the carriers' price cap indexes to account for the expiration of the equal access cost amortizations. See, e.g., *1994 Annual Access TRP*, 9 FCC Rcd at 1063, ¶¶ 21-22. We did so primarily on procedural grounds -- i.e., that the treatment of such amortizations had already been decided in the price cap rulemaking proceeding and that a tariff proceeding was not the proper vehicle for changing that treatment. *Id.* See also *First 1994 Annual Access Charge Order*, 9 FCC Rcd at 3731; *Second 1994 Annual Access Charge Order*, 9 FCC Rcd at 3536; *1993-1996 Annual Access Tariff Filings*, CC Docket Nos. 93-193 and 94-65, Memorandum Opinion and Order, FCC 97-139 (rel. April 17, 1997), at ¶ 82.

⁴³⁴ *LEC Price Cap Reconsideration*, 6 FCC Rcd at 2667, ¶ 66 n.77 ("We also decline to adopt MCI's suggestion to treat BOC equal access costs *in the same way we do amortizations*") (emphasis added).

⁴³⁵ *LEC Price Cap Reconsideration*, 6 FCC Rcd at 2667, ¶ 66 n.77.

⁴³⁶ *LEC Price Cap Reconsideration*, 6 FCC Rcd at 2667, ¶ 66 n.77.

Order and the *Equal Access Cost Reconsideration Order* explicitly recognized two components of equal access costs -- capitalized, which were to be depreciated, and non-capitalized, which were extraordinary and were to be amortized over a set period.⁴³⁷ The Commission established different treatment for these two sets of costs based on policy reasons, and ordered an amortization schedule for the non-capitalized costs. The Commission's establishment of this schedule was beyond the incumbent LECs' control. The Commission's analogy to the lack of exogenous treatment for equipment depreciation and changes in the tempo of recovery should have only applied to the capitalized portion of the equal access costs.

309. The Commission explicitly stated in the *LEC Price Cap Order* that completed amortizations of depreciation reserve deficiencies require an exogenous downward adjustment.⁴³⁸ The Commission found that such an adjustment was necessary to ensure that ratepayers were not paying for a cost that no longer existed. Analytically, the amortized portion of equal access expenses should have been treated in the same fashion as the amortized depreciation reserve deficiency costs. The Commission's imposition of a downward exogenous adjustment for the completion of inside wire amortizations further supports our finding today that an exogenous decrease is appropriate and necessary for the completion of the amortization of equal access non-capitalized expenses.⁴³⁹

310. We reject our prior analysis of amortized equal access costs and accord the expiration of equal access cost amortizations the same exogenous cost treatment given to the amortizations of the depreciation reserve deficiencies and inside wiring costs. Both of those amortizations were given exogenous cost treatment when they expired because they reflected temporary, one-time treatment of costs under ROR regulation that, due to the mid-stream switch to price cap regulation, would have become permanent (even though the costs already had been recovered) absent an exogenous cost adjustment. The same is true for equal access cost amortizations.

311. Because this is a rulemaking, we do not face the same procedural impediments as in some of our prior decisions, as explained *supra*. We determine that the record from this proceeding allows us to make a reasoned decision on this issue. We find that an exogenous decrease is necessary in order to adjust the price caps for the completed recovery of the specified equal access non-capitalized expenses that we required be amortized over an eight-year period. Because the current price cap index includes an expense that has now been completely recovered, the price cap should be adjusted downward to account its recovery. Simply stated, we find that

⁴³⁷ *Equal Access Cost Order*, at ¶ 33.

⁴³⁸ *LEC Price Cap Order*, 5 FCC Rcd at 6808, ¶ 173 (discussing exogenous treatment of expiration of amortizations to correct depreciation reserve deficiencies).

⁴³⁹ *LEC Price Cap Reconsideration*, 6 FCC Rcd at 2673-74, ¶¶ 78-82.

ratepayers should not be forced to pay for a cost that, were it not for the way price cap regulation occurred in this instance, they would no longer be paying. By imposing a downward exogenous adjustment to adjust the PCI for the complete recovery of specific equal access expenses through amortization, we will avoid unfairly imposing a subsidy burden on ratepayers. Our decision in this matter will align charges more closely to costs.

312. Several commenters have argued that they continue to incur costs as a part of the provision of equal access. These ongoing costs are not at issue in the present proceeding. As explained above, the costs at issue were a set of costs that the Commission determined should be amortized for policy reasons. These costs were extraordinary and, if allowed to be imposed in the normal fashion, would have resulted in huge rate fluctuations. We consider the ongoing costs of providing equal access as part of the normal costs of providing telephone service. Exogenous treatment of these costs is unnecessary. In response to BellSouth's contention that the record is inadequate for us to make a decision about an exogenous decrease, we find that the current record provides a sufficient basis for our decision.⁴⁴⁰ Furthermore, we note that in the past, the record may have been sufficient, but, as explained above, the Commission's analysis was incorrect.

313. TCA and GCI are concerned about how the Commission will treat cost recovery for LECs that convert to equal access in the future.⁴⁴¹ As we stated in the *LEC Price Cap First Report and Order*, LECs that have not received a *bona fide* request for equal access at the time they become subject to price cap regulation may request a waiver for special treatment of those special conversion costs when the time arises.⁴⁴²

314. We hereby direct price cap LECs to make a downward exogenous adjustment to the traffic sensitive basket in the Annual Access Tariff filing that takes effect on July 1, 1997 to account for the completed amortization of equal access expenses.

D. Correction of Improper Cost Allocations

1. Marketing Expenses

a. Background

315. Prior to 1987, incumbent LEC marketing expenses were allocated between the interstate and intrastate jurisdictions on the basis of local and toll revenues. In 1987, a Federal-State Joint Board recommended that interstate access revenues be excluded from the allocation

⁴⁴⁰ BellSouth Comments at 87.

⁴⁴¹ TCA Comments at 5-6; GCI Comments at 8.

⁴⁴² See *LEC Price Cap First Report and Order*, 4 FCC Rcd 2873, 3190 at ¶ 657.

factor used to apportion marketing expenses between the interstate and intrastate jurisdictions because marketing expenses are not incurred in the provision of interstate access services.⁴⁴³ The Commission agreed with the Joint Board's recommendation and adopted new procedures that allocated marketing expenses in Account 6610 on the basis of revenues excluding access revenues.⁴⁴⁴ In petitions for reconsideration of the Commission's order, several incumbent LECs argued that the revised separations treatment of marketing expenses would result in a significant, nationwide shift of \$475 million in revenue requirements to the intrastate jurisdiction.⁴⁴⁵ On reconsideration, the Commission adopted for marketing expenses an interim allocation factor that includes access revenues, pending the outcome of a further inquiry by the Joint Board.⁴⁴⁶

316. In the NPRM, we stated that some of the difference between the price cap LECs' interstate allocated costs and forward-looking costs may be traced to past regulatory practices that were designed to shift some costs from the intrastate jurisdiction to the interstate jurisdiction in order to further universal service goals.⁴⁴⁷ We observed that the Commission's decision in the *Marketing Expense Reconsideration Order* to allocate intrastate marketing costs to the interstate jurisdiction was an example of such past regulatory practices.⁴⁴⁸ We asked parties to comment on the extent to which the difference between price cap LECs' interstate allocated costs and forward-looking costs is a result of such decisions.⁴⁴⁹

b. Discussion

317. Under current separations procedures, approximately 25 percent of price cap LECs' total marketing expenses are allocated to the interstate jurisdiction.⁴⁵⁰ We agree with parties that

⁴⁴³ Amendment of Part 67 (New Part 36) of the Commission's Rules and Establishment of a Federal-State Joint Board, CC Docket No. 86-297, Recommended Decision and Order, 2 FCC Rcd 2582 (1987) (*Marketing Expense Recommended Decision*).

⁴⁴⁴ MTS and WATS Market Structure, Amendment of Part 67 (New Part 36) of the Commission's Rules and Establishment of a Federal-State Joint Board, CC Docket Nos. 78-72, 80-286, and 86-297, Report and Order, 2 FCC Rcd 2639 (1987).

⁴⁴⁵ MTS and WATS Market Structure, Amendment of Part 67 (New Part 36) of the Commission's Rules and Establishment of a Joint Board, CC Docket No. 78-72, 80-286, and 86-297, Memorandum Opinion and Order on Reconsideration and Supplemental Notice of Proposed Rulemaking, 2 FCC Rcd 5349, 5350 (1987) (*Marketing Expense Reconsideration Order*).

⁴⁴⁶ *Marketing Expense Reconsideration Order*, 2 FCC Rcd at 5353. See also 47 C.F.R. § 36.372.

⁴⁴⁷ NPRM at ¶ 249.

⁴⁴⁸ NPRM at ¶ 249.

⁴⁴⁹ NPRM at ¶ 254.

⁴⁵⁰ 1996 ARMIS Access Report.

contend that, because marketing expenses generally are incurred in connection with promoting the sale of retail services, those expenses for the most part should be recovered from incumbent LEC retail services, which are found predominantly in the intrastate jurisdiction. Pursuant to section 410(c) of the Act, however, the Commission must refer any rulemaking proceeding regarding the jurisdictional separation of common carrier property and expenses between interstate and intrastate operations to a Federal-State Joint Board.⁴⁵¹ We intend to initiate a proceeding to review comprehensively our Part 36 jurisdictional separations procedures in the near future. We will refer this issue to the Federal-State Joint Board in CC Docket No. 80-286 for resolution as part of that comprehensive review. We therefore do not reallocate these costs between the interstate and intrastate jurisdictions at this time.

318. In the *Marketing Expense Recommended Decision*, the Joint Board stated that the inclusion of access revenues in the allocation factor for marketing expenses is unreasonable because incumbent LECs do not actively market or advertise access services.⁴⁵² Although parties contested the accuracy of this statement on reconsideration, the Commission did not assess incumbent LEC claims that the decision to exclude access revenues in the allocator for marketing expenses was based on an inaccurate perception of the extent to which LECs actively market or advertise exchange access services. The Commission instead referred marketing expense issues back to the Joint Board, with specific instruction to the parties to identify any Account 6610 marketing activities that are related to access services and any such activities that are related to a specific jurisdiction. We continue to recognize that some expenses recorded in Account 6610 may indeed be incurred in the provision of interstate access service, and that this is an issue that must be addressed by the Joint Board when it examines the appropriate allocation factor for marketing expenses. We note, however, that the Commission did not find in the *Marketing Expense Reconsideration Order* that the Joint Board's initial conclusion in the *Marketing Expense Recommended Decision* that incumbent LECs do not market or advertise access services to be inaccurate.

319. We conclude that price cap LECs' marketing costs that are not related to the sale or advertising of interstate switched access services are not appropriately recovered from IXCs through per-minute interstate switched access charges. Pending a recommendation by the Joint Board on a new method of apportioning marketing costs between the intrastate and interstate jurisdictions, we direct price cap LECs to recover marketing expenses allocated to the interstate jurisdiction from end users on a per-line basis, for the reasons we discuss below.

⁴⁵¹ 47 U.S.C. § 410(c). As noted above, when the Commission reconsidered its decision to exclude interstate access revenues from the allocation factor used to apportion marketing expenses between the interstate and intrastate jurisdictions and adopted an interim allocation factor based on both local revenues and interstate access revenues, it referred the issue back to the Federal-State Joint Board in CC Docket No. 80-286 to recommend a permanent solution. *Marketing Expense Reconsideration Order*, 2 FCC Rcd at 5353.

⁴⁵² *Marketing Expense Recommended Decision*, 2 FCC Rcd at 2589.

320. Recovering these expenses from end users instead of from IXC's is consistent with principles of cost-causation to the extent that price cap LEC sales and advertising activities are aimed at selling retail services to end users, and not at selling switched access services to IXC's. Recovery on a per-line basis, while perhaps not precisely reflective of the manner in which marketing costs are incurred, is preferable to the current rule requiring price cap LEC's to recover their marketing expenses through per-minute access charges. A price cap LEC's retail marketing costs are not caused by usage of switched access services, and its efforts to sell additional lines, vertical features, and other retail services would only indirectly cause an increase in switched access usage. Per-minute recovery of retail marketing costs thus distorts prices in the long distance and local markets in the same way as does per-minute recovery of other NTS costs.

321. In the past, price cap LEC retail marketing may have focused on the sale of optional vertical features such as call waiting and caller ID, and on features and services designed for business customers. As local competition develops, we would expect that sales expenses would be driven by the price cap LEC's need to respond to competition. In any case, it is beyond our jurisdiction to reassign retail marketing costs to retail services on a truly cost-causative basis. There is probably a relationship, however, between the number of lines purchased by an end user, particularly a business user, and the amount of effort a price cap LEC expends to sell services and features to that end user. Furthermore, as parties have observed in the record in this proceeding, price cap LEC's actively market second lines to residential customers.⁴⁵³ We conclude, therefore, that the most efficient and cost-causative method legally available to this Commission at this time for recovery of price cap LEC retail marketing costs allocated to the interstate jurisdiction is to charge those end users to whom the price cap LEC's marketing is directed -- multi-line business and non-primary residential line end users. We further note that by not permitting price cap LEC's to recover these costs from primary residential and single-line business customers, we avoid potential universal service concerns that weigh against increasing charges on these end users.⁴⁵⁴

322. Moreover, continued recovery of interstate-allocated marketing expenses in per-minute switched access charges would raise competitive concerns. Increasingly, IXC's will be competing with incumbent, price cap LEC's in the provision of local exchange and exchange access services. By permitting incumbent, price cap LEC's to recover from IXC's through interstate switched access charges their costs of marketing retail services, these potential competitors are forced to bear the incumbent, price cap LEC's costs of competing with the IXC's. Assigning recovery of marketing costs to end users, on the other hand, subjects these costs to the competitive pressures of the market.

⁴⁵³ CompuServe/Prodigy Comments at 14; America On-Line Reply at 12. *See also* Letter from Bruce K. Cox, Vice President, Government Affairs, AT&T, to William F. Caton, Acting Secretary, Federal Communications Commission, March 19, 1997.

⁴⁵⁴ *See* Section III.A.2, *supra*; *see also* Section V.B of the *Universal Service Order*.

323. Marketing expenses are currently recovered through all interstate access rate elements and the interexchange category in proportion to the investment originally assigned to these elements and categories by the Part 69 cost allocation rules.⁴⁵⁵ Special access and interexchange services are purchased by, and marketed to, retail customers. It is therefore appropriate to allow rates for those services to continue to include recovery of marketing expenses.⁴⁵⁶ Marketing expenses must be removed from all other rate elements by means of downward exogenous adjustments to the PCIs for the common line, traffic sensitive, and trunking baskets. With respect to the trunking basket, the exogenous adjustment shall not reflect the amount of any Account 6610 marketing expenses allocated to special access services. The service band indices (SBIs) within the trunking basket shall be decreased based on the amount of Account 6610 marketing expenses allocated to switched services included in each service category to reflect the exogenous adjustment to the PCI for the trunking basket.

324. After performing the appropriate downward exogenous adjustments described above to the PCIs in the common line, traffic sensitive, and trunking baskets, price cap LECs may recover the revenues related to the Account 6610 marketing expenses removed from these baskets by increasing the SLCs for multi-line business and non-primary residential lines. To prevent end-user charges from exceeding levels we have established earlier in this Order,⁴⁵⁷ the amount of marketing expenses to be recovered from multi-line business and non-primary residential lines in their SLCs shall be limited by the ceilings we establish for these SLCs in this Order.⁴⁵⁸ To the extent these ceilings prevent full recovery of these amounts, price cap LECs may recover these costs by increasing equally both the non-primary residential line PICC and the multi-line business PICC, not to exceed the ceilings on the PICC for non-primary residential and multi-line business lines.⁴⁵⁹ In the event the PICC ceilings prevent full recovery of these expenses, any residual may be recovered through per-minute charges on originating access service, subject to its ceiling. Finally, to the extent price cap LECs cannot recover their remaining marketing expenses through per-minute charges on originating access, any residual may be recovered through per-minute charges on terminating access service.⁴⁶⁰ Although these marketing expenses will be recovered through the SLC, they shall not be included in the base factor or considered common

⁴⁵⁵ 47 C.F.R. § 69.403.

⁴⁵⁶ For example, in the *SNFA Order*, we found that certain marketing expenses incurred to provide customer contact operations, service order processing, and the billing and administration of special access services are properly included in special access rates. Investigation of Special Access Tariffs of Local Exchange Carriers, CC Docket No. 85-166, Phase I; Phase II, Part 1; and Phase III, Part 1, FCC 97-42 (rel. Feb. 14, 1997) (*SNFA Order*).

⁴⁵⁷ See Section III.A.2, *supra*.

⁴⁵⁸ In future years, these ceilings shall rise as set forth in Section III.A.2, *supra*.

⁴⁵⁹ See Section III.A.3, *supra*.

