Intercarrier Compensation
(and related policy issues)
Getting Ready for Change

TANE

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2005 – 2006 Critical Years

- **Major events with significant impact for RLEC industry**
  - FCC Intercarrier Compensation FNPRM
  - Post-RTF Universal Service Program
  - USF Collection Mechanism
  - 1996 Telecom Act Re-Write
  - Consolidation of the RBOCs and IXCs
  - Brand X Ramifications
- **Policy ideas with negative implications for RLECs**
  - Bill & Keep
  - Elimination of originating compensation
  - Radical restructure of USF
- **How much of your cash flow comes from USF and Intercarrier Compensation?**
  - It will all be in play

Fundamental Principles

- Focus on the rural consumer
- Networks matter
- Networks require investment
- Ubiquitous broadband by 2007 will require lots of investment
- ICC and USF reform should encourage rural infrastructure investment
- ICC and USF are different sides of the same coin

Rural Realities

- **Policy Realities:**
  - **1996 Act: Rural consumers shall have comparable services and comparable prices to urban areas**

- **Economic Realities:**
  - **It is costly to serve remote, sparsely populated rural areas**
  - **RLECs rely heavily on USF and ICC for cost recovery**

Source of Revenues		
Source	**Rural**	**RBOC**
End User	27%	61%
Access Charges	26%	10%
USF	30%	0%
Other	17%	29%

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Intercarrier Compensation

The ICC Problem

- **Disparate charging mechanisms based on:**
  - Jurisdiction (intrastate, interstate)
  - Nature of the call/technology (local, long distance, Internet)
  - Type of carrier (LEC, IXC, CMRS, ISP, end-user)
- **System is neither economically rational nor sustainable**
  - Disparities leading to arbitrage and/or fraud
  - Phantom traffic
  - Inability to differentiate between interstate, intrastate and local traffic

Key ICC Questions

- How to unify the rate structure?
- Which jurisdiction has authority over unified rates?
- Level of unified rate
  - Finite cost-based rate
    - What type of cost?
  - Zero rate (i.e., Bill and Keep)
- Application of unified rates
  - Terminating only
  - Originating and terminating
- Do we need new interconnection rules?
- Revenue replacement issues
  - Increased SLC charges
  - New revenue replacement mechanism
    - “Benchmark” for qualification
    - Portable to CETCs?

Major ICC Issues

- "Bill & Keep"
  - Not cost-based
  - Invites uneconomic network usage
  - Excessive reliance on USF could make fund unsustainable
- Originating and Terminating Usage
  - Many plans call for terminating compensation only
  - RLECs have "equal access" and 800 service obligations that are costly
  - 251(b)(5) rules do not contemplate these call origination obligations

Major ICC Issues
(continued)

- Interconnection Rules and Obligations
  - The “Edge” plan will harm rural carriers and impose significant costs
  - Existing meet-points and interconnection rules are working
- Regulatory Issues
  - Regulation must focus on preserving investment incentives
  - Appropriate balance between state and federal
  - “Preemption” is not the answer
- Market Consolidation
  - Rural carries need equal and affordable access to IP backbone and network transit resources

Major ICC Players

- Rural Alliance (formerly ARIC and EPG)
- Other RLEC Interests
  - Frontier/Citizens
  - Coalition for Capacity-Based Access Pricing
- Intercarrier Compensation Forum (ICF)
- CLECs
  - Cost-Based Intercarrier Compensation Coalition (CBICC)
  - Various individual CLECs
- Non-ICF RBOCs (BellSouth, Verizon, Qwest)
- Wireless Carriers
- Cable
- Consumer Groups
- State PUCs
  - NARUC ICC Task Force
  - Various individual state Commissioners and Staff

Where Are We Now?

- **FNPRM issued March 3, 2005**
- **Comments filed May 23, 2005**
- **Reply comments filed July 20, 2005**
- **Ex-Parte process now underway**

Positions of the Parties

- **Rural Alliance**
  - Unified rates based upon embedded costs (approx. $0.02)
  - Originating and terminating compensation
  - Revenue replacement mechanisms with benchmarks
  - No SLC cap increases
  - Maintain current meet-points and interconnection rules
  - Affordable access to transit facilities and IP backbones
  - Collaborative federal/state solution
- **ICF**
  - Bill and keep (rural carriers may charge $0.0095 termination)
  - "Edge" plan defines compensation obligations
  - Increase SLC caps to $10
  - New USF mechanisms (non-rural not portable to CETCs)
  - FCC preempts state PUCs

Positions of the Parties
(Continued)

