

SOUTHWESTERN BELL V. FCC

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The chameleon-like nature of the Internet poses thorny questions for the regulators of communications. The Federal Communications Commission (FCC) has carefully built regulatory regimes over several decades governing the telephone, broadcast and cable industries. In the telecommunications industry, the FCC constructed a private/common carrier¹ regulatory regime, whereby so-called private carriers are exempted from regulation in the interest of promoting competition and innovation. But with the convergence of computers and communications, the FCC must perform intellectual contortions to preserve this regulatory dichotomy.

The recent debate surrounding access charges exemplifies the agency's struggle. In the *Access Charge Reform Order*,² recently upheld in *Southwestern Bell v. FCC*,³ the FCC reaffirmed the exemption given to Internet service providers (ISPs) from paying access charges to local telephone companies. But the status quo system threatens to place inconsistent requirements on competing enterprises as ISPs begin to offer services that directly compete with other regulated carriers—namely IP telephony.⁴ Because the *Southwestern Bell* court did not address this concern for regulatory neutrality, this decision is not the last word on FCC regulation of ISPs. Thus, in addition to examining the Eighth Circuit's analysis, this Note discusses the potential for future regulation of ISPs and argues that

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¹ Title II of the Communications Act of 1934 (the "1934 Act") governs telecommunications carriers that qualify as common carriers. See Communications Act of 1934, ch. 652, 48 Stat. 1046 (codified at 47 U.S.C. § 151 *et seq.*). The 1934 Act does not define "common carrier," but the term has come to mean a carrier that holds itself out as serving all comers. See National Ass'n of Regulatory Comm'rs v. FCC, 525 F.2d 630, 640-42 (D.C. Cir. 1976). Common carriers must be certificated by the FCC, and are subject to various restrictions, requirements and fees.

² *In re Access Charge Reform*, 12 F.C.C.R. 15,982 (1997) [hereinafter *Access Charge Reform Order*]. An agency order sets into place a new regulation or policy. It is issued at the end of a proceeding in which interested parties are given notice of the proceeding and the tentative conclusions of the agency. Parties may then file comments with the agency and may also participate in hearings. The final order must demonstrate that the agency considered all comments and must give a rational basis for its decision.

³ 153 F.3d 523 (8th Cir. 1998).

⁴ IP telephony services enable real-time voice or fax transmission over the Internet (or a private network) using Internet protocols (IP).

technological convergence makes the private/common carrier dichotomy unworkable in the long run.

I. REGULATORY BACKGROUND

A. Access Charges Explained

Until recently, most Americans received both their local and long distance telephone service from one company: the pre-divestiture AT&T. The company built a complex web of cross-subsidies into its rates, which eventually became what we know of as universal service support—subsidi-⁵es in the name of affordable telecommunications for all citizens. One of these cross-subsidies involved above-cost pricing of long distance service to defray the costs of providing local telephone service.⁶

The AT&T divestiture in 1982 forced the FCC to create a new regulatory scheme to ensure that newly created Baby Bells (often referred to as local exchange carriers, or LECs) received adequate revenues to cover their cost of service. Subsequently, the FCC instituted rules that allowed all LECs to levy “access charges” on long distance carriers for the use of their networks to originate and terminate interstate communications.⁷ These charges included implicit subsidies that continued the cross-subsidization of local phone rates through above-cost long distance charges.⁸

But the implicit subsidies supporting universal service posed an obstacle to competition because of the distortions they introduced into the market. Above-cost access charges artificially inflate rates that suppress the demand for long distance services.⁹ The current access charge regime also encourages long distance companies to bypass the local networks when-

5. As first coined by AT&T President Theodore Vail in 1907, this term described his company's goal of a single nationwide interconnected telephone system, owned and operated by AT&T. See THOMAS G. KRATTENMAKER, TELECOMMUNICATIONS LAW AND POLICY 350 (1997). The cross-subsidies were later institutionalized through regulatory policy. See *id.* at 351-52.

6. Policymakers believed that it was necessary to keep local residential rates low so that more people would join the network, thus making the network more valuable for everyone who uses it. See *id.* at 349 n.4.

7. See generally *In re MTS and WATS Market Structure*, 93 F.C.C.2d 241 (1983), *recon.*, 97 F.C.C.2d 682 (1983), *second recon.*, 97 F.C.C.2d 834 (1984).