⁴⁶⁰ See Section VI.C, *infra*, for a discussion of terminating access.

line revenues. To prevent price cap LECs from recovering these expenses from access services, we are establishing a separate basket for these marketing expenses.

325. We reject, however, AT&T's assertion that recovery of interstate-allocated marketing expenses through interstate access charges violates the wholesale pricing provisions contained in section 252(d)(3) of the Act.⁴⁶¹ Section 252(d)(3) establishes a pricing standard for the wholesale provision of retail offerings to other carriers that resell the LEC retail services.⁴⁶² Section 252(d)(3) does not apply to the pricing of interstate access, which is not a retail service.

2. General Support Facilities

a. Background

326. In the NPRM, we sought comment on other possible cost misallocations that may contribute to the difference between embedded costs and forward-looking costs allocated to the interstate jurisdiction.⁴⁶³ AT&T suggests that the allocation of embedded general support facilities (GSF) costs, including general purpose computer expenses, among access categories is one such misallocation.⁴⁶⁴ This allocation, AT&T contends, results in the inappropriate support of LECs' billing and collection service, which is a nonregulated, interstate service, through regulated access charges.⁴⁶⁵ AT&T estimates that \$124 million of expenses recovered in interstate access support the nonregulated billing and collection category.⁴⁶⁶ Of the \$124 million, \$60.1 million is included in interstate switched carrier access, and \$20.5 million is in interstate special access, with

⁴⁶¹ AT&T Comments at 66-67. AT&T identifies and quantifies inappropriate retail expenses embedded in current interstate switched access rates based on the requirements of section 252(d)(3) and the criteria for wholesale rate cost studies outlined in the *Local Competition Order*. See *Local Competition Order*, 11 FCC Rcd at 15958.

⁴⁶² 47 U.S.C. § 252(d)(3). Section 252(d)(3) provides that wholesale rates will be determined on the basis of retail rates, excluding the portion attributable to marketing, billing, collection, and other costs that will be avoided by the LEC.

⁴⁶³ NPRM at ¶ 254.

⁴⁶⁴ For a more detailed background on GSF misallocation issues, see Section VII.B, *infra*.

⁴⁶⁵ In 1986, the Commission found that the market for billing and collection service was sufficiently competitive that it was not necessary to require LECs to provide that service as a tariffed common carrier service. The Commission did not, however, preempt state regulation of billing and collection services. See *Detariffing of Billing and Collection Services*, CC Docket No. 85-88, 102 FCC 2d 1150 (1986) (*Billing and Collection Detariffing Order*) *recon. denied*, 1 FCC Rcd 445 (1986). The Commission later decided to treat billing and collection costs as regulated for accounting purposes because such treatment was less likely to misallocate these costs between the interstate and intrastate jurisdictions. *Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities*, Report and Order, CC Docket No. 86-111, 2 FCC Rcd 1298, 1309 (1987) (*Joint Cost Order*).

⁴⁶⁶ AT&T Comments at 67-68, Appendix E at 2.

the remainder recovered by the SLC.⁴⁶⁷

327. The GSF investment category in Part 36 includes assets that support other operations, such as land, buildings, vehicles, as well as general purpose computer investment accounted for in USOA Account 2124.⁴⁶⁸ Some incumbent LECs use general purpose computers to provide nonregulated billing and collection services to IXCs. Part 69 allocates GSF investment among the billing and collection category, interexchange category, and the access elements based on the amount of Central Office Equipment (COE), Cable and Wire Facilities (CWF), and Information Origination/Termination Equipment (IO/T) investment allocated to each Part 69 category.⁴⁶⁹ Because no COE, CWF, or IO/T investment is allocated to the billing and collection category, no investment in general support facilities, and thus no portion of general purpose computer investment, is allocated to the billing and collection category. Likewise, because expenses related to GSF investment are allocated in the same manner as GSF investment, no GSF expenses, including expenses related to general purpose computers, are allocated to the billing and collection category. To the extent that costs are underallocated to the billing and collection category, incumbent LECs' regulated services recover through interstate access charges costs associated with nonregulated provision of billing and collection services.

b. Discussion

328. We agree with AT&T and WorldCom that the current allocation of GSF costs enables incumbent LECs to recover through regulated interstate access charges costs caused by the LECs' nonregulated billing and collection functions. By shifting some costs from interstate access services to the nonregulated billing and collection category, we would move interstate access rates closer to cost. The NPRM, however, may not have provided sufficient notice to interested parties that we would change in the allocation of LEC interstate costs between regulated interstate services and nonregulated billing and collection activities. We therefore seek comment on this issue in Section VII.B below.

V. ACCESS REFORM FOR INCUMBENT RATE-OF-RETURN LOCAL EXCHANGE CARRIERS

A. Background

329. In the NPRM we concluded that, with limited exceptions, the scope of this proceeding should be limited to incumbent price cap LECs because these carriers face the

⁴⁶⁷ AT&T Comments Appendix E at 2.

⁴⁶⁸ 47 C.F.R. § 36.111.

⁴⁶⁹ 47 C.F.R. § 69.307(c).

potential of significant competition in the interstate exchange access market due to the new duties and obligations imposed upon them by the 1996 Act.⁴⁷⁰ We proposed limited exceptions that would subject all incumbent LECs to the rules addressing allocation of universal service support to the interstate revenue requirement, discussed in Section VI.D, below, and to the reforms to the transport rate structure, including the TIC, discussed in sections III.D., above. We invited comment on these tentative conclusions on the scope of this proceeding. We also sought comment on whether we should apply our proposed changes to the common line rate structure to rate-of-return incumbent LECs and whether we should update Part 69 access rules in light of various developments. We further invited comment on the effect of these proposals and tentative conclusions on small business entities, including small incumbent LECs and new entrants.⁴⁷¹ We also noted that we would address access reform for rate-of-return carriers in a separate proceeding in 1997.⁴⁷²

B. Discussion

330. We conclude that, with the limited exceptions discussed in Sections III.D and VI.D, the scope of this proceeding should be limited to price cap incumbent LECs.⁴⁷³ Price cap regulation governs almost 91 percent of interstate access charge revenues⁴⁷⁴ and more than 92 percent of total incumbent LEC access lines.⁴⁷⁵ Currently, all ten of the incumbent LECs with more than two million access lines and 13 of the 17 non-NECA incumbent LECs with more than 50,000 access lines are subject to price cap regulation.⁴⁷⁶ Therefore, even though this proceeding applies only to price cap incumbent LECs, it will nonetheless affect the vast majority of all access lines and interstate access revenues.

331. Small and rural LECs will most likely not experience competition as fast as incumbent price cap LECs. We do not expect small and rural LECs generally to face significant competition in the immediate future because, for the most part, the high cost/ low-margin areas

⁴⁷⁰ NPRM at ¶¶ 50-52.

⁴⁷¹ NPRM at ¶ 53.

⁴⁷² NPRM at ¶ 52.

⁴⁷³ These incumbent LECs are the seven Regional Bell Operating Companies (Ameritech, Bell Atlantic, BellSouth, NYNEX, Pacific Bell, SBC, US West), Citizens, Frontier, GTE, Aliant (formerly Lincoln), SNET, and United/Central.

⁴⁷⁴ Universal Service Fund Data Collection, CC Docket No. 80-286, Universal Service Fund 1996 Submission of 1995 Study Results by NECA, Oct. 1, 1996.

⁴⁷⁵ Data based on LECs' 1995 and 1996 Annual Access Tariffs filed with the Commission.

⁴⁷⁶ Data based on LECs' 1995 and 1996 Annual Access Tariffs filed with the Commission.

served by these LECs are unlikely to be the immediate targets of new entrants or competitors. Moreover, as we noted in the NPRM, all non-price cap incumbent LECs may be exempt from, or eligible for a modification or suspension of, the interconnection and unbundling requirements of the 1996 Act.⁴⁷⁷ By contrast, all incumbent LECs that are ineligible for section 251(f) exemption, suspensions, or modifications are incumbent price cap LECs.⁴⁷⁸ Because the latter incumbent LECs must fulfill the section 251(b) and (c) duties to provide interconnection and unbundled elements to new entrants, they are likely to face significant competition in the interstate exchange access market before the small and mid-sized rate-of-return incumbent LECs face such competition.

332. We recognize that small and rural rate-of-return LECs face unique circumstances and that a few of these carriers may now have, or may soon receive, bona fide requests for interconnection. Although all rate-of-return carriers may not be completely insulated from competitive pressures, we are not persuaded by arguments that delaying the initiation of an access reform proceeding for these carriers until later this year will have a detrimental impact on their viability. A separate proceeding for small and rural rate-of-return LECs will provide us with the opportunity to conduct a comprehensive review of the circumstances and issues unique to these carriers.

333. We do not agree that Citizens Utilities should be exempt from some of the rules we adopt in this order for price cap companies. The decisions we reach here accommodate many of the concerns that Citizens Utilities, as well as a number of other price cap LECs that serve rural areas, voices in its pleadings. Although Citizens Utilities arguably may face different circumstances than other price cap LECs that serve larger urban and suburban populations, Citizens has indicated, by electing price cap regulation, that it believes it can achieve a higher rate of productivity than smaller rate-of-return LECs and that price cap regulation is more beneficial to it than rate-of-return regulation. Citizens Utilities has not demonstrated that the modifications we are adopting in this proceeding would necessarily affect it differently than other price cap LECs. If Citizens Utilities believes that it cannot remain financially viable as a price cap carrier under the revised access charge regime, it may petition for a waiver of the rule that makes its decision to elect price cap regulation irreversible.⁴⁷⁹

⁴⁷⁷ For example, section 251(f)(1) exempts rural telephone companies from the requirements of section 251(c)(2) until the rural telephone company has received a bona fide request for interconnection, services, or network elements, and the state commission determines that the exemption should be terminated. In addition, section 251(f)(2) permits LECs with fewer than two percent of the nation's subscriber lines to petition a state commission for a suspension or modification of any requirements of sections 251(b) and (c).

⁴⁷⁸ See, e.g., USTA Holding Company Report 1996.

⁴⁷⁹ In the *LEC Price Cap Order*, the Commission stated that a LEC's decision to elect price cap regulation is irrevocable. Policy and Rules concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786, 6819 (1990).

334. We reject Centennial's suggestion that we adopt access reform modifications for *all* incumbent LECs but then grant waivers for small, rural LECs whose special circumstances warrant different accommodations. For the most part, rate-of-return LECs face a common set of complex issues, different than those faced by price cap LECs, that are better addressed in a separate proceeding. In that proceeding, we will address any differences that may exist between large and small rate-of-return carriers.

335. We therefore limit application of the rules we adopt in this proceeding to the incumbent price cap LECs, with limited exceptions. Because rate-of-return LECs will collect revenues from the new universal service support mechanisms, we address allocation of universal service support to the interstate revenue requirement for all incumbent LECs in Section VI.D. In addition, because rate-of-return incumbent LECs' transport rates were subject to the rules that were remanded by the court in *CompTel v. FCC*,⁴⁸⁰ the changes to the TIC that we adopt in Section III.D. pursuant to the court's remand, except for changes that require reallocation of costs to newly-created rate elements, will also apply to rate-of-return incumbent LECs. Finally, in order to prevent double recovery of the costs associated with providing access services to new entrants through the sale of unbundled network elements, we conclude in Section VI.A, below, that our exclusion of unbundled network elements from Part 69 access charges applies to all incumbent LECs.

VI. OTHER ISSUES

A. Applicability of Part 69 to Unbundled Elements

1. Background

336. In the NPRM, we requested comment regarding the potential application of Part 69 access charges to unbundled network elements purchased by carriers to provide local exchange services or exchange access services.⁴⁸¹ We tentatively concluded that unbundled network elements should be excluded from such access charges. We noted that the 1996 Act allows telecommunications carriers to purchase access to unbundled network elements and to use those elements to provide all telecommunications services, including originating and terminating access of interstate calls.⁴⁸² We further noted that the 1996 Act requires purchasing carriers to pay cost-based rates to incumbent LECs to compensate them for use of the unbundled network elements.⁴⁸³

⁴⁸⁰ *CompTel v. FCC*, 87 F.3d 522.

⁴⁸¹ NPRM at ¶ 54.

⁴⁸² *Id.*

⁴⁸³ *Id.*

Accordingly, we tentatively concluded that the requesting carrier paying cost-based rates to the incumbent LEC would have already compensated the incumbent LEC for the ability to deploy unbundled network elements to provide originating and terminating access.⁴⁸⁴

2. Discussion

337. We will adhere to our tentative conclusion to exclude unbundled network elements from Part 69 access charges. This conclusion applies to all incumbent LECs.⁴⁸⁵ As we noted in the *Local Competition Order*, payment of cost-based rates represents full compensation to the incumbent LEC for use of the network elements that carriers purchase.⁴⁸⁶ We further noted that sections 251(c)(3) and 252(d)(1), the statutory provisions establishing the unbundling obligation and the determination of network element charges, do not compel telecommunications carriers using unbundled network elements to pay access charges.⁴⁸⁷ Moreover, these provisions do not restrict the ability of carriers to use network elements to provide originating and terminating access.⁴⁸⁸ Allowing incumbent LECs to recover access charges in addition to the reasonable cost of such facilities would constitute double recovery because the ability to provide access services is already included in the cost of the access facilities themselves. Excluding access charges from unbundled elements ensures that unbundled elements can be used to provide services at competitive levels, promoting the underlying purpose of the 1996 Act.⁴⁸⁹ If incumbent LECs added access charges to the sale of unbundled elements, the added cost to competitive LECs would impair, if not foreclose, their ability to offer competitive access services.⁴⁹⁰ The availability of access services at competitive levels is vital to the general approach we adopt in this Order, which relies on the growth of competition, including from competitors using unbundled network

⁴⁸⁴ *Id.*

⁴⁸⁵ Although our rule applies to all incumbent LECs, we note that small LECs (those with fewer than two percent of the nation's subscriber lines) may petition the appropriate state commission for a suspension or modification of the unbundling requirements of the 1996 Act. 47 U.S.C. § 251(f)(2). In addition, a rural telephone company is exempt from the obligation to provide access to unbundled network elements until it has received a bona fide request for unbundled elements. 47 U.S.C. § 251(f)(1). *See also, Local Competition Order*, 11 FCC Rcd at 1611.

⁴⁸⁶ 11 FCC Rcd at 15864.

⁴⁸⁷ *Id.*

⁴⁸⁸ *Id.*

⁴⁸⁹ *See* 11 FCC Rcd at 15682.

⁴⁹⁰ There would be serious questions about the wisdom of a market-based approach to access reform as advocated by some incumbent LECs, *see, e.g., Ameritech Comments* at 38; *Cincinnati Bell Comments* at 13, if incumbent LECs could impose access charges on the use of unbundled network elements.

elements, to move overall access rate levels toward forward-looking economic cost.⁴⁹¹ In addition, we note that excluding unbundled network elements from access charges benefits small entities seeking to enter the local service market by ensuring that they can acquire unbundled elements at competitive prices.

338. We disagree with suggestions offered by some commenters that access charges should be imposed on unbundled elements because cost-based rates for such elements would not recover universal service support subsidies built into the access charge regime.⁴⁹² Although our plan to implement comprehensive universal service reform is not fully implemented, we believe excluding access charges from the sale of unbundled elements will not dramatically affect the ability of price cap LECs to fulfill their universal service obligations. First, competitors using unbundled network elements to provide interstate services will contribute to universal service requirements pursuant to section 254. Carriers receive no exemption from their obligation to contribute to universal service by using unbundled network elements. Second, rate structure modifications adopted in this Order -- including reallocation of TIC costs, adoption of a mechanism to phase out the TIC, and raising multi-line SLCs -- should reduce the impact on price cap LECs of excluding the recovery of TIC costs in the sale of unbundled network elements. Third, if unbundled network element prices are geographically deaveraged, LECs will receive higher prices when they sell unbundled network elements that embody higher costs. Fourth, because the difference between the level of access charges and the forward-looking economic costs of network elements may include more than universal service support, imposing access charges on the sale of unbundled network elements could recover from market entrants substantially more than amounts used to support universal service. Accordingly, we are not persuaded by suggestions that the universal service obligations of price cap LECs compel the imposition of access charges on the purchase of unbundled network elements by requesting carriers.

339. Although, in the *Local Competition Order*, we allowed application of certain non-cost-based access charges (the CCLC and a portion of the TIC) to unbundled elements, we limited the duration of such application to a transition period ending June 30, 1997 even if access and universal service reform were not completed by the end of the transition period.⁴⁹³ The transition period was limited in order to minimize the burden on competitive local service providers seeking to use unbundled network elements to offer the competitive services that the 1996 Act sought to promote. The interim application of certain access charges was also limited

⁴⁹¹ Were we to allow the assessment of access charges by incumbent LECs for access services provided by carriers over unbundled network elements, we would be compelled to take a more prescriptive approach to the rate level issue.