- **CLECs**
  - Unified cost-based rates (default $0.001)
  - Don't apply the Edge or "Hierarchical" proposals
- **Wireless**
  - Bill and keep is default
  - Restructure USF based on FLEC of most-efficient technology
  - Maintain current rules (intraMTA, VNXX, single POI, etc.)
- **Cable**
  - Mixed, but tending toward bill and keep
- **Consumer groups**
  - Gradual transition to unified rates
  - No SLC increases
  - Maintain state authority over intrastate rates
  - No revenue replacement unless state PUC approves

Positions of the Parties
(Continued)

- **BellSouth**
  - Originating and terminating compensation at BellSouth's rates
  - Revenue loss offset by SLC increases
  - Transit should be provided at market-based, negotiated rates
- **Qwest**
  - Bill and keep at the Edge
  - Revenue loss offset by SLC increases
  - The size of the federal USF should not be increased
- **Verizon**
  - Rates should be established through commercial negotiation
  - Carriers have no obligation to provide transiting services
  - Why bother with current system – the World is going IP, and interconnection arrangements in the IP World are well established

Positions of the Parties
(Continued)

- **NARUC ICC Task Force Plan Version 7**
  - **Default terminating rates by wire center size**
    - **0 – 500 $0.02**
    - **500 – 5,000 $0.005**
    - **5,000+ $0.001**
  - **Optional originating rate $0.002**
  - **Terminating transport rate $.0095 ($0.019 if > 200 miles)**
  - **Adopts ICF Edge Plan**
  - **Revenue Replacement Funding – 1st 3 years**
    - **“Transitional Benchmark” (basic + SLC) will be established annually**
    - **$1 per year SLC increase if above benchmark ($2 if below)**
    - **Remainder by federal fund subject to state PUC earnings test**
  - **USF – after 3 years**
    - **“Block Grants” to states**
    - **Each state gets “no less” than it received in 2004**
    - **State PUC decides where funding goes (no rural/non-rural)**
    - **Permanent benchmark at 125% of national urban rate**

Where Are We Now?

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- Reply comments filed July 20, 2005
- Ex-Parte process now underway
- NARUC ICC Task Force Seeking to Facilitate Dialogue

Rural Alliance Reply Comments

Minimize impact of ICC reform on USF and end users through:

1. **Uniform application of unified, cost-based rates to all RSPs that use RLEC networks**
   - **For RoR carriers rates should be based on embedded costs**
2. **Compensation for both terminating and originating traffic when the RSP lacks a connection to the end user**
3. **Maintain access and reciprocal compensation rules**
4. **Establish nationwide local rate benchmarks for revenue replacement qualification**
5. **Increase SLCs to current cap levels before receiving revenue replacement funding**
6. **Maintain existing interconnection rules and meet-points**
7. **Develop rules that minimize "phantom traffic"**

RA Collaborative ICC Reform Plan

- **12/31/2005 – FCC Order**
  - **Adopt reforms that can be implemented quickly**
    - **Abolish IntraMTA rule**
    - **Restrict virtual NXX**
    - **POIs must be in LEC network area**
    - **LECs not required to deliver traffic out of local network area**
    - **Clarify ESP/ISP Exemption**
    - **Address “Phantom Traffic” issues**
  - **Establish overall framework for collaborative ICC reform**
    - **Separations and Universal Service Joint Boards function as a “Super Joint Board”**
    - **FCC provides policy recommendations for JBs’ consideration**
  - **Issue FNPRM to address optional capacity-based ICC pricing**

Collaborative ICC Reform Plan
(continued)

- **9/30/2006 – Joint Boards issue Recommended Decisions**
  - **Address issues related to the development, implementation and administration of unified ICC rates, local rate benchmarks and revenue replacement mechanisms**
  - **See Appendix C to RA Reply Comments for details**
- **6/30/2007 – FCC Final Order**
  - **Adopt Joint Board recommendations**
- **12/31/2007 – Individual States make opt-in decisions**
  - **Report status to FCC**
  - **FCC and States begin development of rates, funding, etc.**
- **12/31/2008 - First phase of implementation**
  - **Subsequent phases annually for duration of transition as recommended by Joint Boards and approved by FCC**

Rural Alliance ICC Reform Process

7/20/05 | 12/31/05 | 6/30/06 | 9/30/06 | 6/30/07 | 12/31/07 | 12/31/08

	7/20/05 – 12/31/05	12/31/05 – 6/30/06	6/30/06 – 9/30/06	9/30/06 – 6/30/07	6/30/07 – 12/31/07	12/31/07 – 12/31/08	12/31/08 –
FCC	Issues initial order and refers issues to the Super Joint Board			Issues final order adopting Joint Boards recommended decisions		Work with each state to establish ICC rates and implement 1st phase of transition	2nd, 3rd, and additional phases of transition (if necessary)
Super Joint Board		Super Joint Board solicits input	Joint Boards issue decisions on ICC and the Universal Service Joint Board issues decision for establishing post RTF USF				
State PUC	Provide input to the FCC including input from the NARUC Task Force	Individual states discuss initial thoughts on opting in and provide input and data to Joint Boards		States determine whether to opt into the national ICC reform plan and work to establish a state USF or other revenue replacement mechanism		Work with FCC to establish ICC rates, ratify rates if necessary, establish USF or other mechanism and implement 1st phase of transition	2nd, 3rd, and additional phases of transition (if necessary)