8. See *Access Charge Reform Order*, *supra* note 2, ¶ 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.”).

9. See *Access Charge Reform Order*, *supra* note 2, ¶ 30.

ever feasible, by contracting with competing providers of access services who could undercut the LECs' prices.¹⁰

When Congress passed the Telecommunications Act of 1996¹¹ (the "1996 Act"), which sought to establish "a pro-competitive and deregulatory national policy framework,"¹² the FCC was again compelled to rethink both universal service and access charges.¹³ The FCC carried out its mandate under the 1996 Act in part through its *Access Charge Reform Order*, where it outlined a process to remove implicit cross-subsidies from interstate access charges.

B. The Private/Common Carrier Dichotomy

ISPs have never been required to pay access charges, even though they use the local networks to provide interstate communications services.¹⁴ The origin of this so-called exemption can be traced back to the *Computer* proceedings, initiated by the FCC in the late 1960s to address computerized communications. In the *Computer I* order, the FCC established a bright line distinction between computers used as a means of providing communication (e.g., computerized switching), and computers providing data processing services transmitted over telephone networks.¹⁵ Only the former category would be subject to common carrier regulation (which includes payment of access charges), and any "hybrid" service that fell between these two categories would be dealt with on a case-by-case basis.¹⁶

10. See HENK BRANDS & EVAN T. LEO, *THE LAW AND REGULATION OF TELECOMMUNICATIONS CARRIERS* 205 (1998). Although bypass means greater competition for access services, it can hurt the public in two ways: by decreasing the funding available for universal service support, and by encouraging inefficient use of the telephone networks. See *Access Charge Reform Order*, *supra* note 2, ¶ 30.

11. Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (codified as amended in scattered sections of 47 U.S.C.).

12. S. Rep. 104-23 at 1 (1995).

13. The 1996 Act specifically required that universal support mechanisms be explicit, and that carriers contribute to universal service support in an equitable and non-discriminatory fashion. See 47 U.S.C. § 254 (d)-(e) (Supp. II 1997).

14. See, e.g., *In re* Amendments of Part 69 of the Commission's Rules Relating to Enhanced Service Providers, 3 F.C.C.R. 2631, ¶ 7 (1988) ("Enhanced service providers, like facilities-based interexchange carriers and resellers, use the local network to provide interstate services.") [hereinafter *ESP Exemption Order*].

15. See generally *In re* Regulatory and Policy Problems Presented by the Interdependence of Computer and Communication, 28 F.C.C.2d 267 (1971), *aff'd in part sub nom.*, *GTE Serv. Corp. v. FCC*, 474 F.2d 724 (2d Cir. 1973) [hereinafter *Computer I*].

16. See *id.* ¶ 27.

This strategy soon proved unworkable once the FCC faced a flood of case-by-case determinations.¹⁷ In reaction to the inadequacy of the *Computer I* categories, the FCC initiated the *Computer II* proceeding.¹⁸ The FCC made two important decisions in this proceeding. First, the FCC revised the analytic basis for its classification scheme. Rather than distinguishing services based on how they employed computer processing, the FCC created a new scheme that focused on the market position of a service. The new scheme divided communications services into two categories: "basic" and "enhanced."¹⁹ In a nutshell, basic service providers offered pure transmissions capacity,²⁰ while enhanced service providers offered capacity plus computerized processing of information content.²¹

Second, the FCC intentionally defined the scope of the enhanced service provider status broadly so as to avoid future case-by-case determinations.²² The agency accomplished this by defining all hybrid services—those which offer both communications transmission capacity and information services—as enhanced services. The FCC reasoned that no regulatory framework could rationally distinguish and classify hybrid services, and any attempt to do so would result in an "unpredictable or inconsistent scheme of regulation."²³ This in turn could lead to market distortions, such as providers structuring their services to avoid regulation.²⁴

With the 1996 Act, Congress introduced yet another classification scheme. Under this new scheme, a "telecommunications" service, like the

17. See Robert Cannon, *The Internet at the Federal Communications Commission: Cybersnauts Versus Ma Bell*, Address at INET '97, Annual Meeting of the Internet Society (June 1997) <<http://www.cybertelecom.org/memos/inet97.htm>>.

18. See *In re* Amendment of Section 64.702 of the Commission's Rules and Regulations, 77 F.C.C.2d 384, ¶¶ 20, 103 (1980) [hereinafter *Computer II*].