⁴⁹² PacTel Comments at 55-57. *See also* GVNW Comments at 5.

⁴⁹³ 11 FCC Rcd at 15866.

to non-cost-based charges because such charges, unlike facilities-based charges, were more likely to include subsidies for universal service. All facilities-based charges were completely excluded from unbundled network elements to prevent double recovery by incumbent LECs of the costs of these facilities when they are purchased by competitive carriers.

340. We are also unpersuaded by suggestions that access charges should be imposed on unbundled elements because provision of competitive service by rebundling the same network elements used by the incumbent LEC to provide access is equivalent to resale of a retail service.⁴⁹⁴ First, in the *Local Competition Order*, we recognized major differences between competition through the use of unbundled network elements and competition through resale of an existing retail service offered by an incumbent LEC. We explained, for example, that an entrant relying on unbundled elements rather than resale has the flexibility to offer all telecommunications services made possible by using network elements but also assumes the risk that end users will not generate sufficient demand to justify the investment. The entrant using a resale strategy, however, is limited to offering the retail service itself without the attendant investment risk.⁴⁹⁵ Thus, we reject the notion that the rebundling of network elements is equivalent to resale. Second, although we concluded in the *Local Competition Order* that IXCs must continue to pay access charges to incumbent LECs for access services when the end user is served by a competitive carrier reselling the incumbent LEC's retail services, our conclusion was based on the resale provisions of the 1996 Act which limit resale to retail services offered to subscribers or other customers who are not telecommunications carriers.⁴⁹⁶ The resale provision does not apply to non-retail services, including access services, that may be offered using the same facilities.⁴⁹⁷ Unlike the provision of local exchange services, access services are not services that LECs provide directly to end users on a retail basis. To impose access charges on the sale of unbundled elements would contravene the terms of the resale provision by effectively treating exchange access as a service provided on a retail basis.

⁴⁹⁴ BellSouth Comments at 13; PacTel Reply at 8-10.

⁴⁹⁵ 11 FCC Rcd at 15667-68.

⁴⁹⁶ 47 U.S.C. § 251(c)(4)(A).

⁴⁹⁷ 11 FCC Rcd at 15982-83.

B. Treatment of Interstate Information Services

1. Background

341. In the 1983 *Access Charge Reconsideration Order*, the Commission decided that, although information service providers⁴⁹⁸ (ISPs) may use incumbent LEC facilities to originate and terminate interstate calls, ISPs should not be required to pay interstate access charges.⁴⁹⁹ In recent years, usage of interstate information services, and in particular the Internet and other interactive computer networks, has increased significantly.⁵⁰⁰ Although the United States has the greatest amount of Internet users and Internet traffic, more than 175 countries are now connected to the Internet.⁵⁰¹ As usage continues to grow, information services may have an increasingly significant effect on the public switched network.

342. As a result of the decisions the Commission made in the *Access Charge Reconsideration Order*, ISPs may purchase services from incumbent LECs under the same intrastate tariffs available to end users. ISPs may pay business line rates and the appropriate subscriber line charge, rather than interstate access rates, even for calls that appear to traverse state boundaries.⁵⁰² The business line rates are significantly lower than the equivalent interstate access charges, given the ISPs' high volumes of usage.⁵⁰³ ISPs typically pay incumbent LECs a

⁴⁹⁸ The term "enhanced services," which includes access to the Internet and other interactive computer networks, as well as telemessaging, alarm monitoring, and other services, appears to be quite similar to the term "information services" in the 1996 Act. "Enhanced services" are defined in § 64.702(a) of our rules: "For the purposes of this subpart, the term *enhanced services* shall refer to services, offered over common carrier transmission facilities used in interstate communications, which employ computer processing applications that act on the format, content, code, protocol, or similar aspects of the subscriber's transmitted information; provide the subscriber additional different, or restructured information; or involve subscriber interaction with stored information." The 1996 Act defines "information services" as offering the capability for "generating, acquiring, storing, transforming, processing, retrieving, utilizing, or making available information via telecommunications." 47 U.S.C. § 153(20). For purposes of this order, providers of enhanced services and providers of information services are referred to as ISPs.

⁴⁹⁹ MTS and WATS Market Structure, Memorandum Opinion and Order, Docket No. 78-72, 97 FCC 2d 682, 711-22 (*Access Charge Reconsideration Order*). See also Amendments of Part 69 of the Commission's Rules Relating to Enhanced Service Providers, CC Docket No. 87-215, Order, 3 FCC Rcd 2631 (1988) (*ESP Exemption Order*).

⁵⁰⁰ The number of U. S. households with Internet access more than doubled over the past year, and approximately 38.7 million Americans over the age of 18 have accessed the Internet at least once. Jared Sandberg, "U.S. Households with Internet Access Doubled to 14.7 Million in Past Year," *Wall Street Journal*, October 21, 1996, at B11.

⁵⁰¹ Network Wizards Internet Domain Survey, January 1997, available on the World Wide Web at <<http://www.nw.com/zoneWWW/top.html>>.

⁵⁰² *ESP Exemption Order*, 3 FCC Rcd at 2631 nn.8, 53. To maximize the number of subscribers that can reach them through a local call, most ISPs have deployed points of presence.

⁵⁰³ CIEA Comments at 5-6.

flat monthly rate for their connections regardless of the amount of usage they generate, because business line rates typically include usage charges only for outgoing traffic.

343. In the *NPRM*, we tentatively concluded that ISPs should not be required to pay interstate access charges as currently constituted. We explained that the existing access charge system includes non-cost-based rates and inefficient rate structures. We stated that there is no reason to extend such a system to an additional class of customers, especially considering the potentially detrimental effects on the growth of the still-evolving information services industry. We explained that ISPs should not be subjected to an interstate regulatory system designed for circuit-switched interexchange voice telephony solely because ISPs use incumbent LEC networks to receive calls from their customers.⁵⁰⁴ We solicited comment on the narrow issue of whether to permit incumbent LECs to assess interstate access charges on ISPs.⁵⁰⁵ In the companion *Notice of Inquiry (NOI)*, we sought comment on broader issues concerning the development of information services and Internet access.⁵⁰⁶

2. Discussion

344. We conclude that the existing pricing structure for ISPs should remain in place, and incumbent LECs will not be permitted to assess interstate per-minute access charges on ISPs. We think it possible that had access rates applied to ISPs over the last 14 years, the pace of development of the Internet and other services may not have been so rapid. Maintaining the existing pricing structure for these services avoids disrupting the still-evolving information services industry⁵⁰⁷ and advances the goals of the 1996 Act to "preserve the vibrant and competitive free market that presently exists for the Internet and other interactive computer services, unfettered by Federal or State regulation."⁵⁰⁸

345. We decide here that ISPs should not be subject to interstate access charges. The access charge system contains non-cost-based rates and inefficient rate structures, and this Order goes only part of the way to remove rate inefficiencies. Moreover, given the evolution in ISP technologies and markets since we first established access charges in the early 1980s, it is not clear that ISPs use the public switched network in a manner analogous to IXCs. Commercial

⁵⁰⁴ NPRM at para 288.

⁵⁰⁵ *Id.*

⁵⁰⁶ See *In the Matter of Usage of the Public Switched Network by Information Service and Internet Access Providers*, CC Docket No. 96-263, Notice of Inquiry, FCC 96-488 (rel. December 24, 1996) (*NOI*).

⁵⁰⁷ See, e.g., CompuServe/Prodigy Comments at 11; Information Industry Association Comments at 4; Minnesota Internet Services Trade Association Reply at 1.

⁵⁰⁸ 47 U.S.C. § 230(b)(2).

Internet access, for example, did not even exist when access charges were established. As commenters point out, many of the characteristics of ISP traffic (such as large numbers of incoming calls to Internet service providers) may be shared by other classes of business customers.

346. We also are not convinced that the nonassessment of access charges results in ISPs imposing uncompensated costs on incumbent LECs. ISPs do pay for their connections to incumbent LEC networks by purchasing services under state tariffs. Incumbent LECs also receive incremental revenue from Internet usage through higher demand for second lines by consumers, usage of dedicated data lines by ISPs, and subscriptions to incumbent LEC Internet access services. To the extent that some intrastate rate structures fail to compensate incumbent LECs adequately for providing service to customers with high volumes of incoming calls, incumbent LECs may address their concerns to state regulators.

347. Finally, we do not believe that incumbent LEC allegations about network congestion warrant imposition of interstate access charges on ISPs.⁵⁰⁹ The Network Reliability and Interoperability Council has not identified any service outages above its reporting threshold attributable to Internet usage, and even incumbent LEC commenters acknowledge that they can respond to instances of congestion to maintain service quality standards. Internet access does generate different usage patterns and longer call holding times than average voice usage. However, the extent to which this usage creates congestion depends on the ways in which incumbent LECs provision their networks, and ISPs use those networks. Incumbent LECs and ISPs agree that technologies exist to reduce or eliminate whatever congestion exists; they disagree on what pricing structure would provide incentives for deployment of the most efficient technologies.⁵¹⁰ The public interest would best be served by policies that foster such technological evolution of the network. The access charge system was designed for basic voice telephony provided over a circuit-switched network, and even when stripped of its current inefficiencies it may not be the most appropriate pricing structure for Internet access and other information services.

348. Thus, in our review of the record filed in response to the *NOI*, we will consider solutions to network congestion arguments other than the incumbent LECs' recommendation that we apply access charges to ISPs' use of circuit-switched network technology. We intend rather to focus on new approaches to encourage the efficient offering of services based on new network configurations and technologies, resulting in more innovative and dynamic services than exist today. In the *NOI*, we will address a range of fundamental issues about the Internet and other

⁵⁰⁹ See, e.g., USTA Comments at 81-82.

⁵¹⁰ SWBT Comments at 20; PacTel Reply at 26; Internet Access Coalition Reply at 11-12; America On-Line Reply at 7-9.

information services, including ISP usage of the public switched network.⁵¹¹ The *NOI* will give us an opportunity to consider the implications of information services more broadly, and to craft proposals for a subsequent NPRM that are sensitive to the complex economic, technical, and legal questions raised in this area. We therefore conclude that ISPs should remain classified as end users for purposes of the access charge system.

C. Terminating Access

349. In the NPRM, we requested comment regarding the regulation of terminating access. We noted that, unlike originating access, the choice of an access provider for terminating access is made by the recipient of the call. The call recipient generally does not pay for the call and, therefore, is not likely to be concerned about the rates charged for terminating access. We suggested that neither the originating caller nor its long-distance service provider can exert substantial influence over the called party's choice of terminating access provider.⁵¹² Thus, even if competitive pressures develop at the originating end as new entrants offer alternatives, the terminating end of a long-distance call may remain a bottleneck, controlled by the LEC providing access for a particular customer.⁵¹³ We also recognized, however, that excessive terminating access charges could furnish an incentive for IXC's to enter the access market in order to avoid paying excessive terminating access charges.⁵¹⁴

1. Price Cap Incumbent LECs

a. Background

350. We requested comment on various alternative special methods for regulating the terminating access rates of price cap LECs. For instance, we sought comment on whether to establish a ceiling on the terminating access rates of price cap LECs equal to the forward-looking economic cost of providing the service. We suggested alternative methods for measuring forward-looking economic cost, including reference to prices in reciprocal compensation arrangements for the transport and termination charges of telecommunications under sections 251(b)(5) and 252(d)(2) or a requirement that terminating rates be based on a TSLRIC study or other acceptable forward-looking cost-based model.⁵¹⁵

⁵¹¹ In particular, we requested data about alleged network congestion, rates paid by ISPs today, alternative network access technologies, and additional services desired by ISPs. *NOI* at ¶¶ 313-317.

⁵¹² NPRM at ¶ 271.

⁵¹³ *Id.*

⁵¹⁴ *Id.* at ¶ 272.

⁵¹⁵ NPRM at ¶ 274.

b. Discussion

351. We believe that new entrants, by purchasing unbundled network elements or providing facilities-based competition, will eventually exert downward pressure on originating access rates assessed by incumbent LECs. We agree that excessive terminating access rates could encourage long-distance companies to avoid the payment of such charges by seeking to become the local exchange and exchange access provider for end user customers. These market developments, however, would not fully address the concerns expressed in the NPRM and reflected in comments with respect to the ability of incumbent LECs to charge unreasonable rates for terminating access.

352. We are also not convinced that a significant competitive impact would result from changes in calling patterns between pairs of callers. Commenters have not described any realistic way that users, by changing their calling patterns, could experience savings attributable to differing levels of terminating access charges paid by IXCs.⁵¹⁶ Although one commenter points to high termination charges in foreign countries as affecting the market for overseas calls originating in the United States,⁵¹⁷ such results are less likely to occur for domestic calls, which are much less expensive than international calls and are subject to geographic rate averaging and rate integration requirements.⁵¹⁸ Thus, we are reluctant to base our approach on the expectation that a significant proportion of callers will implement such a strategy.

353. Accordingly, we are establishing regulatory requirements that will address the potential that incumbent LECs could charge unreasonable rates for terminating access. Specifically, we are adopting rules in this Order that, for price cap LECs, will limit recovery of TIC and common line costs from terminating access rates for a limited period, and then eliminate any recovery of common line and TIC costs from terminating access. Under this approach, beginning January 1, 1998, price cap LECs will recover common line and residual TIC revenues through a new flat charge, subject to a ceiling. Remaining common line and residual TIC revenues will then be first recovered through originating access rates, subject to a ceiling. Any remaining common line and residual TIC revenues may then be recovered through terminating rates. As the caps on SLCs applicable to non-primary residential lines and the PICC are raised, none of these residual revenues will be recovered through terminating access charges. When the

⁵¹⁶ We question whether switching carriers would have an immediate impact on the overall cost of long-distance calls between discrete pairs of callers. A local access provider's terminating access charges are spread across an IXC's customer base. As a practical matter, alterations in calling behavior, unless done on a massive scale across the IXC's customer base, are not likely to have an immediate or predictable impact on the bills of two callers seeking to reduce the cost of their long-distance calls to each other.

⁵¹⁷ TCI Comments, Attachment A at 4.

⁵¹⁸ NPRM at n. 357.

increased SLCs and PICCs are fully implemented, recovery of these costs will be more susceptible to competitive forces because IXCs could seek to influence the end user's choice of its provider of local service, and the end user's choice of service provider will determine whether the incumbent LEC is able to recover these costs from the end user.

354. In addition, pending full recovery of all common line and residual TIC costs in flat rate SLCs and PICCs, this approach will put downward pressure on terminating access rates by lowering the overall service revenues derived from terminating access charges. Because competitive pressure is more likely to develop on the originating end of a long-distance call, we can rely to a greater extent on competitive forces to ensure just and reasonable rates under this approach by moving recovery of certain revenues from terminating access to originating access. By stripping terminating access rates of CCL and residual TIC charges and, pending full implementation of the new flat charges, placing more of the burden of TIC recovery on originating access rates, we reduce potential excesses in terminating access charges while exposing the CCL and residual TIC recovery to competitive pressures in the originating access market.

355. The NPRM described proposals linking terminating rates to originating rate levels or shifting costs from terminating to originating access charges.⁵¹⁹ Some commenters support limiting price cap LEC terminating access rates to the level of the LEC originating access rates.⁵²⁰ If originating access charges are lowered because of competition, the ceiling on terminating access rates would be lowered as well, placing downward pressure on terminating rates. This approach, however, would not substantially affect terminating access rates where originating access rates have not responded to competitive inroads. Moreover, linking an incumbent LEC's terminating access rate to its own originating rate could reduce the incumbent LEC's incentive to lower its originating access rates. Thus, we decline to adopt this method of regulating terminating access rates.

356. The NPRM requested comment on the possibility of eliminating all charges for terminating access by shifting the burden of recovering all costs currently recovered in terminating access rates to originating access charges.⁵²¹ We decline to adopt this approach because a complete shift of terminating access costs to originating access conflicts with one of the basic objectives of this proceeding -- to ensure that charges for access services reflect the manner in which the costs of providing those services are incurred. Switching costs, for example, should continue to be recovered in part from terminating access charges because those costs are traffic sensitive and are related to the volumes of both originating and terminating traffic. Moreover, we

⁵¹⁹ NPRM at ¶ 276.

⁵²⁰ BA/NYNEX Comments at 42; Ohio Commission Comments at 12.

⁵²¹ NPRM at ¶ 276.

emphasize that, as discussed in Section III.A, the rate structure we are adopting, which will replace per-minute recovery of the CCL charge and the TIC with flat rate charges, helps to achieve our goal of ensuring that charges for access services reflect the manner in which costs are incurred. Our requirement that incumbent LECs recover a greater portion of common line and TIC costs in originating access rates pending full implementation of flat-rated charges will address concerns about the reasonableness of terminating access charges while providing price cap LECs sufficient latitude to recover the reasonable costs of deploying their facilities to provide terminating access services.