Intercarrier Compensation Solutions

- **Unified, cost-based rates**
  - For RoR carriers rates should be based on embedded costs
- **Compensation for both terminating and originating traffic**
- **Revenue replacement funding**
  - Subject to basic rates at national benchmark
- **Maintain existing interconnection rules and meet-points**
- **Develop procedures and rules that minimize "phantom traffic"**

ICC Action Items

- Unite around the Rural Alliance Plan!
- Chairman Martin will be receptive to a well-crafted and broadly supported rural solution
- Continue to support RLEC messaging initiatives
- Educate consumers and other rural stakeholders on their stake in ICC and USF issues

In Summary

- If you use the network – you pay!
  - Cost-based rates for origination and termination
  - Contributions to the USF that supports ubiquitous connections
  - No free ride for the technology de-jour
- ICC rates and USF support based on embedded cost
- Regulatory environment that promotes investment in rural telecom infrastructure
- Focus on the Rural Consumer

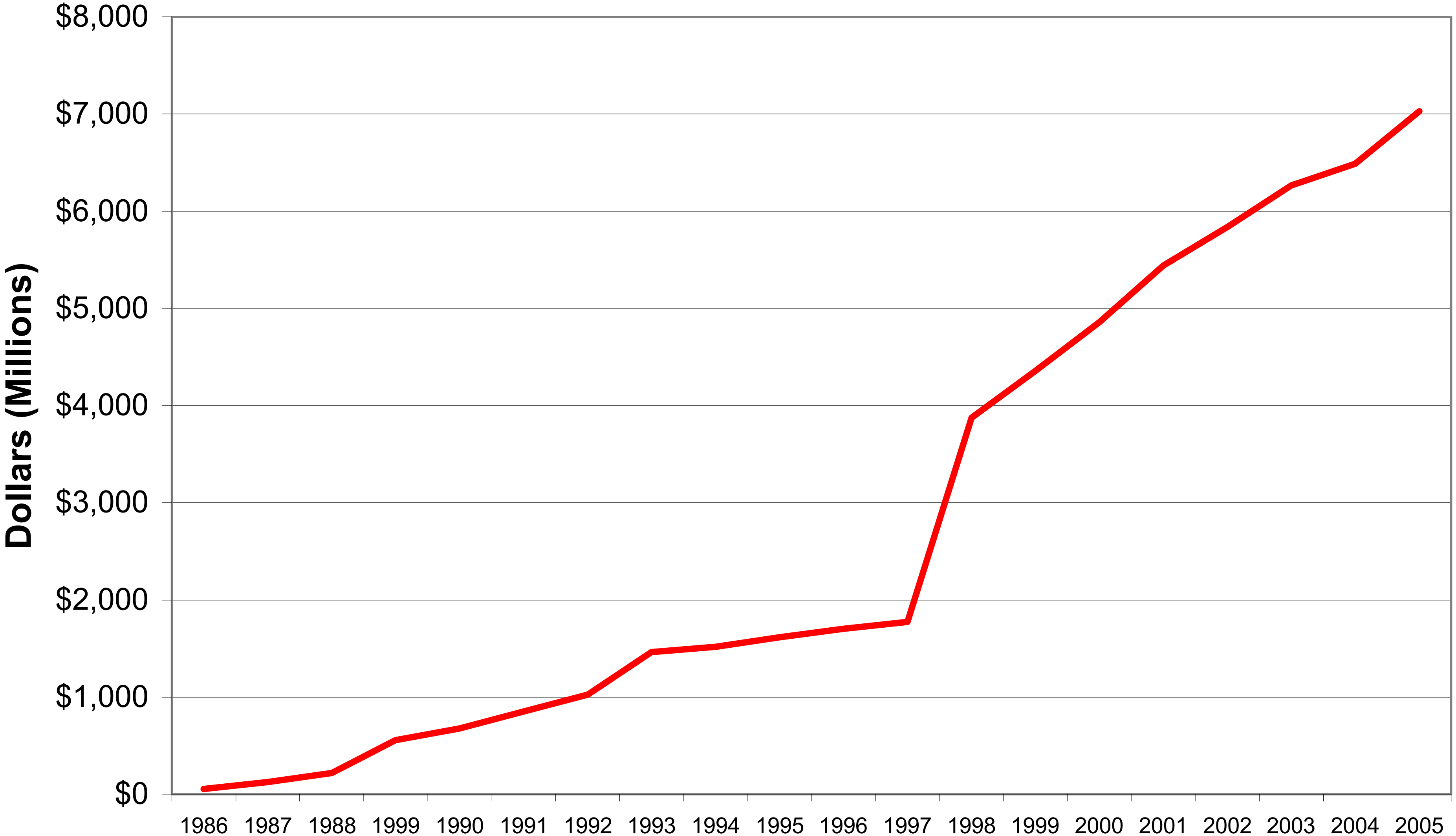
- Support the Rural Alliance!