19. See *id.* ¶ 5.

20. See *id.* ¶ 93 ("A basic transmission service is one that is limited to the common carrier offering of transmission capacity for the movement of information.").

21. Enhanced services are services 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." 47 C.F.R. 64.702(a).

22. See, e.g., *Computer and Communications Indus. Assoc. v. FCC*, 693 F.2d 198, 209 (D.C. Cir. 1982) ("A policy of identifying regulable enhanced services would, in the Commission's view, be a reversion to the futile *Computer I* case-by-case approach that inhibited technological innovation and diverted Commission resources from more beneficial activities.").

23. *Computer II*, *supra* note 18, ¶¶ 107-08. Therefore, the FCC determined that providers would be deemed enhanced services for regulatory purposes even if the "basic" aspect of a given hybrid service dominated. See *id.* ¶ 114.

24. See *id.* ¶ 111.

basic category before it, involves pure transmission services²⁵ and may be regulated as a common carrier.²⁶ By contrast, an “information service” provider offers the “capability for generating, acquiring, storing, transforming, processing, retrieving, utilizing, or making available information via telecommunications....”²⁷ The FCC has interpreted these two classifications to be mutually exclusive, like basic and enhanced service classifications before them,²⁸ and has also confirmed that information service providers are exempt from common carrier regulation.²⁹ Thus, the FCC treats the telecommunications/information service framework as yet another private/common carrier dichotomy.

C. The ESP Exemption As Applied to ISPs

Internet access has always been deemed an enhanced service, and more recently an information service.³⁰ ISPs are thus treated like end users of telecommunications services for regulatory purposes; they purchase services from the LECs under tariffed intrastate rates even though the phone calls that ISPs receive and transfer for their own customers (to connect to the Internet) may cross state boundaries.³¹

The FCC has acknowledged that the private carrier status enjoyed by enhanced service providers (ESPs) can lead to unfair results. Because of the exemption given to ESPs from paying access charges, for example, other interstate service providers that pay access charges must cover a disproportionate share of the local exchange costs that access charges fund.³²

25. See 47 U.S.C. § 153(48) (Supp. II 1997) (“The term ‘telecommunications’ means the transmission, between or among points specified by the user, of information of the user’s choosing, without change in the form or content of the information as sent and received.”).

26. See *id.* § 153(49) (stating that a telecommunications carrier “shall be treated as a common carrier ... only to the extent that it is engaged in providing telecommunications services....”); § 153(51) (“The term ‘telecommunications service’ means the offering of telecommunications directly to the public, or to such classes of users as to be effectively available directly to the public, regardless of the facilities used.”).

27. *Id.* § 153(41).

28. See, e.g., *In re Federal-State Joint Board on Universal Service*, 13 F.C.C.R. 11,501, ¶ 13 (1998) [hereinafter *Report to Congress*].

29. See *id.*

30. See KEVIN WERBACH, DIGITAL TORNADO: THE INTERNET AND TELECOMMUNICATIONS POLICY 32-33 (FCC Office of Plans and Policy Working Paper No. 29, 1997).

31. See *Access Charge Reform Order*, *supra* note 2, ¶ 342.

32. See *ESP Exemption Order*, *supra* note 14, ¶ 2 (“To the extent that [enhanced service providers] are exempt from access charges, the other users of exchange access pay a disproportionate share of the costs of the local exchange that access charges are designed to cover.”).

But the agency has consistently balanced its concern for regulatory neutrality against its interest in fostering competition in the marketplace for enhanced services. While it has reviewed the temporary ESP exemption on three separate occasions since the *Computer II* decision, each time it retained the exemption out of concern that change could harm the development of a competitive ESP industry.³³

In the *Access Charge Reform Order*, released May 7, 1997, the FCC again upheld the ESP exemption—this time specifically for ISPs. As in the earlier proceedings, the FCC cited concern that imposing access charges on ISPs could disrupt competition in the “still-evolving information services industry.”³⁴ Additionally, the FCC expressed doubt that LECs would be harmed by the exemption.³⁵

II. THE EIGHTH CIRCUIT'S DECISION

In *Southwestern Bell v. FCC*, both local and long distance telephone companies challenged portions of the *Access Charge Reform Order*.³⁶ But only LECs challenged the FCC's refusal to extend the access charge regime to ISPs. The bottom line to all LEC arguments is that failure to extend access charges to ISPs imposes a financial burden on them. This section summarizes the court's analysis.