357. The NPRM also discussed the alternative of requiring price cap LECs to establish end user charges for terminating access. This approach would place direct responsibility for the cost of terminating access on the recipient of terminating access services and would expose terminating access to competitive pressures. We noted that wireless companies already charge called parties for receiving calls and requested comment on how we might implement a system of end user charges in the context of access reform and whether its implementation would increase the number of uncompleted calls due to a reluctance by called parties to accept the charges.⁵²² We agree with commenters that such a change could prove disruptive to consumers of wireline services.⁵²³ After review of the record, which produced few, if any, advocates of such an approach, we conclude that we should not mandate at this time this change in current pricing practices for wireline service.

2. Non-Incumbent LECs

a. Background

358. In the NPRM, we requested comment about whether to impose ceilings on the terminating access rates of non-incumbent LECs.⁵²⁴ We stated in the NPRM that our policy since the *Competitive Carrier Proceeding*,⁵²⁵ has consistently been that a carrier is non-dominant unless the Commission makes or has made a finding that it is dominant.⁵²⁶ We noted that, since the *Competitive Carrier Proceeding*, new entrants into the exchange access market have been

⁵²² NPRM at ¶ 275.

⁵²³ Ameritech Comments at 54; LCI Comments at 19; California Commission Comments at 17-18.

⁵²⁴ NPRM at ¶ 280.

⁵²⁵ In the *Competitive Carrier Proceeding*, we established a comprehensive framework for determining whether carriers are dominant or non-dominant, classified then existing classes of carriers as either dominant or non-dominant, and promulgated general definitions providing that a carrier will be non-dominant in the absence of a Commission finding of market power. *Competitive Carrier First Report and Order*, 85 FCC 2d at 51 (promulgating 47 C.F.R. § 61.15(A)(2)).

⁵²⁶ NPRM at ¶ 277.

presumptively classified as non-dominant because they have not been shown to exercise significant market power in their service areas.⁵²⁷ At the same time, we stated that competitive LECs may possess market power over IXCs needing to terminate calls because the LEC controlling the terminating local loop is the only access provider available to the IXC seeking to terminate a long-distance call on that particular loop.⁵²⁸ We solicited comment on several alternatives, including whether we should use incumbent LEC terminating access rates as a benchmark to determine the reasonableness of competitive LEC terminating rates. We invited commenters to offer other approaches including, for example, whether we should establish a presumption of reasonableness if the competitive LEC's terminating access rate is no higher than the incumbent LEC's rate in the same geographic market.⁵²⁹

b. Discussion

359. We recently noted that the test in deciding whether to apply dominant carrier regulation to a class of carriers is whether those carriers have market power.⁵³⁰ As we discussed in the *Dominant/Nondominant Order*, in determining whether a firm possesses market power, the Commission has previously focused on certain well-established market features, including market share, supply and demand substitutability, the cost structure, size or resources of the firm, and control of bottleneck facilities.⁵³¹ Competitive LECs currently have a relatively small market share in the provision of local exchange and exchange access service. Nonetheless, at first blush,

⁵²⁷ *Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor*, CC Docket No. 79-252, Notice of Inquiry and Proposed Rulemaking, 77 FCC 2d 308 (1979) (*Competitive Carrier NPRM*); First Report and Order, 85 FCC 2d 1 (1980) (*First Report and Order*); Further Notice of Proposed Rulemaking, 84 FCC 2d 445 (1981) (*Competitive Carrier Further NPRM*); Second Further Notice of Proposed Rulemaking, FCC 82-187. 47 Fed. Reg. 17,308 (1982); Second Report and Order, 91 FCC 2d 59 (1982) (*Second Report and Order*); Order on Reconsideration, 93 FCC 2d 54 (1983); Third Further Notice of Proposed Rulemaking, 48 Fed. Reg. 28,292 (1983); Third Report and Order, 48 Fed. Reg. 46,791 (1983); Fourth Report and Order, 95 FCC 2d 554 (1983) (*Fourth Report and Order*), vacated, *AT&T Co. v. FCC*, 978 F.2d 727 (D.C. Cir. 1992), cert. denied, *MCI Telecommunications Corp. v. AT&T Co.*, 509 U.S. 913 (1993); Fourth Further Notice of Proposed Rulemaking, 96 FCC 2d 922 (1984); Fifth Report and Order, 98 FCC 2d 1191 (1984) (Fifth Report and Order); Sixth Report and Order, 99 FCC 2d 1020 (1985) (*Sixth Report and Order*), vacated, *MCI Telecommunications Corp. v. FCC*, 765 F.2d 1186 (D.C. Cir. 1985) (collectively referred to as the *Competitive Carrier proceeding*).

⁵²⁸ *Id.* at ¶ 279.

⁵²⁹ *Id.* at ¶ 280.

⁵³⁰ *Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area and Policy and Rules Concerning the Interstate, Interexchange Marketplace*, CC Docket Nos. 96-149 and 96-61, Second Report and Order in CC Docket No. 96-149 and Third Report and Order in CC Docket No. 96-61, FCC 97-142 at ¶ 12 (rel. April 18, 1997) (*Dominant/Non-Dominant Order*).

⁵³¹ *Dominant/Non-Dominant Order* at ¶ 93. See also *Implementation of Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934 and Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area*, Notice of Proposed Rulemaking, FCC No. 96-308, CC Docket No. 94-149 at ¶ 133 (rel. July 18, 1996).

there is a concern that a competitive LEC may have market power over an IXC that needs to terminate a long-distance call to a customer of that particular competitive LEC. Therefore, we sought comment on whether and to what extent we should regulate the terminating access charges of competitive LECs.

360. We conclude, based on the record before us, that non-incumbent LECs should be treated as nondominant in the provision of terminating access. Although an IXC must use the competitive LEC serving an end user to terminate a call, the record does not indicate that competitive LECs have previously charged excessive terminating access rates. Nor have commenters provided evidence demonstrating that competitive LECs are, in fact, charging excessive terminating rates. Indeed, the record suggests that the terminating rates of competitive LECs are equal to or below the tariffed rates of incumbent LECs.⁵³² In addition, the record does not show that competitive LECs distinguish between originating and terminating access in their offers of service. Therefore, it does not appear that competitive LECs have structured their service offerings in ways designed to exercise any market power over terminating access. Accordingly, the concerns expressed in the NPRM about the ability of competitive LECs to exercise market power in the provision of terminating access are not substantiated in the record.

361. Further, as competitive LECs, which have a small share of the interstate access market, attempt to expand their market presence, the rates of incumbent LECs or other potential competitors will constrain the terminating access rates of competitive LECs.⁵³³ Specifically, competitive LECs compete with incumbent LECs whose rates are regulated. The record indicates that long-distance carriers have established relationships with incumbent LECs for the provision of access services, and new market entrants are not likely to risk damaging their developing relationships with IXCs by charging unreasonable terminating access rates.⁵³⁴ This is especially true with respect to competitive access providers seeking to maintain or expand their access transport, special access, or other services apart from switched access.⁵³⁵

362. In addition, we believe that overcharges for terminating access could encourage access customers to take competitive steps to avoid paying unreasonable terminating access charges. If, for example, a competitive LEC consistently overcharged an IXC for terminating access, the IXC would have an incentive to enter a marketing alliance with another competitive LEC in the same market or in other geographic markets where the overcharging competitive LEC seeks to expand. Although high terminating access charges may not create a *disincentive* for the

⁵³² Spectranet Comments at 7; TCI Comments, Attachment A at 6.

⁵³³ ALTS Comments at 29; American Communications Services Reply at 21; ICG Telecom Group Reply at 23.

⁵³⁴ See WinStar Comments at 5-6; TCI Comments, Attachment A at 9; Cox Communications Reply at 4-5.

⁵³⁵ ALTS Comments, Attachment B at 14.

call recipient to retain its local carrier (because the call recipient does not pay the long distance charge), the call recipient may nevertheless respond to *incentives* offered by an IXC with an economic interest in encouraging the end user to switch to another local carrier. Such an approach could have particular impact when the IXC has significant brand recognition among consumers. Moreover, as noted in the NPRM, excessive terminating access charges could encourage IXCs to enter the access market in an effort to win the local customer.⁵³⁶ We believe that the possibility of competitive responses by IXCs will have a constraining effect on non-incumbent LEC pricing.

363. Thus, we will not adopt at this time any regulations governing the provision of terminating access provided by competitive LECs.⁵³⁷ Because competitive LECs have not charged unreasonable terminating access rates, and because they are not likely to do so in the future, competitive LECs do not appear to possess market power. Thus, the imposition of regulatory requirements with respect to competitive LEC terminating access is unnecessary. We similarly find no reason to adopt a presumption of reasonableness where a competitive LEC's terminating access rates are less than its rates for originating access or less than the incumbent LEC's terminating access rates. Instead, if we need to examine the reasonableness of competitive LEC terminating access rates in an individual instance, we can do so taking into account all relevant factors including relationships to other rates. Thus, if an access provider's service offerings violate section 201 or Section 202 of the Act, we can address any issue of unlawful rates through the exercise of our authority to investigate and adjudicate complaints under section 208.⁵³⁸ On the basis of the current record, we conclude that reliance on the complaint process will be sufficient to assure that non-incumbent LEC rates are reasonable. We emphasize that we will not hesitate to use our authority under section 208 to take corrective action where appropriate.

364. We will be sensitive to indications that the terminating access rates of competitive LECs are unreasonable. The charging of terminating access rates above originating rates in the same market, for example, may suggest the need to revisit our regulatory approach. Similarly, terminating rates that exceed those charged by the incumbent LEC serving the same market may suggest that a competitive LEC's terminating access rates are excessive. If there is sufficient indication that competitive LECs are imposing unreasonable terminating access charges, we will revisit the issue of whether to adopt regulations governing competitive LEC rates for terminating access.

⁵³⁶ NPRM at ¶ 272.

⁵³⁷ We are examining in a separate proceeding whether tariffing of rates for access services provided by competitive LECs is necessary to assure that such rates are reasonable. *See* Petitions Requesting Forbearance of Hyperion Telecommunications, Inc. (CCB/CPD No. 96-462) and Time Warner Communications (CCB/CPD No. 96-902).

⁵³⁸ 47 U.S.C. § 208.

3. "Open End" Services

365. In some cases, an IXC is unable to influence the end user's choice of access provider for originating access services because the end user on the terminating end is paying for the call. For example, charges for the "open end" originating access minutes for 800 or 888 services are paid by the recipient of the call. Consequently, the Commission has treated incumbent LEC originating "open end" minutes as terminating minutes for access charge purposes.⁵³⁹ The NPRM solicited comment on whether such regulatory treatment should be retained for "open end" services under which terminating access rates serve as originating access rates, and whether this approach should be extended to competitive LECs.⁵⁴⁰

366. We continue to believe that "open end" originating minutes should be treated as terminating minutes for access charge purposes. Although few comments were filed regarding this issue, commenters addressing this matter advocate retention of the current regulatory approach.⁵⁴¹ By continuing to treat "open end" originating minutes as terminating minutes for access charge purposes, we recognize that access customers have limited ability to influence the calling party's choice of access provider. Accordingly, access charges for these "open end" minutes will be governed by the requirements we adopt in this Order applicable to terminating access provided by incumbent LECs. Thus, residual common line charges and the per-minute TIC will not be recovered through "open end" originating minutes except to the extent such recovery is permitted under the rules described in Section III.A of this Order.

D. Universal Service-Related Part 69 Changes

367. In the NPRM, we recognized that, because of the role that access charges have played in funding and maintaining universal service, it is critical to implement changes in the access charge system together with complementary changes in the universal service system. In this section, we address the manner in which incumbent LECs must adjust their interstate access charges to reflect the universal service support mechanisms adopted in the *Universal Service Order*.

1. Background

368. In November 1996, pursuant to Section 254 of the Act, the Federal-State Universal Service Joint Board issued its recommendations to the Commission for reforming our system of universal service so that universal service is preserved and advanced, but in a manner that permits

⁵³⁹ 47 C.F.R. § 69.105(b)(1)(iii).

⁵⁴⁰ NPRM at ¶ 281.

⁵⁴¹ ACTA Comments at 24; WorldCom Comments at 93.

the local exchange and exchange access markets to move from monopoly to competition.⁵⁴² In our *Universal Service Order*, we are adopting most of the Joint Board's recommendations relating to the support of rural and high cost areas.

369. Section 254 of the Act requires that any federal universal service support provided to eligible carriers be "explicit"⁵⁴³ and recovered on an "equitable and nondiscriminatory basis"⁵⁴⁴ from all telecommunications carriers providing interstate telecommunications service. In our companion *Universal Service Order*, we agree with the Joint Board that these programs must be replaced with universal service support mechanisms that satisfy section 254.⁵⁴⁵

370. Currently, there are three mechanisms designed expressly to provide support for high cost and small telephone companies: the Universal Service Fund (high cost assistance fund),⁵⁴⁶ the Dial Equipment Minutes (DEM) weighting program,⁵⁴⁷ and Long Term Support (LTS).⁵⁴⁸ An incumbent LEC is eligible for high cost assistance from the current Universal Service Fund if its embedded loop costs exceed 115 percent of the national average loop cost. This program is funded entirely by IXCs.⁵⁴⁹ DEM weighting assistance is an implicit support mechanism that permits LECs with fewer than 50,000 access lines to apportion a greater proportion of these local switching costs to the interstate jurisdiction than larger LECs may allocate. Finally, the existing LTS program supports carriers with higher-than average subscriber line costs by providing carriers that are members of the NECA pool with enough support to enable them to charge IXCs only a nationwide average CCL interstate access rate.⁵⁵⁰ LTS payments reduce the access charges of smaller, rural incumbent LECs participating in the loop-

⁵⁴² *Joint Board Recommended Decision*, 12 FCC Rcd 87.

⁵⁴³ 47 U.S.C. § 254(e).

⁵⁴⁴ 47 U.S.C. § 254(d).

⁵⁴⁵ See Section III of the *Universal Service Order*.

⁵⁴⁶ 47 C.F.R. § 36.601 *et seq.*

⁵⁴⁷ 47 C.F.R. § 36.125(b).

⁵⁴⁸ 47 C.F.R. §§ 69.105, 69.502, 69.603(e), 69.612.

⁵⁴⁹ Each IXC with at least .05 percent of presubscribed lines nationwide contributes to the fund an amount based on the number of its presubscribed lines. 47 C.F.R. § 69.116.

⁵⁵⁰ Prior to 1989 all LECs were required to participate in a pool of carrier common line costs and revenues. Beginning in April 1989, LECs were permitted to withdraw from the pool, but LECs with below average CCL charges that choose to exit the pool are required to contribute enough so that LECs remaining in the pool would be able to charge the same industry average CCL rates they would have charged if the pool were still mandatory for all LECs. See MTS and WATS Market Structure; Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board, CC Docket Nos. 78-72, 80-286, Report and Order, 2 FCC Rcd 2953 (1987).

cost pool by raising the access charges of non-participating incumbent LECs.

371. In the NPRM, we sought comment on whether incumbent LECs' access charges must be adjusted to reflect elimination of LTS contribution requirements and receipt of explicit universal service funds in order to prevent incumbent LECs from being compensated twice for providing universal service.⁵⁵¹ We proposed a downward exogenous cost adjustment for price cap incumbent LECs to reflect elimination of LTS contribution requirements and any revenues received from any new universal service support mechanisms, and sought comment on how interstate costs must also be reduced to account for explicit universal service support.⁵⁵²

2. Discussion

372. In our companion *Universal Service Order*, we conclude that a carrier will continue to receive universal service support based upon the existing LTS, high cost, DEM weighting mechanisms, until the carrier begins to receive support based upon forward-looking economic cost.⁵⁵³ In the following sections, we will discuss the manner in which incumbent LECs must reduce their interstate access charges to reflect the elimination of the obligation to contribute to LTS, increase their interstate access charges to permit recovery of the new universal service obligation, and, to the extent necessary, adjust their interstate access charges to account for any additional universal service funds received under the modified universal service mechanisms.

a. Removal of LTS Obligation from Interstate Access Rates

373. In our companion *Universal Service Order*,⁵⁵⁴ we agree with the Joint Board that LTS payments constitute a universal service support mechanism that is inconsistent with the Act's requirement that support be collected from all providers of interstate telecommunications services on an equitable and non-discriminatory basis⁵⁵⁵ and be available to all eligible telecommunications carriers.⁵⁵⁶ In that order, we conclude that LTS should be removed from the interstate access charge system. We provide, instead, for recovery of comparable payments from the new federal

⁵⁵¹ NPRM at ¶ 244.

⁵⁵² NPRM at ¶¶ 245-46.

⁵⁵³ See Section VII.D of the *Universal Service Order*.

⁵⁵⁴ See Section XII.B of the *Universal Service Order*.

⁵⁵⁵ 47 U.S.C. § 254(d).