Universal Service

Universal Service Issues

- Growth in the fund
- USF Collection Mechanism
- Support for Competitive ETCs
- Post-RTF funding
- Proxy Models
- State Block Grants

Growth in the USF



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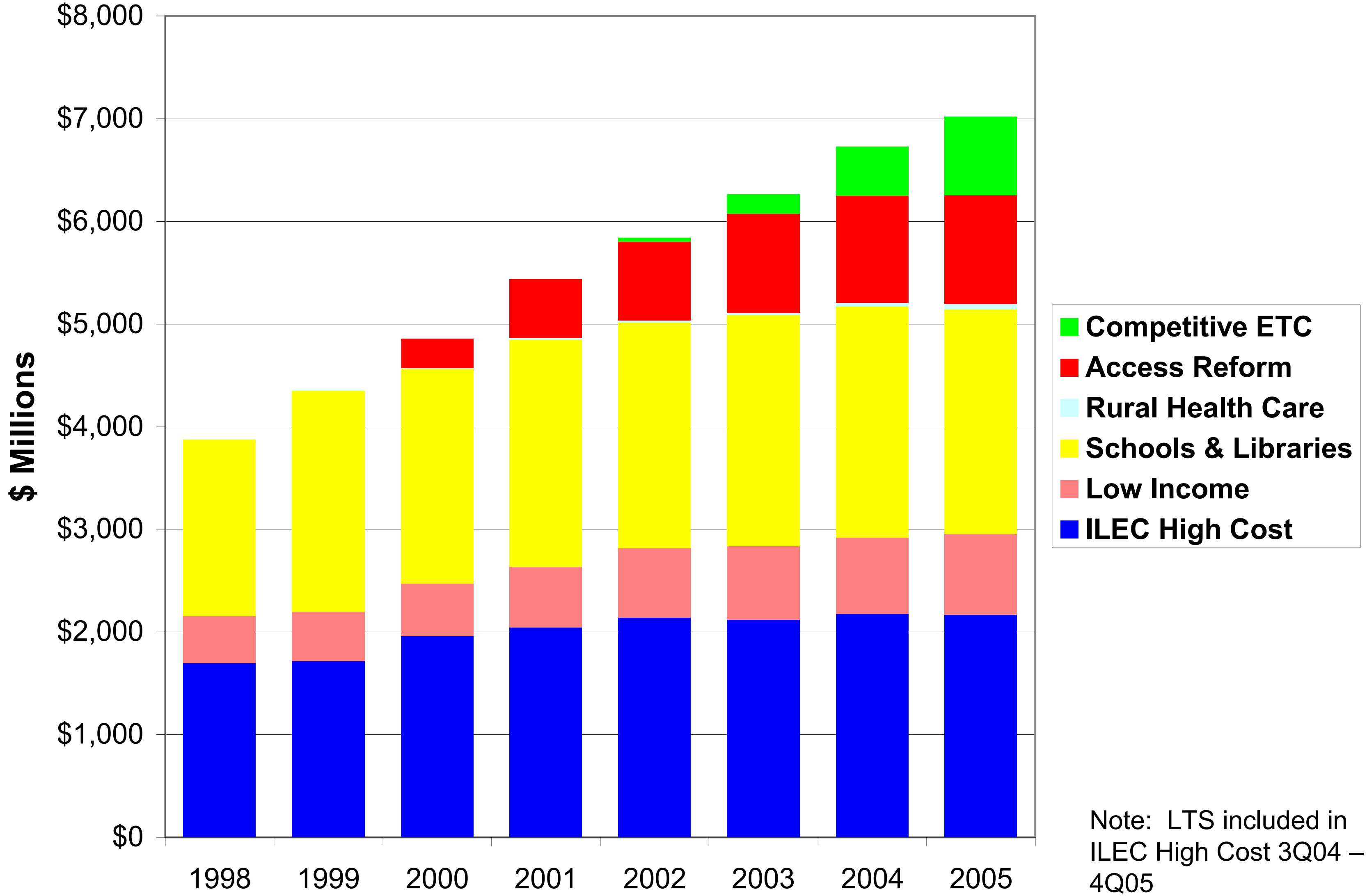
Sources of Growth