⁵⁵⁶ See 47 U.S.C. § 254(e).

universal service support mechanisms.⁵⁵⁷

374. Currently, only incumbent LECs that do not participate in the NECA CCL tariff (non-pooling incumbent LECs) make LTS payments and only incumbent LECs participating in the NECA CCL tariff receive LTS support.⁵⁵⁸ Non-pooling incumbent LECs' contributions to the common line pool are set annually based on the total projected amount of LTS, converted to a monthly payment amount. Non-pooling incumbent LECs recover the revenue necessary for their LTS contributions through their CCL charges. We agree with commenters that argue that, to the extent we do not reduce interstate access revenues by the amount of LTS contribution currently recovered in the rates, incumbent LECs will double recover. We therefore conclude that incumbent LEC interstate access charges must be reduced to reflect elimination of the obligation to contribute to LTS.

375. Because payments from the existing LTS mechanism will cease on January 1, 1998, incumbent LECs should no longer contribute to the existing LTS fund after that date. For price cap LECs, which were requested to stop participating in the NECA Common Line tariff before coming under price cap regulation, LTS contributions were included in the common line revenue requirement when the PCI for the common line basket was established.⁵⁵⁹ We conclude that price cap LECs must make a one-time downward exogenous adjustment to the PCI for the common line basket to account fully for the elimination of their LTS obligations. This exogenous adjustment shall be made in a manner consistent with section 61.45 and other relevant provisions of the Commission's rules.⁵⁶⁰

376. Non-pooling, rate-of-return LECs recover their LTS contributions in the common line revenue requirement.⁵⁶¹ Because current LTS contributors will no longer be making such contributions after January 1, 1998, their CCL charges should be adjusted to account for this change. Rate-of-return LECs that formerly made LTS contributions should recompute their common line revenue requirements based on the elimination of their LTS obligations, and adjust their CCL charges accordingly.⁵⁶²

377. We note that the replacement of LTS with comparable support from the new

⁵⁵⁷ See Sections VII and XII.B of the *Universal Service Order*.

⁵⁵⁸ See 47 C.F.R. § 69.105(b)(3)-(4).

⁵⁵⁹ See 47 C.F.R. §§ 69.501(a).

⁵⁶⁰ 47 C.F.R. § 61.45.

⁵⁶¹ See 47 C.F.R. § 69.501(a).

⁵⁶² See 47 C.F.R. § 69.105(b)(4)(ii).

universal service support mechanisms requires us to amend the NECA Common Line tariff rules, which establish the CCL for pooling members at the average of price cap LECs' CCL charges.⁵⁶³ Under the current LTS support system, NECA annually projects the common line revenue requirement, including an 11.25 percent return on investment, for incumbent LECs that participate in the common line pool.⁵⁶⁴ NECA then computes the total amount of LTS support needed by subtracting the amount pooling carriers will receive in CCL revenues and SLCs from the pool's projected revenue requirement, after removing pay telephone costs and revenues. Our rules currently provide that the NECA CCL tariff be set to recover the average of price cap LECs' CCL charges.⁵⁶⁵ If we were to retain this rule, our decision eliminating LTS obligations for price cap LECs and requiring them to reduce their CCL charges accordingly would automatically reduce the CCL revenues of NECA pool members. Further, reductions would occur as price cap LECs implemented our decisions in Section III of this Order, which restructures the common line rate structure for price cap LECs to recover common line costs through flat-rated charges instead of the per-minute CCL charge. Because we have deferred consideration of access reform for non-price cap LECs⁵⁶⁶ and did not seek comment on this issue in the NPRM, we must address this issue in a future proceeding that undertakes access reform for small, non-price cap LECs.

b. Recovery of New Universal Service Obligations

378. In the *Universal Service Order*, we conclude that assessment of contributions for the interstate portion of the high cost and low-income support mechanisms shall be based solely on end-user interstate revenues,⁵⁶⁷ and that assessment of universal support for eligible schools, libraries, and rural health care providers shall be based on interstate and intrastate total end-user revenues.⁵⁶⁸ As to the manner in which carriers may recover their contributions to the universal service fund, in our *Universal Service Order* we conclude that carriers may recover universal service contributions via interstate mechanisms.⁵⁶⁹ In this Section, we address the manner in which incumbent price cap LECs may recover their universal service contributions. We address non-price cap LECs' recovery of universal service contributions in Section XIII.F of the *Universal*

⁵⁶³ See 47 C.F.R. § 69.105(b)(2).

⁵⁶⁴ The actual rate of return that pooling companies earn on a monthly basis is determined by the total rate of return that the pool earns, *i.e.*, the difference between the total costs that the pooling companies submit and the total amount of revenue in the pool, as a percentage of all pooling companies' total common line investment.

⁵⁶⁵ See 47 C.F.R. § 69.105(b)(2).

⁵⁶⁶ See Section V.B, *supra*.

⁵⁶⁷ See Sections VII, VIII, and XIII.F of the *Universal Service Order*.

⁵⁶⁸ See Sections X, XI, and XIII.F of the *Universal Service Order*.

⁵⁶⁹ See Section XII of the *Universal Service Order*.

Service Order.

379. Price cap LECs may treat their contributions to the new universal service mechanisms, including high cost and low-income support and support for eligible schools, libraries, and health care, as exogenous changes to their price cap indices (PCIs).⁵⁷⁰ Because the only interstate revenues that will serve as the basis for assessing universal service contributions in 1998 will be end-user revenues, we find that price cap LECs recovering their universal service obligation through interstate access charges must recover those contributions in the baskets for services that generate end-user interstate revenues. Because price cap LECs do not recover revenues from end users of services in all baskets, the exogenous adjustment should not be across-the-board. The baskets containing end-user interstate services are the common line, interexchange, and trunking baskets.⁵⁷¹ Price cap LECs electing to recover their universal service obligation through interstate access charges must therefore apply the full amount of the exogenous adjustment among these three baskets on the basis of relative size of end-user revenues. We note, however, that the tandem-switched transport, interconnection charge, and tandem switch signalling service categories⁵⁷² in the trunking basket do not recover end-user interstate revenues. In order to prevent recovery from customers of these services, the service band indices (SBI) for these service categories should not be increased to reflect the exogenous adjustment to the PCI for the trunking basket. To reflect the exogenous adjustment to the trunking basket PCI, price cap LECs should, instead, increase the SBIs for the remaining service categories in the trunking basket⁵⁷³ based on the relative end-user interstate revenues generated in each service category.

380. In 1999, the percentage of price cap LECs' revenues that will be assessed for universal service support may increase as a result of the anticipated increases in high cost, low-income support and support for schools, libraries, and health care in 1999. Price cap LECs shall therefore perform an upward exogenous adjustment to the PCIs for the common line, interexchange, and trunking baskets in the same manner as the exogenous adjustment performed in 1998, to reflect any change in the assessment rate in 1999.

⁵⁷⁰ See Section XIII.F of the *Universal Service Order*.

⁵⁷¹ The end-user charges assessed on services in the common line basket are recovered through the SLC; in the interexchange basket, end-user charges are recovered through per-minute toll charges; and in the trunking basket, end user charges are recovered through special access service provided directly to end users.

⁵⁷² 47 C.F.R. §§ 61.42(e)(2)(v), (vi), and (vii).

⁵⁷³ The four remaining service categories in the trunking basket are as follows: (1) voice grade entrance facilities, voice grade direct-trunked transport, voice grade dedicated signalling transport, voice grade special access, WATS special access, metallic special access, and telegraph special access services; (2) audio and video service; (3) high capacity flat-rated transport, high capacity special access, and DDS services; and (4) wideband data and wideband analog services. See 47 C.F.R. §§ 61.42(e)(2)(i), (ii), (iii), (iv).

c. Adjustments to Interstate Access Charges to Reflect Additional Support from the Modified Universal Service Mechanisms

381. In our *Universal Service Order*, we conclude that the federal universal service mechanism should support 25 percent of the difference between the forward-looking economic cost of serving the customer and the appropriate revenue benchmark.⁵⁷⁴ We further conclude in that order that 25 percent approximates the portion of the cost of providing the supported network facilities that would be assigned to the interstate jurisdiction, and that, by funding these interstate costs, we will ensure that federal implicit universal service support is made explicit. Consistent with our decision in the *Universal Service Order* to fund only interstate costs through the federal universal service fund, we direct incumbent LECs to use any universal service support received from the new universal service mechanisms to reduce or satisfy the interstate revenue requirement otherwise collected through interstate access charges.

382. *Non-Rural Carriers.* In our *Universal Service Order*, we conclude that, until a forward-looking economic cost methodology takes effect on January 1, 1999, non-rural carriers will continue to receive high cost assistance and LTS amounts based on the existing universal service mechanisms.⁵⁷⁵ As there will be no change until January 1, 1999 to the support non-rural incumbent LECs currently receive as high cost and LTS support, we conclude that it is not necessary at this time to determine the manner in which non-rural carriers should adjust their interstate access charges to reflect a difference in universal service support. We will address this issue prior to the January 1, 1999, effective date of the forward-looking cost mechanisms for non-rural carriers.

383. *Rural Carriers.* In our *Universal Service Order*, we conclude that rural carriers, as defined in section 153(37) of the Act,⁵⁷⁶ shall continue to receive support based on embedded costs for at least three years.⁵⁷⁷ Beginning on January 1, 1998, rural carriers shall receive high cost loop support, DEM weighting assistance, and LTS benefits on the basis of the modified support mechanisms.

384. In our *Universal Service Order*, we adopt modified per-line support mechanisms for providing support comparable to the LTS support received under the existing mechanisms. Beginning on January 1, 1998, we will allow a rural carrier's annual LTS support to increase from its support for the preceding calendar year based on the percentage of increase of the nationwide

⁵⁷⁴ See Section VII.C.6 of the *Universal Service Order*.

⁵⁷⁵ See Section VII.D.1 of the *Universal Service Order*.

⁵⁷⁶ See 47 U.S.C. § 153(37).

⁵⁷⁷ See Section VII.D.2 of the *Universal Service Order*.

average loop cost.⁵⁷⁸ Rural, non-price cap LECs should continue to apply any revenues received from the modified universal service support mechanisms that replace current LTS amounts to the accounts to which they are currently applying LTS support.

385. We also decide in the *Universal Service Order* that, from January 1, 1998 through December 31, 1999, rural carriers shall calculate their high cost support using the current high cost formulas. We conclude that no adjustment to rural incumbent LECs' interstate access charges is necessary at this time because incumbent LECs will continue to use the existing high cost formulas to determine high cost support. As we determine in that order, however, beginning January 1, 2000, rural carriers shall receive high cost loop support for their average loop costs that exceed 115 percent of an inflation-adjusted nationwide average loop cost. The inflation adjusted nationwide average cost per loop shall be calculated by multiplying the 1997 nationwide average cost per loop by the percentage in change in Gross Domestic Product Chained Price Index (GDP-CPI) from 1997-1998.⁵⁷⁹ We conclude that rural, non-price cap LECs should continue to apply any revenues received from the modified universal service support mechanism that replace amounts received under the current high cost support system to the accounts to which they are currently applying high cost support.

386. Finally, in our *Universal Service Order*, we adopt the Joint Board's recommendation that a subsidy corresponding in amount to that generated formerly by DEM weighting be recovered from the new universal service support mechanisms.⁵⁸⁰ Beginning on January 1, 1998 and continuing until permanent mechanisms for them become effective, rural carriers will receive DEM weighting assistance calculated as follows: assistance will equal the difference between the 1996 weighted DEM factor and the unweighted DEM factor multiplied by the annual unseparated local switching revenue requirement. As with comparable LTS and high cost support, rural, non-price cap LECs should continue to apply any support received from the modified universal service support mechanisms that replaces existing DEM weighting amounts to the accounts to which they are currently applying DEM weighting assistance.

387. Currently, the high cost and DEM weighting support mechanisms shift a portion of the intrastate revenue requirement to the interstate jurisdiction in order to permit LECs to recover a greater percentage of their costs from the interstate jurisdiction. Some non-price cap LECs are concerned that, to the extent that support from the modified universal service mechanisms is not

⁵⁷⁸ See Section VII.D.2 of the *Universal Service Order*.

⁵⁷⁹ See Section VII.D.2 of the *Universal Service Order*. The inflation adjusted nationwide average loop cost for the year 2000 shall be calculated in the following manner: 1998 GDP-CPI X 1997 nationwide average loop cost = 2000 inflation adjusted nationwide average loop cost.

⁵⁸⁰ See Section VII of the *Universal Service Order*.

applied to the intrastate jurisdiction, an intrastate revenue shortfall will occur.⁵⁸¹ In the *Universal Service Order*, we conclude that, until universal service support is based on forward-looking economic cost, carriers should continue to receive amounts from the new universal service mechanisms comparable to existing high cost and DEM weighting support. In that order, we do not alter the existing revenue-shifting mechanisms in place for the current high cost support and DEM weighting at this time.⁵⁸² Thus, no intrastate revenue shortfall will occur, because no revenue requirement is being shifted back to the intrastate jurisdiction.

E. Part 69 Allocation Rules

1. Background

388. In the NPRM, we solicited comment on whether it would be appropriate for incumbent price cap LECs to be relieved of complying with Subparts D and E of Part 69 of our rules, which address the allocation of investments and expenses to the access rate elements.⁵⁸³

2. Discussion

389. We conclude that at this time we should maintain our Part 69 cost allocation rules. In this Report and Order, we have instituted a phasing out of the CCL charge. Until the per-minute CCL charge is phased out completely and multi-line PICCs do not recover any common line revenues,⁵⁸⁴ price cap LECs will need to use these rules to calculate the SLC. Therefore, we decline to eliminate the cost allocation rules at this time. We note that we may revisit this issue when these rules are no longer needed to calculate the SLC.

F. Other Proposed Part 69 Changes

1. Background

390. In the NPRM, we sought comment on revisions necessary to update Part 69 and conform it to the 1996 Act. In the NPRM, we made several proposals that we thought necessary to bring Part 69 current, including: eliminating the rules that provide for a "contribution charge" that may be assessed on special access and expanded interconnection; removing the rule and sections referencing the rule that establishes the equal access rate element; and removing the rule

⁵⁸¹ See, e.g., Roseville Tel. Comments at 16.

⁵⁸² See Section VII.D of the *Universal Service Order*.

⁵⁸³ NPRM at ¶ 294.

⁵⁸⁴ See Section III.A.

and sections referencing the rule that establishes a rate element for costs associated with lines terminating at "limited pay telephones"; and changing the definition of "Telephone Company" to mean incumbent LEC. We also sought comment on whether rate elements and subelements established pursuant to waiver should be incorporated into Part 69.⁵⁸⁵

2. Discussion

391. The passage of the 1996 Act and the subsequent enactment of implementing regulations requires that we update and revise various sections of Part 69. Sections 69.4(f) and 69.122 of our rules provide for a "contribution charge" that may be assessed on special access and expanded interconnection. These sections are inconsistent with section 254 as amended by the 1996 Act, which requires, *inter alia*, that such carrier contributions be equitable and nondiscriminatory. Furthermore, our rules governing the contribution charge merely allow a LEC to try to justify this charge in the expanded interconnection context. No party has even attempted to justify such a charge in more than four years. Given this and the relevant amendments in the 1996 Act, we find that there is no need for this rate element. We conclude that sections 69.4(f) and 69.122 of our rules, which provide for a "contribution charge" that may be assessed on special access and expanded interconnection, should be deleted.

392. Under Part 69, we required carriers to eliminate any separate equal access charge by January 1, 1994.⁵⁸⁶ We conclude, therefore, that section 69.4(d), which established the equal access rate element for a limited duration, should be deleted because of the expiration of the designated time period. Similarly, we conclude that section 69.107, which governs the computation of the equal access rate element charges, and sections 69.308 and 69.410, which concern allocation of costs to that rate element, should be deleted because the designated time period for separate equal access rate elements has expired. We conclude that references to these deleted sections should also be removed from Part 69.⁵⁸⁷ To ensure consistency, a new section, designated as section 69.3(3)(12), should be added and should read as follows: "Such a tariff shall not contain any separate carrier's carrier tariff charges for an Equal Access element." Similarly, we conclude that section 69.205, which concerns transitional premium charges for IXC's and others should be deleted because the designated transition period for these charges has expired.

393. Section 69.103 requires incumbent LECs to establish a separate rate element for

⁵⁸⁵ NPRM at ¶¶ 295-299.

⁵⁸⁶ 47 C.F.R. § 69.4(d).

⁵⁸⁷ Section 69.309 refers to section 69.308 and section 69.411 refers to section 69.410.

costs associated with lines terminating at "limited pay telephones."⁵⁸⁸ Sections 69.303(a), 69.304(c), 69.307(c), and 69.406(a)(9) concern the allocation of costs to this rate element. Section 276 of the Act and the implementing regulations require a new per call compensation plan, which requires, *inter alia*, that incumbent LECs remove all payphone costs from access charges.⁵⁸⁹ This new compensation plan, as well as the payphone dialing parity requirements,⁵⁹⁰ have eliminated the need for sections 69.103, 69.303(a), 69.304(c), 69.307(c), and 69.406(a)(9). We conclude that these sections should be deleted.