Note: LTS included in ILEC High Cost 3Q04 – 4Q05

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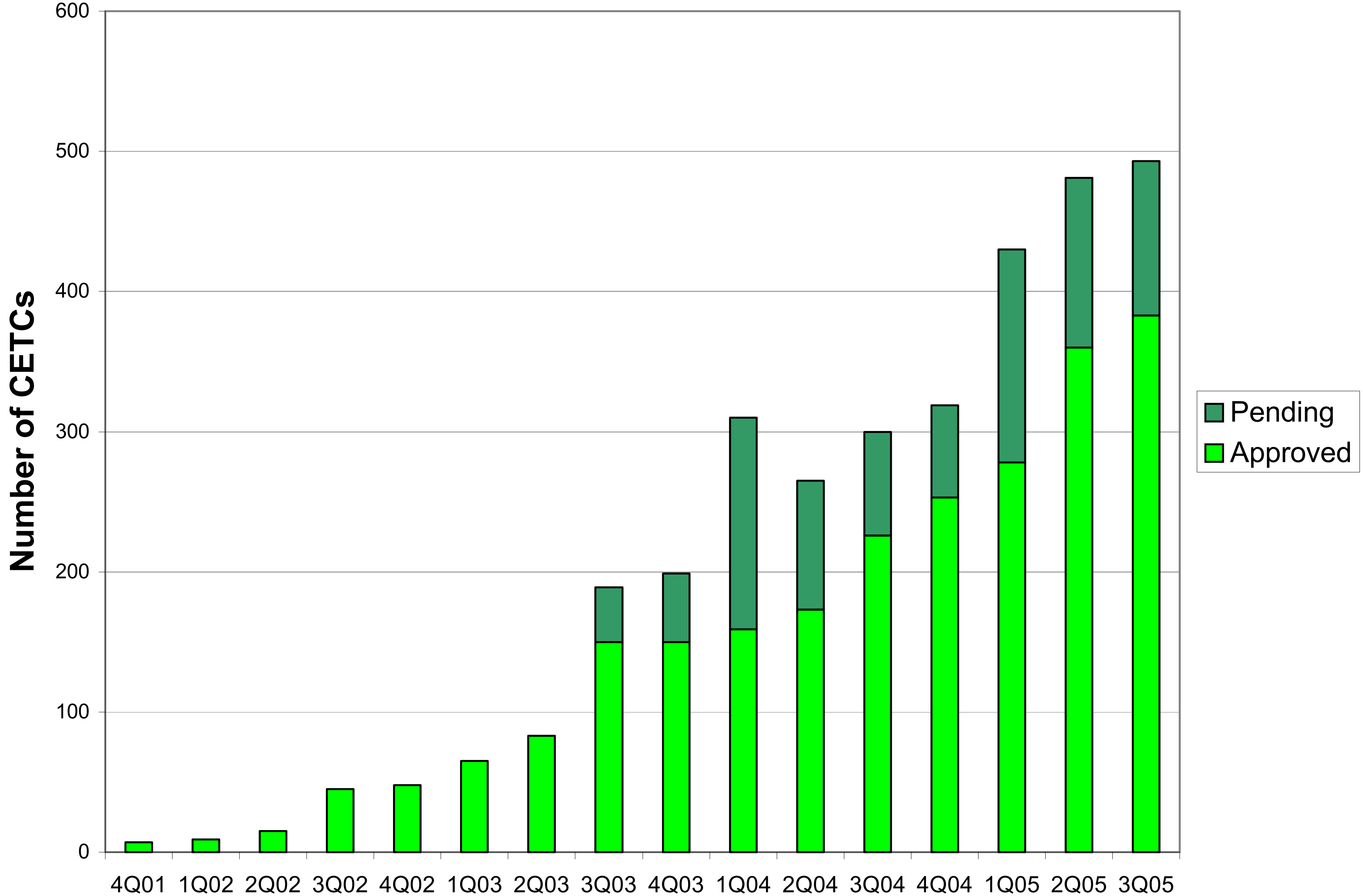
Number of CETCs



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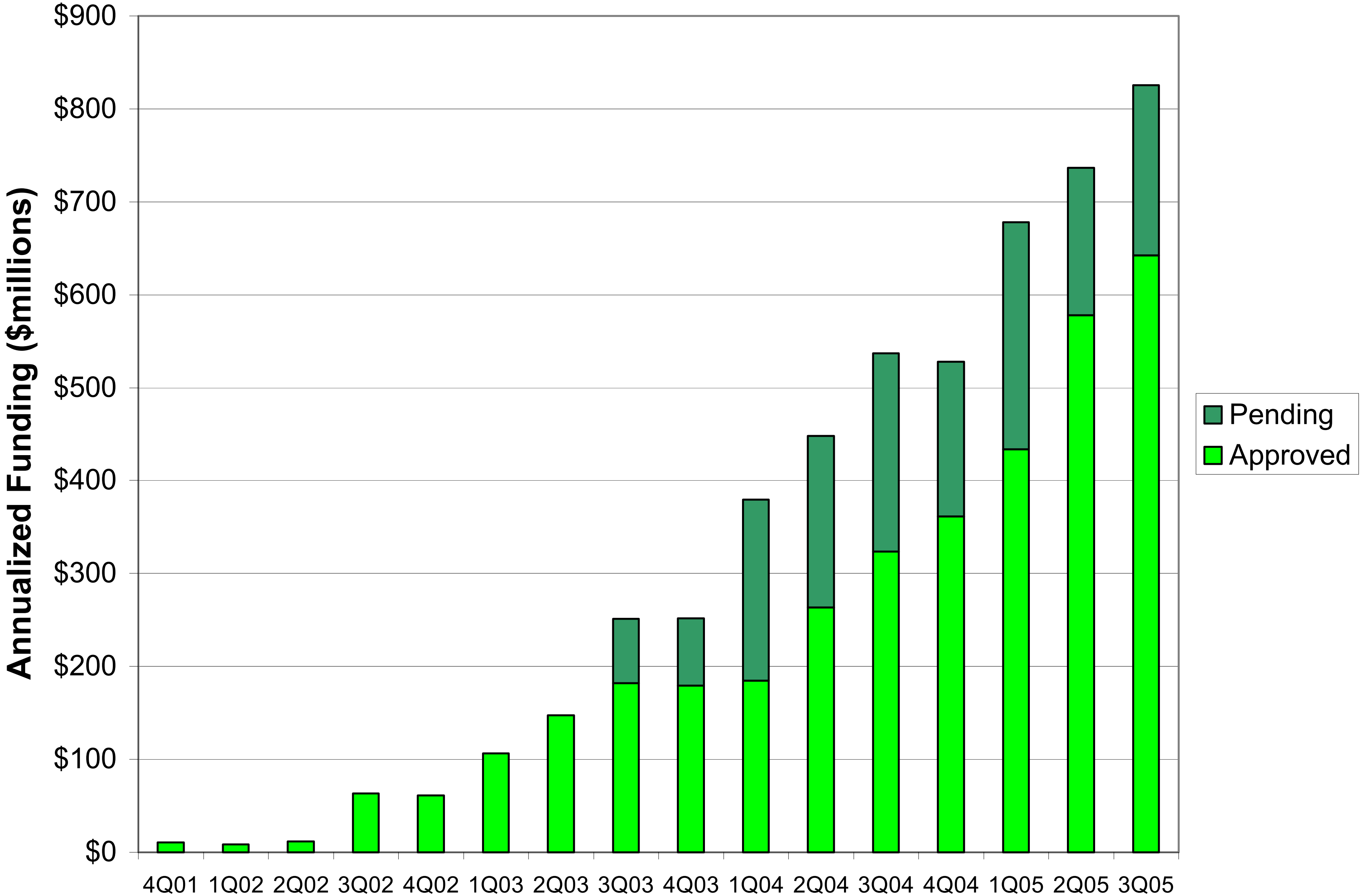
CETC Support