394. We conclude that codifying previously-granted Part 69 waivers is not necessary at this time. Under the *Price Cap Performance Review Third Report and Order*, a party seeking to introduce a new service may do so by filing a petition showing that the new service is in the public interest.⁵⁹¹ Once that petition for a new service has been granted, carriers seeking to introduce the same service with the same rate structure may do so under expedited procedures.⁵⁹² This streamlined alternative for introducing new services should resolve past difficulties encountered with the Part 69 waiver process. The proposed codification of previously-granted waivers is thus unnecessary. We therefore decline to codify previously-granted Part 69 waivers into our rules.

395. NECA and TCA have requested that the Commission extend to all rate-of-return companies, the right to offer new services based on an expedited process, which requires, *inter alia*, a showing that the new service is in the public interest. In the Third Report and Order, we granted to incumbent price cap LECs the right to introduce new services under a streamlined procedure.⁵⁹³ We will address the request of NECA and TCA when we take up access reform for rate-of-return companies in the near future.

396. In the NPRM, we solicited comment on whether we should adopt regulatory requirements to govern rates for terminating access offered by competitive LECs. In Section VI.C., *supra*, we conclude that we will not adopt such regulatory requirement at this time. For the same reasons, we find it unnecessary to apply any of our Part 69 regulations to competitive

⁵⁸⁸ We note that few, if any, payphone service providers offer this type of service today.

⁵⁸⁹ Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, Report and Order, CC Docket No. 96-128, FCC 96-388 (rel. Sep. 20, 1996) (*Payphone Order*), *recon.*, FCC 96-439 (rel. Nov. 8, 1996) (*Payphone Reconsideration Order*), *appeal docketed sub nom., Illinois Public Telecommunications Ass'n v. FCC and United States*, Case No. 96-1394 (D.C. Cir., filed Oct. 17, 1996).

⁵⁹⁰ *Payphone Order* at ¶¶ 291-293.

⁵⁹¹ NPRM at ¶ 309.

⁵⁹² NPRM at ¶ 310.

⁵⁹³ NPRM at ¶¶ 309-310.

LECs. We therefore conclude that Section 69.2(hh), which currently defines "Telephone Company" by reference to Section 3(r) of the 1934 Act, should be changed to read as follows: "Telephone Company' or 'local exchange carrier' as used in this Part means an incumbent local exchange carrier as defined in section 251(h)(1) of the 1934 Act as amended by the 1996 Act." There is no indication in the record that competitive LECs have exercised any degree of market power in provision of terminating access or other access services. By definition, non-dominant carriers do not exercise market power. Further, non-dominant carriers possess a negligible share of the current access market and they will be competing with incumbent LECs whose rates are subject to regulation. As a practical matter, the rates of the incumbent LECs will serve as a constraint to some degree on the pricing and practices of non-dominant LECs. We therefore find on this record that it is sufficient to rely on the Section 208 complaint process to assure compliance with the Act by competitive LECs, and that we should not apply Part 69 to them. To the extent that our definitions or our application of Part 69 needs in the future to be expanded to encompass LECs other than incumbent LECs, we can revisit this issue.

VII. FURTHER NOTICE OF PROPOSED RULEMAKING

A. PICCs for Special Access Lines

397. In this Further Notice of Proposed Rulemaking, we seek comment on our proposal to allow incumbent local exchange carriers to impose a PICC on special access lines.

1. Background

398. As discussed in Section III.A., in most cases, the \$3.50 SLC ceiling for primary residential and single-line business customers does not allow recovery through the SLC of the average per-line common line revenues permitted under our price cap rules. Similarly, in certain service areas, the \$6.00 SLC for multi-line business lines is insufficient to recover the average per-line revenues permitted by price cap regulation. To alleviate this shortfall, we are instituting a number of changes, including raising the ceiling on the SLC for multi-line business and second and additional residential lines.⁵⁹⁴ Although this increase in the SLC will recover some of the shortfall, other measures are needed to allow recovery of the common line revenues permitted under our rules.

399. Therefore, we have permitted LECs to recover common line revenues not recovered from the SLC by assessing flat, per-line charges on the end-user's presubscribed interexchange carrier. Specifically, we are permitting LECs to assess a PICC on all lines, subject to ceilings which will be increased each year. To the extent that the revenues from SLCs and PICCs on primary residential lines and single-line business lines are insufficient to recover the full common

⁵⁹⁴ See Section III.A. for additional revisions to the recovery of common line revenues.

line revenues permitted by our price cap rules for these lines, or the multi-line SLCs are at their ceilings, incumbent LECs shall recover the difference by assessing an additional PICC on non-primary residential and multi-line business lines. To the extent that these PICCs do not recover an incumbent LEC's remaining permitted CCL revenues, incumbent LECs generally shall recover any such residual common line revenues through per-minute CCL charges assessed on originating access minutes.

400. As a result of our new rules, certain multi-line businesses will be paying higher SLCs than they do now. Similarly, as the PICCs are phased in, IXCs initially will be required to pay higher PICCs for a multi-line business end user compared to the PICC paid for a primary residential end user or a single-line business end user.

401. In contrast, users of special access do not pay a SLC. Furthermore, under special access, IXCs do not incur the same local access charges that are incurred by end users using switched access. In light of our most recent changes to charges incurred by multi-line businesses, including the higher SLC and the new multi-line business PICC, it may be cost effective for some multi-line businesses that are currently using switched access to purchase instead special access lines.

402. We are concerned that these facts could lead to the migration of certain businesses from the public switched network to special access, which would result in a decrease in projected revenue from multi-line SLCs. As a result PICCs for all remaining switched access lines will necessarily increase to make up for the loss of revenue.

2. Proposal

403. We tentatively conclude that we should permit price cap LECs to assess a PICC on special access lines to recover revenues for the common line basket. The special access PICC would be no higher than the PICC that an incumbent LEC could charge for a multi-line business line. Under our proposal, the special access PICC would not recover TIC or marketing expense.

404. We acknowledge that our proposal is a departure from established Commission practice that special access will not subsidize other services. Although our proposal is a subsidy, it is temporary in nature and will be phased out as the single-line PICC is phased in. We tentatively conclude that our proposal is necessary for our transition from the per-minute CCL charge to the flat PICC to work.

405. We invite parties to comment on this proposal. We also seek comment on how special access connections should be counted for purposes of assessing a "per line" PICC. Parties should also address the extent to which our proposal affects large and small LECs differently and

how small business entities, including small incumbent LECs and new entrants, will be affected.⁵⁹⁵

406. Consistent with our approach to reform the interstate access charge regime, however, we tentatively conclude that the scope of this proceeding should be limited to incumbent price cap LECs. As discussed in Section V., *supra*, we have limited the scope of access reform, with some limited exceptions, to price cap incumbent LECs.⁵⁹⁶ Similarly, we limit the scope of this NPRM. To the extent necessary, we will instead address the effect of these issues on rate-of-return carriers in our separate access reform proceeding for rate-of-return carriers in 1997. In that proceeding, we will have the opportunity to conduct a comprehensive review of the circumstances unique to these carriers. We seek comment on this tentative conclusion regarding the scope of this proceeding. We also invite parties to identify any changes that should be made to other access elements as a result of this proposed change.

B. General Support Facilities Costs

407. As discussed in Section IV. D above, the current allocation of GSF costs enables incumbent LECs to recover through regulated interstate access charges costs associated with the LECs' nonregulated billing and collection functions. In this section, we seek comment on proposed changes in the allocation of price cap LECs' interstate costs between regulated interstate services and nonregulated billing and collection activities.

1. Background

408. The costs that incumbent LECs recover through interstate access charges are determined by a multi-step process. Incumbent LECs first record their investment costs and booked expenses in the accounts prescribed by the Commission's Part 32 Uniform System of Accounts (USOA).⁵⁹⁷ They next divide the recorded investment and expenses between regulated and nonregulated services pursuant to Part 64 of the Commission's rules. Incumbent LECs then divide regulated expenses and investment costs between the state and interstate jurisdictions pursuant to the separations procedures prescribed in Part 36 of the Commission's rules.⁵⁹⁸ Finally, in accordance with our Part 69 access charge rules, the LEC apportions its regulated interstate

⁵⁹⁵ See Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

⁵⁹⁶ These incumbent LECs are the seven Regional Bell Operating Companies (Ameritech, Bell Atlantic, BellSouth, NYNEX, Pacific Telesis, SWBT, U S West), Citizens, Frontier, GTE, Aliant (formerly Lincoln), SNET, and United/Central.

⁵⁹⁷ See 47 C.F.R. Part 32.

⁵⁹⁸ See 47 C.F.R. Part 36.

costs among the interstate access and interexchange service categories.⁵⁹⁹

409. Because the Part 69 access charge rules are applied at the end of this multi-step process, they are written to accommodate the accounts defined by the USOA and the cost categories prescribed by the Separations Manual. In 1987, the Commission revised its access charge rules⁶⁰⁰ in response to the Commission's comprehensive revision of both the USOA⁶⁰¹ and the Separations Manual.⁶⁰² In its *Part 69 Conformance Order*, the Commission amended Part 69 to reapportion regulated interstate costs, including General Support Facilities (GSF) investment expenses, among the existing access elements.

410. As discussed in Section IV.D above, the GSF investment category in Part 36 includes assets that support other operations, such as land, buildings, vehicles, as well as general purpose computer investment accounted for in USOA Account 2124.⁶⁰³ Some incumbent LECs use general purpose computer equipment, which is included in the GSF investment category, to provide nonregulated billing and collection services to IXCs.⁶⁰⁴ The costs of providing interstate billing and collection service are not, however, treated as nonregulated in the Part 64 cost allocation process. Instead, nonregulated interstate billing and collection costs are identified through the Part 36 and Part 69 cost allocation process. The separations process allocates these costs to the various separations categories based on the separations of the three largest categories of expenses, *i.e.*, plant specific expenses, plant non-specific expenses, and customer operations

⁵⁹⁹ See 47 C.F.R. Part 69.

⁶⁰⁰ Amendment of Part 69 of the Commission's Rules and Regulations, Access Charges, To Conform It With Part 36, Jurisdictional Separations Procedures, CC Docket No. 87-113, Report and Order, 2 FCC Rcd 6447 (1987) (*Part 69 Conformance Order*).

⁶⁰¹ Revision of the Uniform System of Accounts and Financial Reporting Requirements for Class A and Class B Telephone Companies (Parts 31, 33, 42, and 43 of the FCC's Rules), CC Docket No. 78-196, Report and Order, FCC 86-221 (rel. May 15, 1986) (creating Part 32 of the Commission's rules).

⁶⁰² MTS and WATS Market Structure, Amendments of Part 67 (New Part 36) of the Commission's Rules and Establishment of a Federal-State Joint Board, CC Docket Nos. 78-72, 80-286, and 86-297, Report and Order, 2 FCC Rcd 2639 (1987). See Part 36 of the Commission's rules, 47 C.F.R. Part 36.

⁶⁰³ See 47 C.F.R. § 36.111.

⁶⁰⁴ In 1986, the Commission found that the market for billing and collection service was sufficiently competitive that it was not necessary to require LECs to provide that service as a tariffed common carrier service. The Commission did not, however, pre-empt state regulation of billing and collection services. See *Detariffing of Billing and Collection Services*, CC Docket No. 85-88, 102 FCC 2d 1150 (1986) (*Billing and Collection Detariffing Order*); *recon. denied*, 1 FCC Rcd 445 (1986). The Commission later decided to treat billing and collection costs as regulated for accounting purposes because it found that such treatment was less likely to misallocate these costs between the interstate and intrastate jurisdictions. *Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities*, Report and Order, CC Docket No. 86-111, 2 FCC Rcd 1298, 1309 (1987) (*Joint Cost Order*).

expenses.⁶⁰⁵

411. In its comments in response to the NPRM, AT&T refers to the allocation of embedded GSF expenses, including general purpose computer expenses, among access categories as a misallocation resulting in an implicit cross-subsidy of incumbent LECs' nonregulated billing and collection services. This allocation, AT&T contends, results in the inappropriate support through regulated access charges of LECs' billing and collection service, which is a nonregulated, interstate service. AT&T estimates that \$124 million of expenses recovered in interstate access support the nonregulated billing and collection category.⁶⁰⁶ Of the \$124 million, AT&T states that \$60.1 million is included in interstate switched access, and \$20.5 million is in interstate special access, with the remainder recovered by the SLC.⁶⁰⁷

2. Proposal

412. The failure of Part 69 to assign general purpose computer costs to the billing and collection category can be traced to our decision in the *Part 69 Conformance Order* to use an investment-based allocator to apportion general support facilities (GSF) investment.⁶⁰⁸ As discussed in Section IV.D above, Section 69.307 of the Commission's rules apportions GSF investment among the billing and collection category, the interexchange category, and the access elements based on the amount of Central Office Equipment (COE), Cable and Wire Facilities (CWF), and Information Origination/Termination Equipment (IO/T) investment allocated to each Part 69 category.⁶⁰⁹ This rule appears on its face to provide for an allocation of GSF investment to billing and collection. Because no COE, CWF, or IO/T investment is allocated to the billing and collection category, however, no GSF investment, and thus no portion of general purpose computer investment, is allocated to the billing and collection category. Similarly, because expenses related to GSF investment are allocated in the same manner as GSF investment, no GSF expenses (including expenses related to general purpose computers) are allocated to billing and collection. Price cap LECs' costs allocated to the interstate billing and collection category are

⁶⁰⁵ These three largest categories, or the "Big Three Expenses," are the combined expense groups comprising: (1) Plant Specific Operations Expense, Accounts 6110, 6120, 6210, 6220, 6230, 6310, and 6410; (2) Plant Nonspecific Operations Expenses, Accounts 6510, 6530, and 6540; and (3) Customer Operations Expenses, Accounts 6610 and 6620. 47 C.F.R. § 69.2(e). The "Big Three Expense Factors" are the ratios of the sum of Big Three Expenses apportioned to each element or category to the combined Big Three Expenses. 47 C.F.R. § 69.2(f).

⁶⁰⁶ AT&T Comments at 67-68, Appendix E at 2.

⁶⁰⁷ AT&T Comments Appendix E at 2.

⁶⁰⁸ *Part 69 Conformance Order*, 2 FCC Rcd at 6452.

⁶⁰⁹ 47 C.F.R. § 69.307(c).

estimated to be approximately \$480 million.⁶¹⁰

413. As discussed in Section V of the *Access Reform Order*, we limit the scope of access reform, with some limited exceptions, to price cap incumbent LECs. Consistent with our approach to reform the interstate access charge regime, we tentatively conclude that our proposed changes to the allocation of GSF investment will apply only to price cap LECs. We will address the misallocation of rate-of-return LECs' interstate costs between regulated interstate services and nonregulated billing and collection activities in our separate access reform proceeding for rate-of-return carriers in 1997, which will provide us with the opportunity to conduct a comprehensive review of the circumstances unique to these carriers. We seek comment on this tentative conclusion regarding the scope of this proceeding.

414. To the extent that incumbent LECs' costs are underallocated to the billing and collection category, incumbent LECs' regulated services are recovering through interstate access charges costs associated with unregulated services. We therefore tentatively conclude that price cap incumbent LECs' general purpose computer costs attributable to billing and collection should not be recovered through regulated access charges. We seek comment on two options for reassigning these costs to the billing and collection category.

415. Under the first option, a price cap LEC would study the uses of the general purpose computer assets recorded in Account 2124 to determine the percentage of investment in that account that is used for billing and collection activities.⁶¹¹ That percentage, multiplied by the ratio of the dollar amount in Account 2124 to the dollar amount in Account 2110,⁶¹² which accumulates the total GSF investment, would be applied to the interstate portion of Account 2110 to determine a dollar amount that represents general purpose computer assets used for interstate billing and collection activities. The dollar amount so identified would be attributed directly to the billing and collection category. The remainder of the interstate portion of Account 2110 shall be apportioned among the access elements and the interexchange category using the current investment allocator. General purpose computer expenses recorded in Account 6124 would be treated in a similar fashion to Account 2124.⁶¹³ The interstate portion of Account 6124 would be allocated between (a) the billing and collection category and (b) all other elements and categories using the percentage derived for Account 2124. The remainder of Account 6120 (GSF expense)

⁶¹⁰ 1996 ARMIS Access Report.

⁶¹¹ Investment in general purpose computer equipment is recorded in Account 2124. *See* 47 C.F.R. § 32.2124.

⁶¹² Investment in land and support assets is recorded in Account 2110. *See* 47 C.F.R. § 32.2110.