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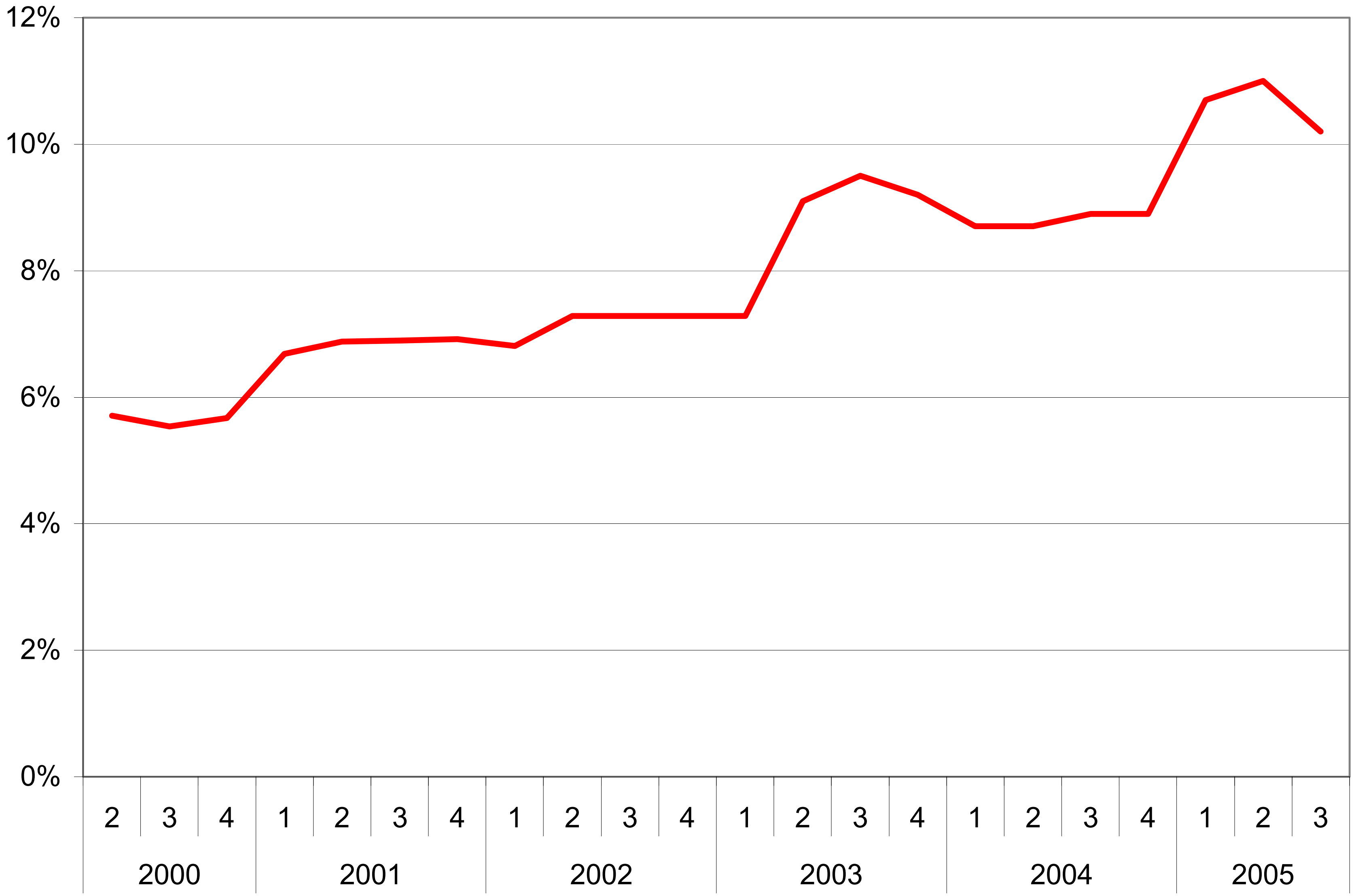
Top 10 CETC Recipients

	Annual Funding ($Millions)		
Company (States)	**Approved**	**Pending**	**Total**
Alltel (12)	$127.6		$127.6
US Cellular (11)	$43.4	$19.0	$62.4
Western Wireless (17)	$58.1	$2.0	$60.1
Sprint (27)	$24.2	$31.3	$55.5
RCC (10)	$45.3	$1.4	$46.7
Dobson (7)	$10.1	$35.4	$45.5
Centennial (6)	$39.0	$1.8	$40.8
Cellular South (2)	$38.6		$38.6
AT&T Wireless (4)	$19.0	$14.5	$33.5
American (6)	$12.6	$15.2	$27.8

(Source: USAC Report HC01 2Q05)

USF Contribution Factor



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USF Reform

- FCC Notice to Joint Board (June, 2004)
  - Replacement for RTF mechanism (expires 6/30/2006)
  - Support based on embedded cost or FLEC?
  - Should the rural mechanism only be applied to small carriers?
- Contribution Mechanism Reform
  - ICF “connections-based” proposal
  - Martin “telephone numbers-based” proposal
- Impact of “Brand X” Decision
  - Will Cable Modem/DSL/VoIP services contribute?
- Joint Board State Member and Staff Proposals
  - SAM – Ray Baum (OR)
  - 3-Stage – Billy Jack Gregg (WV)
  - HIP – Robert Nelson (MI)
  - USERP – Peter Bluhm (VT), Jeff Pursley (NE), Joel Shifman (ME)