⁶¹³ General purpose computers expenses are recorded in Account 6124. *See* 47 C.F.R. § 32.6124.

would be apportioned based on current GSF allocators.⁶¹⁴ Appropriate downward exogenous cost adjustments would be made to all price cap baskets.

416. Two objections are commonly raised to the use of special studies to make regulatory cost allocations. First, such studies are said to be costly. We recognize that there are costs attached to a special study approach. We note, however, that price cap LECs may already be required to study the use of computer investment in Account 2124 as part of the process of allocating that investment between regulated and nonregulated activities pursuant to the Part 64 joint cost rules. Second, it may be claimed that permitting price cap LECs to use special studies gives them too much discretion and that regulators are unable to ascertain the validity of the studies. To remedy this concern, we propose that each price cap LEC add to its cost allocation manual (CAM) a new section entitled "Interstate Billing and Collection." That section would describe: (1) the manner in which the price cap LEC provides interstate billing and collection services, and (2) the study it uses to determine the portion of Account 2124 investment that it attributes to the billing and collection category. The special study would then be subject to the same independent audit requirements as other regulated and nonregulated cost allocations. In addition, to obtain an independent certification of the validity of the procedures adopted by the price cap LEC, we would instruct the independent auditors to examine the design and execution of the study during the first independent audit following the addition of the billing and collection section to the CAM and to report their conclusions on the validity of the study.

417. Under the second option, we would modify Section 69.307 of our rules to require use of a general expense allocator to allocate the interstate portion of Account 2110 between: (1) the billing and collection category, and (2) all other elements and categories. We propose to use the "Big Three Expense" allocator used elsewhere in Part 69,⁶¹⁵ excluding, however, any account or portion of an account that is itself apportioned based on the apportionment of GSF to avoid circularity. The GSF investment not allocated to the billing and collection category would then be apportioned among the access elements and the interexchange category using the current investment allocator. This would ensure that GSF costs are allocated among all access categories, including the billing and collection category. The interstate portion of Account 6120 would be apportioned among all elements and categories based on the overall apportionment of GSF investment. This option covers only price cap incumbent LECs that provide interstate billing and collection using regulated assets. Carriers that acquire billing and collection services from unregulated affiliates through affiliate transactions or from third parties would continue recording their expenses for acquiring such services in Account 6623,⁶¹⁶ which is already apportioned to the billing and collection category.

⁶¹⁴ General support expenses are recorded in Account 6120. *See* 47 C.F.R. § 32.6120.

⁶¹⁵ *See* 47 C.F.R. § 69.2(f).

⁶¹⁶ *See* 47 C.F.R. § 32.6623.

418. We invite parties to comment on the feasibility of these two options and propose alternative methods for reassigning general purpose computer costs to the billing and collection category. Parties should also address the extent to which either option affects large and small LECs differently and how small business entities, including small incumbent LECs and new entrants, will be affected.⁶¹⁷ We invite parties to identify any changes that should be made to other access elements as a result of any changes we may make to the GSF allocation procedures.

VIII. FINAL REGULATORY FLEXIBILITY ANALYSIS

419. As required by the Regulatory Flexibility Act (RFA),⁶¹⁸ an Initial Regulatory Flexibility Analysis (IRFA) was incorporated in the NPRM in this proceeding.⁶¹⁹ The Commission sought written public comments on the proposals in the NPRM, including the IRFA. The Commission's Final Regulatory Flexibility Analysis (FRFA) in this Order (the First Report and Order in this Access Charge Reform proceeding) conforms to the RFA, as amended.⁶²⁰ We provide this summary analysis to provide context for our analysis in this FRFA. To the extent that any statement contained in this FRFA is perceived as creating ambiguity with respect to our rules or statements made in preceding sections of this Order, the rules and statements set forth in those preceding sections shall be controlling.

A. Need for and Objectives of this First Report and Order

420. The Telecommunications Act of 1996 requires incumbent LECs to offer interconnection and unbundled elements on an unbundled basis, and imposes a duty to establish reciprocal compensation arrangements for the transport and termination of calls. The Commission's access charge rules were adopted at a time when interstate access and local exchange services were offered on a monopoly basis, and in many cases are inconsistent with the competitive market envisioned by the 1996 Act. This proceeding is being conducted to revise the Commission's access charge rules to make them consistent with the Telecommunications Act of 1996.

⁶¹⁷ See Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

⁶¹⁸ See 5 U.S.C. § 603.

⁶¹⁹ NPRM at ¶¶ 321-37.

⁶²⁰ See 5 U.S.C. § 604. The Regulatory Flexibility Act, 5 U.S.C. § 601 *et seq.*, was amended by the "Small Business Regulatory Enforcement Fairness Act of 1996" (SBREFA), which was enacted as Title II of the Contract With America Advancement Act of 1996, Pub.L. No. 104-121, 110 Stat. 847 (1996) (CWAAA).

B. Summary of Significant Issues Raised by the Public Comments in Response to the IRFA

421. Only one party, Rural Tel. Coalition, commented on the IRFA contained in the NPRM. Rural Tel. Coalition disagrees with our conclusion that rules applying only to price cap LECs will not affect non-price cap LECs in a way that requires analysis under the RFA. According to Rural Tel. Coalition, the decisions made in this Order will "prejudge and prejudice" a later rulemaking addressing access charge reform for non-price cap LECs.⁶²¹ In addition, Rural Tel. Coalition argues that non-price cap LECs, which include small incumbent LECs, will be injured if the access reform issues addressed in this Order are not implemented for them as well as price-cap LECs. Finally, Rural Tel. Coalition argues that the Commission impermissibly determined that small incumbent LECs are not small businesses within the meaning of the RFA.⁶²²

422. Rather than attempt to enact "one size fits all" access charge reform that would risk not fully accounting for the special circumstances of rate-of-return and other non-price cap LECs, we have chosen to address those LECs separately in a proceeding in which we may better focus on their needs. We do not agree with Rural Tel. Coalition that our decisions in this Order will "prejudge and prejudice" our consideration of the issues in a subsequent rulemaking. Although we may often find that the public interest concerns are similar for large and small carriers, our analysis will begin anew, and will address all relevant factors. Moreover, where the special circumstances faced by small incumbent LECs justify different treatment than is accorded price cap LECs in this Order, we will be better able to explain and address those concerns in a separate proceeding. For the reasons set forth in Section V above, we also disagree with Rural Tel. Coalition that small incumbent LECs may be injured by the delay involved in conducting separate rulemakings. Finally, although we are not persuaded on the basis of this record that our prior practice of finding incumbent LECs not subject to regulatory flexibility analysis (because they are not small businesses) has been incorrect,⁶²³ we have fully performed an RFA analysis for small incumbent LECs in this Order, including consideration of any adverse impact of the rules we adopt and consideration of alternatives that may reduce adverse impacts on such entities.

⁶²¹ Rural Tel. Coalition Comments at 4, 32.

⁶²² *Id.* at 32-35.

⁶²³ See *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, First Report and Order, 11 FCC Rcd 15499 ¶¶ 1328-30 (1996) (*Local Competition Order*), motion for stay denied, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, Order, 11 FCC Rcd 11754 (1996), *partial stay granted*, *Iowa Utilities Board v. FCC*, No. 96-3321, 1996 WL 589204 (8th Cir. 1996).

C. Description and Estimate of the Number of Small Entities To Which the Rules Will Apply:

423. The RFA generally defines "small entity" as having the same meaning as the terms "small business," "small organization," and "small governmental jurisdiction."⁶²⁴ In addition, the term "small business" has the same meaning as the term "small business concern" under the Small Business Act unless the Commission has developed one or more definitions that are appropriate for its activities.⁶²⁵ A small business concern is one which: (1) is independently owned and operated; (2) is not dominant in its field of operation; and (3) satisfies any additional criteria established by the Small Business Administration (SBA).⁶²⁶

424. Pursuant to 5 U.S.C. § 601(3), the statutory definition of a small business applies "unless an agency after consultation with the Office of Advocacy of the Small Business Administration and after opportunity for public comment, establishes one or more definitions of such term which are appropriate to the activities of the agency and publishes such definition(s) in the Federal Register." SBA has developed a definition of small business for Standard Industrial Classification (SIC) category 4813 (Telephone Communications, Except Radiotelephone). We first discuss the number of small businesses falling within this category, and then we attempt to refine further our estimate to correspond with the categories of telephone companies that are commonly used under our rules.

425. Consistent with our prior practice, our use of the terms "small entities" and "small businesses" does not encompass "small incumbent LECs." We use the term "small incumbent LECs" to refer to any incumbent LECs that arguably might be defined by SBA as "small business concerns."⁶²⁷ Because the small incumbent LECs subject to these rules are either dominant in their field of operations or are not independently owned and operated, they are, consistent with our prior practice, excluded from the definition of "small entity" and "small business concerns."⁶²⁸ Out of an abundance of caution, however, for regulatory flexibility analysis purposes, we will consider small incumbent LECs within this analysis and use the term "small incumbent LECs" to refer to any incumbent LECs that arguably might be defined by the SBA as "small business concerns."⁶²⁹

⁶²⁴ 5 U.S.C. § 601(6).

⁶²⁵ 5 U.S.C. § 601(3) (incorporating by reference the definition of "small business concern" in 15 U.S.C. § 632).

⁶²⁶ Small Business Act, 15 U.S.C. § 632 (1996).

⁶²⁷ See 13 C.F.R. § 121.210 (SIC 4813).

⁶²⁸ See *Local Competition Order*, 11 FCC Rcd at 15499 ¶¶ 1328-30, 1342.

⁶²⁹ *Id.*

1. Telephone Companies, Except Radiotelephone Companies (SIC 4813)

426. *Total Number of Telephone Companies Affected.* The United States Bureau of the Census ("the Census Bureau") reports that, at the end of 1992, there were 3,497 firms engaged in providing telephone services, as defined therein, for at least one year.⁶³⁰ This number contains a variety of different categories of carriers, including local exchange carriers, interexchange carriers, competitive access providers, cellular carriers, mobile service carriers, operator service providers, pay telephone operators, personal communications services providers, covered specialized mobile radio providers, and resellers. It seems certain that some of those 3,497 telephone service firms may not qualify as small entities or small incumbent LECs because they are not "independently owned and operated."⁶³¹ For example, a PCS provider that is affiliated with an interexchange carrier having more than 1,500 employees would not meet the definition of a small business. It seems reasonable to conclude that fewer than 3,497 telephone service firms are small entity telephone service firms or small incumbent local exchange carriers.

427. According to the *Telecommunications Industry Revenue: Telecommunications Relay Service Fund Worksheet Data (TRS Worksheet)*, there are 2,847 interstate carriers. These carriers include, *inter alia*, local exchange carriers, wireline carriers and service providers, interexchange carriers, competitive access providers, operator service providers, pay telephone operators, providers of telephone toll service, providers of telephone exchange service, and resellers.

428. *Wireline Carriers and Service Providers.* The SBA has developed a definition of small entities for telephone communications companies other than radiotelephone (wireless) companies. According to the SBA's definition, a small business telephone company other than a radiotelephone company is one employing no more than 1,500 persons.⁶³² The Census Bureau reports that, there were 2,321 such telephone companies in operation for at least one year at the end of 1992.⁶³³ All but 26 of the 2,321 non-radiotelephone companies listed by the Census Bureau were reported to have fewer than 1,000 employees. Thus, even if all 26 of those companies had more than 1,500 employees, there would still be 2,295 non-radiotelephone companies that might qualify as small entities or small incumbent LECs. We do not have information on the number of carriers that are not independently owned and operated, and thus

⁶³⁰ United States Department of Commerce, Bureau of the Census, *1992 Census of Transportation, Communications, and Utilities: Establishment and Firm Size*, at Firm Size 1-123 (1995) (*1992 Census*).

⁶³¹ 15 U.S.C. § 632(a)(1).

⁶³² 13 CFR § 121.201, SIC Code 4812.

⁶³³ *1992 Census, supra*, at Firm Size 1-123.

are unable at this time to estimate with greater precision the number of wireline carriers and service providers that would qualify as small business concerns under the SBA's definition. Consequently, we estimate that there are fewer than 2,295 small telephone communications companies other than radiotelephone companies.

429. *Incumbent Local Exchange Carriers.* Neither the Commission nor the SBA has developed a definition for small incumbent providers of local exchange services (LECs). The closest applicable definition under the SBA rules is for telephone communications companies other than radiotelephone (wireless) companies.⁶³⁴ The most reliable source of information regarding the number of LECs nationwide is the data that we collect annually in connection with the *TRS Worksheet*. According to our most recent data, 1,347 companies reported that they were engaged in the provision of local exchange services.⁶³⁵ We do not have information on the number of carriers that are not independently owned and operated, nor what carriers have more than 1,500 employees, and thus are unable at this time to estimate with greater precision the number of incumbent LECs that would qualify as small business concerns under SBA's definition. Consequently, we estimate that there are fewer than 1,347 small incumbent LECs.

2. Information Service Providers and Competitive LECs Are Not Affected

430. In Section VIII.B of the NPRM, we sought comment on whether to continue to exempt enhanced service providers (which we now refer to as information service providers, or ISPs) from any requirement to pay access charges. Because we decide to retain the ISP exemption, and do not permit LECs to impose access charges on ISPs at this time, we conclude that the RFA does not require us to consider the effects of any proposed rules on ISPs that fall within the definition of a small entity. Instead, as set forth in Section VI.B above, we find that the proceeding commenced with the Notice of Inquiry issued contemporaneously with the NPRM is the appropriate forum to address the fundamental questions about ISP usage of the public switched network.⁶³⁶ Similarly, we sought comment in Section VIII.A of the NPRM on whether the public interest would be served by regulating interstate terminating access services offered by

⁶³⁴ 13 CFR § 121.201, SIC Code 4813.

⁶³⁵ Federal Communications Commission, CCB, Industry Analysis Division, *Telecommunications Industry Revenue: TRS Fund Worksheet Data*, Tbl. 1 (Average Total Telecommunications Revenue Reported by Class of Carrier) (December 1996) (*TRS Worksheet*).

⁶³⁶ See *In the Matter of Usage of the Public Switched Network by Information Service and Internet Access Providers*, Notice of Inquiry, CC Docket No. 96-263, __ FCC Rcd ____ (1996), __ Fed. Reg. ____ (Released December 24, 1996) (NOI). In the NOI, we sought comment on broader issues concerning the development of information services and Internet access. The information provided will give us the data we need to make further reasonable and informed decisions regarding Internet access and other information services, and, if necessary, to craft proposals for a subsequent Notice of Proposed Rulemaking that are sensitive to the complex economic, technical, and legal questions raised in this area.

competitive (non-incumbent) LECs. Because we conclude that the public interest would not be served by imposing any regulations on competitive LECs' interstate terminating access offerings at this time, we conclude that the RFA does not require us to consider the effects of any proposed rules on competitive LECs that fall within the definition of a small entity.

D. Summary Analysis of the Projected Reporting, Recordkeeping, and Other Compliance Requirements

431. In Section V.A above, we adopt changes to transport interconnection charge (TIC) rate structures and transport rate structures to comply with the court order in *CompTel v. FCC*.⁶³⁷ These changes will affect all incumbent LECs, including small incumbent LECs, and will require small incumbent LECs to make one or more tariff filings reflecting the new rate structures, which will involve the use of legal skills, and possibly accounting, economic, and financial skills.

432. As set forth in Section VI.D above, incumbent LECs, including small incumbent LECs, must reduce their interstate access charges to reflect the elimination of those former universal service obligations that are being replaced with new universal service obligations, increase their interstate access charges to reflect their new universal service obligations, and, to the extent necessary, adjust their interstate access charges to account for any additional universal service funds received under the modified universal service mechanisms. This will require small incumbent LECs to make one or more tariff filings, which will involve the use of legal skills.

E. Burdens on Small Entities, and Significant Alternatives Considered and Rejected

433. *Sections III.C-D: Transport/TIC Rate Structure Changes.* As set forth in Sections III.C-D above, we adopt a new tandem-switched transport rate structure and rate levels that replace the interim rate structure in place prior to today. In addition, we adjust the TIC to reflect the changes made by the new tandem-switched transport rate structure and rate levels. Unlike before, we adopt for the first time a final, cost-based rate structure, which should reduce and minimize uncertainty for those small businesses and small incumbent LECs whose businesses involve these services. Moreover, the new rate structure and rate levels are more closely related to the costs of providing the underlying services, which should minimize the economic impact of these rules on small businesses and small incumbent LECs by minimizing the adverse impacts that can accompany non-cost based regulation.⁶³⁸

434. We also adopt a transition plan that will have the effect of giving small businesses

⁶³⁷ *CompTel v. FCC*, 87 F.3d 522 (D.C.Cir. 1996).

⁶³⁸ See Section III.C.2.b *supra*.

and small incumbent LECs the opportunity to plan, adjust, and develop their networks with a minimum of disruption for them and their customers. Finally, as set forth in Section III.C-D above, we find that the reallocation of TIC costs and the new recovery procedures will facilitate the development of competitive markets. This is because incumbent LEC rates will move toward cost-based levels and incumbent LECs will no longer have the ability to assess TICs on switched access minutes that do not use their transport facilities. These pricing revisions may create new opportunities for small entities, including small business and small incumbent LECs wishing to enter local telecommunications markets.

435. *Section V: Access Reform for Incumbent Rate-of-Return Local Exchange Carriers.* Our decision to limit access charge reform, with certain specified exceptions, to price cap LECs, which do not include small businesses or small incumbent LECs, should mitigate the potential that access charge reform could have a significant economic impact on any small incumbent LECs. This is because the Commission will address in a separate proceeding the common set of complex issues faced by non-price cap LECs, which are different than those faced by price cap LECs. Moreover, as discussed above in Section V, we find that small incumbent LECs are unlikely to face imminent harm as a result of the continued application of our current access charge rules because all non-price cap incumbent LECs may be exempt from, or eligible for a modification or suspension of, the interconnection and unbundling requirements of the 1996 Act.

436. *Section VI.A: Applicability of Part 69 to Unbundled Elements.* As a result of the exclusion of unbundled elements from Part 69 access charges, described in Section VI.A above, incumbent LECs, including small incumbent LECs, may receive reduced overall levels of interstate access charges as competitors enter local markets using unbundled network elements. They will, however, receive payment for those unbundled network elements pursuant to interconnection agreements under Section 251 of the Act. Moreover, to the extent that small incumbent LECs receive universal service support through interstate access charges, such funding will continue to be received without regard to any loss of revenue from interstate access charges. This is because all universal service support received by small incumbent LECs will be received from the new Universal Service Fund, established in a separate order released today. Finally, we note that section 251 of the Act contains provisions expressly designed to take into account the special circumstances of small incumbent LECs, including those that qualify as rural LECs, with respect to interconnection obligations.

437. Our decisions in Section VI.A above to exclude unbundled elements from the application of Part 69 access charges is likely to facilitate the development of competitive markets. This is because prices for unbundled elements will reflect the costs of those elements, and will not impose on competitors additional charges unrelated to the costs of elements being purchased. Accordingly, as set forth in Section VI.A above, competitors using unbundled elements will contribute to universal service on an equitable and non-discriminatory basis instead of paying implicit subsidies to incumbent LECs (whether in addition to, or in place of, explicit universal service mechanisms). These decisions may create new opportunities for small entities,

including small businesses and small incumbent LECs, wishing to enter local telecommunications markets.

438. *Section VI.C: Terminating Access Services Offered by Non-Incumbent LECs.* As set forth in Section VI.C above, we find that treating new entrants as dominant carriers subject to regulation of their terminating access services until we find otherwise would impose unnecessary regulation, including potentially increased regulatory burdens on small businesses. Instead of imposing such burdens, we find that the imposition of regulatory requirements with respect to competitive LEC terminating access is unnecessary in the absence of some stronger record evidence that competitive LECs have in the past charged unreasonable terminating access rates, or are likely to do so in the future. If there is sufficient indication that competitive LECs are imposing unreasonable terminating access charges, we will revisit this issue.

439. *Section VI.D: Universal Service Related Part 69 Changes.* As set forth in Section VI.D.2.a above, we require that LECs that contribute to the Long Term Support (LTS) program and LECs that receive LTS payments revise their tariffs to reflect the fact that the LTS program is being replaced with explicit support from the new Universal Service Fund implemented pursuant to the *Universal Service Order* adopted today. This will require small incumbent LECs to make one or more tariff filings. The new Universal Service Fund will facilitate the transition to competitive markets while maintaining specific, predictable and sufficient support for universal service as required under section 254 of the Act. Accordingly, the required changes in LECs' tariff filings, including those in tariffs filed by small incumbent LECs, are part of an overall mechanism designed to minimize the economic impact of the 1996 Act on small businesses and small incumbent LECs. The other universal service related changes that we adopt in this Order affect only price-cap LECs, which do not include any small businesses or small incumbent LECs.

F. Report to Congress

440. The Commission shall include a copy of this FRFA, along with this Order, in a report to be sent to Congress pursuant to SBREFA.⁶³⁹ A copy of this FRFA (or a summary thereof) will also be published in the Federal Register.

IX. PROCEDURAL ISSUES

⁶³⁹ 5 U.S.C. § 801(a)(1)(A).

A. Paperwork Reduction Act

441. On April 1, 1997, the Office of Management and Budget (OMB) approved all of our proposed information collection requirements in accordance with the Paperwork Reduction Act.⁶⁴⁰ The OMB made one recommendation, suggesting that we try "to minimize the number of new filings that firms must create in order to be compliant with the rules adopted . . . allowing firms to use many of the filings they must create in order to demonstrate that they meet the Telecommunications Act of 1996 requirements for provision of inter-LATA services within their operating regions." The recommendation of OMB primarily affects proposals that were not adopted in this Order, but will be the subject of a future Report and Order. At that time, the Commission will consider carefully whether the number of required new filings can be minimized by relying to the greatest extent possible on those filings referenced by OMB in its approval. Furthermore, in this Order, although we have made certain adjustments, we have minimized the paperwork burden where possible. For example, the first inflation adjustment will be done in January 1, 1999, but the next one will not be done until July 1, 2000. This schedule will minimize the number of filings and paperwork burden associated with necessary adjustments for inflation.

442. In the course of preparing this Order, we have decided to modify several of the information collection requirements proposed in the NPRM. For example, price cap local exchange carriers must make a downward exogenous adjustment to the price cap index for the common line basket to account fully for the elimination of their LTS obligations by December 16, 1997 to be effective January 1, 1998.⁶⁴¹ We conclude that these modifications constitute a new "collection of information," within the meaning of the Paperwork Reduction Act of 1995, 44 U.S.C. §§ 3501-3520. These modifications are subject to OMB review and the Commission has requested emergency approval of these modifications to ensure that the requirements may be effective on June 16, 1997. In addition, we will seek final OMB approval for these modifications.

443. The Further Notice of Proposed Rulemaking contains either a proposed or modified information collection. As part of its continuing effort to reduce paperwork burdens, we invite the general public and the OMB to take this opportunity to comment on the information collections contained in the Further Notice of Proposed Rulemaking, as required by the Paperwork Reduction Act of 1995, 44 U.S.C. §§ 3501-3520. Public and agency comments are due at the same time as other comments on the Further Notice of Proposed Rulemaking; OMB comments are due 60 days from date of publication of the Further Notice of Proposed Rulemaking in the Federal Register. Comments should address: (a) whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information shall have practical utility; (b) the accuracy of the

⁶⁴⁰ *Notice of Office Management and Budget Action*, OMB No 3060-0760 (Apr. 1, 1997).

⁶⁴¹ *See* Section VI.D., *supra*.

Commission's burden estimates; (c) ways to enhance the quality, utility, and clarity of the information collected; and (d) ways to minimize the burden of the collection of information on the respondents, including the use of automated collection techniques or other forms of information technology.

B. Initial Regulatory Flexibility Act Analysis

444. Pursuant to the Regulatory Flexibility Act (RFA),⁶⁴² the Commission has prepared the following initial regulatory flexibility analysis (IRFA) of the expected impact on small entities of the policies and rules proposed in the Further Notice of Proposed Rulemaking (Further Notice). Written public comments are requested on the IRFA. These comments must be filed in accordance with the same filing deadlines as comments on the rest of the Further Notice, but they must have a separate and distinct heading designating them as responses to the regulatory flexibility analysis. The Secretary shall cause a copy of the Further Notice, including the initial regulatory flexibility analysis, to be sent to the Chief Counsel for Advocacy of the Small Business Administration in accordance with Section 603(a) of the RFA.⁶⁴³

445. Reason for action. The Commission has revised its interstate access charge rules to make them consistent with the Telecommunications Act of 1996. As discussed in Section VII.A of the Further Notice, multi-line business customers will pay a higher subscriber line charge as a result of access charge reform, while special access customers do not pay such a charge. In addition, as the PICCs are phased in IXCs will be required to pay a substantially higher PICC for a multi-line business end user compared to the PICC paid for a primary residential end user or single-line business end user. An IXC serving multi-line business customers through special access can avoid paying the PICCs. As discussed in Section VII.B, the current allocation of general support facilities expenses enables incumbent LECs to recover through regulated interstate access charges costs caused by the LECs' nonregulated billing and collection functions.

446. Objectives. In Section VII.A, by proposing to allow LECs to impose a subscriber line charge on special access customers, we seek to prevent a decrease in projected revenue from multi-line subscriber line charges and PICCs caused by the migration of certain multi-line business customers from the public switched network to special access. In Section VII.B, we seek to revise the Commission's current allocation of price cap LECs' interstate costs between regulated interstate access services and nonregulated billing and collection activities to move interstate access rates closer to cost, consistent with the 1996 Act's new competitive paradigm.

⁶⁴² 47 U.S.C. § 603. The RFA, *see* 5 U.S.C. § 601 *et seq.*, has been amended by the Contract With America Advancement Act of 1996, Pub. L. No. 104-21, 110 Stat. 847 (1996) (CWAAA). Title II of the CWAAA is the "Small Business Regulatory Enforcement Fairness Act of 1996" (SBREFA).

⁶⁴³ 47 U.S.C. § 603(a).

447. Legal Basis. The proposed action is supported by Sections 4(i), 4(j), 201-205, 208, 251, 252, 253, and 403 of the Communications Act of 1934, as amended, 47 U.S.C. §§ 154(i), 154(j), 201-205, 208, 251, 252, 253, 403.

448. Description, potential impact and number of small entities affected. For purposes of this Further Notice, the Regulatory Flexibility Act defines a "small business" to be the same as a "small business concern" under the Small Business Act (SBA), 15 U.S.C. § 632, unless the Commission has developed one or more definitions that are appropriate to its activities.⁶⁴⁴ Under the SBA, a "small business concern" is one that: (1) is independently owned and operated; (2) is not dominant in its field of operation; and (3) meets any additional criteria established by the SBA.⁶⁴⁵ The Small Business Administration has defined a small business for Standard Industrial Classification (SIC) category 4813 (Telephone Communications, Except Radiotelephone) to be a small entity that has no more than 1500 employees.⁶⁴⁶

449. Total Number of Telephone Companies Affected. The proposals in Sections VII.A and VII.B of this Further Notice, if adopted, would affect all LECs that are regulated by the Commission's price cap rules. Currently, 13 incumbent LECs are subject to price cap regulation. We tentatively conclude that all price cap carriers have more than 1500 employees and, therefore, are not small entities.

450. Reporting, record keeping and other compliance requirements. It is not clear whether, on balance, all proposals in this Further Notice would increase or decrease incumbent LECs' administrative burdens.

451. We believe that the reforms proposed in Section VII.A of this Further Notice would require price cap LECs (not small entities) to make at least one tariff filing, and possibly several additional filings, but otherwise should not affect their administrative burdens. The reforms proposed in Section VII.B of the Further Notice may require price cap LECs (not small entities) to study the uses of the general purpose computer assets recorded in Account 2124 to determine the percentage of investment in that account that is used for billing and collection activities, but otherwise should not affect their administrative burdens.

452. Federal rules which overlap, duplicate or conflict with this proposal. None.

⁶⁴⁴ See 5 U.S.C. § 601(3) (incorporating by reference the definition of "small business concern" in 15 U.S.C. § 632).

⁶⁴⁵ 15 U.S.C. § 632. See, e.g., *Brown Transport Truckload, Inc., v. Southern Wipers, Inc.*, 176 B.R. 82 (N.D. Ga. 1994).

⁶⁴⁶ 13 C.F.R. § 121.201.

453. Any significant alternatives minimizing impact on small entities and consistent with stated objectives. In Sections VII.A and VII.B of this Further Notice, we limit the scope of our proposals to incumbent price cap LECs, thereby not affecting small entities. We seek comment on these proposals and urge that parties support their comments with specific evidence and analysis.

C. Further Notice of Proposed Rulemaking Comment Filing Dates

454. Pursuant to applicable procedures set forth in Section 1.399 and 1.411 *et seq.* of the Commission's rules, 47 C.F.R. Sections 1.399, 1.411 *et seq.*, interested parties may file comments in response to the Further Notice of Proposed Rulemaking, including comments on the information collection requirements, no later than June 26, 1997 with the Secretary, Federal Communications Commission, Washington D.C. 20554. Interested parties may file replies no later than July 11, 1997, except that reply comments on the information collection requirements are due no later than July 28, 1997. To file formally in this proceeding, participants must file an original and twelve copies of all comments, reply comments, and supporting comments. If participants want each Commissioner to receive a personal copy of their comments, an original plus 16 copies must be filed. In addition, parties should file two copies of any such pleading with the Competitive Pricing Division, Common Carrier Bureau, Room 518, 1919 M Street, N.W., Washington, D.C. 20554. Comments and reply comments will be available for public inspection during regular business hours in the FCC Reference Center, Room 239, 1919 M Street, N.W., Washington D.C. 20554.

455. Parties submitting diskettes should submit them along with their formal filings to the Office of the Secretary. Submissions should be on a 3.5 inch diskette formatted in an DOS PC compatible form. The document should be saved in WordPerfect 5.1 for Windows format. The diskette should be submitted in "read only" mode. The diskette should be clearly labelled with the party's name, proceeding, type of pleading (comment or reply comment), docket number, and date of submission.

456. You may also file informal comments electronically via e-mail <access@fcc.gov>. Only one copy of electronically-filed comments must be submitted. You must put the docket number of this proceeding in the subject line (see the caption at the beginning of this Notice, or in the body of the text if by Internet). You must note whether an electronic submission is an exact copy of formal comments on the subject line. You also must include your full name and Postal Service mailing address in your submission.

457. Comments and replies must comply with Section 1.49 and all other applicable sections of the Commission's rules. We also direct all interested parties to include the name of the filing party and the date of the filing on each page of their comments and replies. Comments and replies must also clearly identify the specific portion of this Notice of Proposed Rulemaking to which a particular comment or set of comments is responsive. If a portion of a party's comments

does not fall under a particular topic listed in the Table of Contents of this Notice, such comments must be included in a clearly labelled section at the beginning or end of the filing.

458. Written comments by the public on the proposed and/or modified information collections are due July 28, 1997. Written comments must be submitted by the Office of Management and Budget (OMB) on the proposed and/or modified information collections on or before 60 days after date of publication in the Federal Register. In addition to filing comments with the Secretary, a copy of any comments on the information collections contained herein should be submitted to Judy Boley, Federal Communications Commission, Room 234, 1919 M Street, N.W., Washington, DC 20554, or via the Internet to jboley@fcc.gov and to Timothy Fain, OMB Desk Officer, 10236 NEOB, 725 - 17th Street, N.W., Washington, DC 20503 or via the Internet to fain_t@al.eop.gov.

X. ORDERING CLAUSES

459. Accordingly, IT IS ORDERED, pursuant to Sections 1-4, 10, 201-205, 251, 254, 303(r), and 410(a) of the Communications Act of 1934, as amended, and Section 601 of the Telecommunications Act of 1996, 47 U.S.C. §§ 151-154, 160, 201-205, 251, 254, 303(r), 410(a), and 601, that the ORDER IS ADOPTED.

460. IT IS FURTHER ORDERED that the provisions in this Order will be effective June 17, 1997. We anticipate this date will be at least thirty days after publication of the rules in the Federal Register. If publication of the rules is delayed, however, we find good cause under 5 U.S.C. § 553(d)(3) to make the rules effective less than thirty days after publication, because the local exchange carriers subject to price cap regulation must file tariffs by June 16, in order for them to be effective on July 1, 1997, as required by Section 69.3 of the Commission's rules, 47 C.F.R. § 69.3. In addition, to ensure that the local exchange carriers subject to price cap regulation have actual notice of these rules immediately following their release, we are serving those entities by overnight mail. The collections of information contained within are contingent upon approval by the Office of Management and Budget.

461. IT IS FURTHER ORDERED that the waiver petitions of Bell Atlantic, Pacific Bell, GTE, Cincinnati Bell, U S West, and BellSouth discussed in Section III.A.5., regarding Section 69.104 as applied to ISDN service ARE DISMISSED.

462. IT IS FURTHER ORDERED that the rulemaking proceeding in CC Docket No. 95-72 IS TERMINATED.

463. IT IS FURTHER ORDERED, pursuant to Sections 1-4, 10, 201-205, 251, 254, 303(r), and 701 of the Communications Act of 1934, as amended, 47 U.S.C. §§ 151-154, 160, 201-205, 251, 254, 303(r), and 601, that NOTICE IS HEREBY GIVEN OF the rulemaking

described above and that COMMENT IS SOUGHT on these issues.

FEDERAL COMMUNICATIONS COMMISSION

William F. Caton
Acting Secretary