State JB Member/Staff Proposals

Item	Baum	Gregg	Nelson	Bluhm/Pursley/Shifman
Short Term (immediately)		• Combine study areas in a state owned by a single company • Carriers with over 100K lines have support determined by FCC model • Freeze per-line support on competitive entry • Determine support based on each ETC's own costs • Extend rate comparability review to rural carriers		
Mid Term (prior to ICC reform)	• USF distributions frozen at 2Q06 levels	• Base support on total cost of rural carriers • Compare embedded costs to available revenues • Federal support based on a percentage of costs in excess of revenues		
State Allocation Mechanism (SAM) (after ICC reform)	• Federal USF provided to each state as a block grant • State determines distribution of support to ETCs, subject to federal guidelines • State may supplement federal support through state-specific assessments • USAC would collect and distribute funds • Federal allocations to states established every five years	• Federal USF provided to each state as a block grant • State determines distribution of support to ETCs, subject to federal guidelines • No distinction between rural and non-rural study areas • The amount of block grants would be adjusted annually for changes in GDP-CPI index • After five years the level of federal support would be adjusted as necessary.	• Federal USF provided to each state as a block grant • State determines distribution of support to ETCs, subject to federal guidelines • No distinction between rural and non-rural study areas • With continuing federal oversight, SAM would not be an impermissible delegation of authority • States would have more discretion to decide specific allocations than in other plans	• Federal USF provided to each state as a block grant • State determines distribution of support subject to federal guidelines • No distinction between rural and non-rural study areas • States are encouraged to create their own USFs, but are not required to do so • USAC would collect and distribute funds
Cost Standard	• Cost model – either forward-looking or embedded • "Average Schedules" could be used as an embedded cost model • Support should be based on statewide average of costs		• FCC guidelines would determine how much each state receives (embedded cost, forward looking cost, Lifeline/Linkup participation)	• Plan would look generally at embedded cost • Plan looks comprehensively at all categories of ILEC cost • Costs would be limited to reduce incentives for waste (e.g., percentage of model costs, "best in class" standards)
Benchmark	• State-specific benchmarks based on household income, cost of living, Lifeline/Linkup eligibility and penetration of supported services		• Benchmark set at 125% of nationwide average urban rate	• "Permanent Benchmark" set at 125% of nationwide average urban rate

State JB Member/Staff Proposals
(continued)

Item	Baum	Gregg	Nelson	Bluhm/Pursley/Shifman
Fund Determination	• Model determines total cost for the state • Rate benchmark is multiplied by total number of lines • Difference between cost and benchmark would be credited to the state by USAC		• FCC guidelines would spell out factors that states could consider in making distributions (embedded cost, forward looking cost, Lifeline/Linkup participation) • Combining study areas and existing programs in a holistic manner allows each state to better control the growth of the total USF	• **Part I Support** ○ Provided to states with high average costs • **Part 2 Support** ○ Provided where state needs to make extraordinary efforts to equalize differences within state ○ If state USF assessment > $2 per line, Part II support makes up difference
Transition Issues			• During three year transition period companies held harmless to support received in 2004 • States may find a carrier should receive less support if earnings are unreasonably high, or service quality is below acceptable levels	• Each year, hold-harmless support to any carrier might decrease by $1 per month per line
Other Provisions	Implementation Schedule 12/05 Joint Board Recommended Decision 6/06 FCC ICC Decision FCC Refers SAM issues to Joint Board 12/06 Joint Board Recommended Decision 6/07 FCC Issues Guidelines for state plans First step of ICC reform 6/08 States submit SAM plans to FCC Second step of ICC reform 6/09 SAM distributions to states begin Third step of ICC reform	• Alaska and other insular areas would be exempted from the requirement to combine study areas	• If a state wanted to extend the transition period for certain small carriers (less than 5K lines), it could do so • The "parent trap" rule (54.305) should be repealed • USF contribution methodology should be expanded through use of a connections, bandwidth or numbers-based approach • All carriers that utilize the PSTN should be required to contribute to the USF	• **Wireless ETC Provisions** ○ No longer funded by "portable" support at wireline levels ○ Separate "Portability Fund" capped at $1B per year ○ Goal to improve wireless coverage, particularly along roads ○ Federal allocation to states, states sub-allocate to CMRS providers using a competitive grant method ○ Fund sunsets after 5 years

Rural Advocacy
(Where have we been?)

- **Multiple voices**
- **Mixed messages**
- **We bring problems – not solutions**
- **Who else supports our positions?**
- **Not good at saying what we want**
- **We need to do a better job of telling our story**
- **Everything is <u>so complicated!</u>**
- **What are our 3 to 5 "fight and die" principles?**

What Must the Rural ILEC Industry Do?

- Focus on impact on the rural consumer
  - Cumulative impact of multiple inter-related proceedings
  - Affordable basic connectivity
- Develop sound advocacy fundamentals
  - Proactive plans to allow us to serve customers
  - Support with compelling facts and data
- Advocate as a united rural industry
  - Overcome our culture of independence and “turf”
  - Learn to “hunt like a pack”
- Educate other rural stakeholders
  - Rural consumer and economic development organizations
  - Investment community
  - Our own employees

The Bottom Line

- Join the Rural Alliance
- The stakes are enormous – the time is short
- Powerful interests are trying to move the process in a direction harmful to RLECs and rural consumers
- Policy makers respond best to broad coalitions
- Chairman Martin will be receptive to well-crafted rural policy solutions
- Together we can be stronger!