A. Exemption Does Not Violate The 1996 Act

The Eighth Circuit first held that the FCC did not discriminate in favor of ISPs when it refused to impose access charges on this group.³⁷ Section 254(e) of the 1996 Act requires that any new mechanism for universal service support be nondiscriminatory.³⁸

33. See *In re MTS and WATS Market Structure*, 97 F.C.C.2d 682, ¶¶ 75-90 (1983); *ESP Exemption Order*, *supra* note 14, ¶ 13; *In re Amendments of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Supplements for Open Network Architecture Policy and Rules Concerning Rates for Dominant Carriers*, 6 F.C.C.R. 4524, ¶ 60 (1991). See also WERBACH, *supra* note 30, at 50-51.

34. *Access Charge Reform Order*, *supra* note 2, ¶ 343.

35. See *id.* ¶¶ 345-347.

36. The FCC's rulemaking authority over common carriers is subject to the procedural rules of the “notice and comment” provisions of the Administrative Procedures Act (APA). See 5 U.S.C. § 551 (1994). A final rulemaking is subject to judicial review in any federal court of appeals. See 47 U.S.C. § 402(a) (Supp. II 1997). The court may test an FCC rule for consistency with statutory guidelines and applies an “arbitrary and capricious” standard of review. 5 U.S.C. § 706(A)(2)(1994).

37. See *Southwestern Bell v. FCC*, 153 F.3d 523, 541 (8th Cir. 1998).

38. See 47 U.S.C. § 254(e) (Supp. II 1997).

Following *Competitive Telecommunications Ass'n v. FCC (CompTel II)*,³⁹ the court noted that "even where two different sets of carriers seek to use LEC network services and facilities that might be 'technologically identical,' the services and facilities provided by the LEC are 'distinct' if the carriers are making different uses of them."⁴⁰ Because the court agreed with the FCC that ISPs do not use a LEC's network in the same manner or for the same purposes as other customers who are subject to access charges, it held that the FCC's treatment of ISPs was not discriminatory.⁴¹

Additionally, the Eighth Circuit rejected petitioners' claim that the ISP exemption violates the Act's requirement that universal service support mechanisms be explicit.⁴² Because a portion of an ISP's traffic may be interstate in nature, exempting an ISP from paying any access charges for interstate traffic could be construed as an implicit subsidy. Although the Act requires the FCC to implement a plan for eliminating implicit subsidies, the Eighth Circuit held that the 1996 Act does not mandate their immediate elimination.⁴³

B. The FCC Appropriately Exercised Its Forbearance Authority

The Eighth Circuit next addressed the claim that the FCC impermissibly neglected its duty by requiring state regulatory commissions to recover *interstate* costs imposed on LECs by ISPs.⁴⁴ The court noted that the facilities used by ISPs are "jurisdictionally mixed;" they carry both interstate and intrastate traffic.⁴⁵ Since some of the traffic an ISP carries may be exclusively intrastate, and therefore outside the FCC's jurisdiction, the court ruled that the FCC acted reasonably when it chose to exercise its forbearance authority rather than attempt to separately regulate a portion of an ISP's communications traffic.⁴⁶ Moreover, the court reasoned that since the FCC has opened a Notice of Inquiry⁴⁷ to investigate the possibility of additional regulations on ISPs, LECs have another avenue in which to press their concerns.⁴⁸

39. 117 F.3d 1068 (8th Cir. 1997).

40. *Southwestern Bell*, 153 F.3d at 542 (quoting *Competitive Telecommunications*, 117 F.3d at 1073).

41. *See id.*

42. *See id.*

43. *See Southwestern Bell v. FCC*, 153 F.3d 523, 536-37 (8th Cir. 1998).

44. *See id.* at 542-43.

45. *See id.* at 543 (quoting FCC Brief at 79).

46. *See id.* at 543-44.

47. A Notice of Inquiry (NOI) is a proceeding before the FCC in which the agency essentially concedes that it needs additional information before it can act.

48. *See Southwestern Bell v. FCC*, 153 F.3d 523, 543 (8th Cir. 1998).

C. The Order Does Not Depart from Prior Ratemaking Policy

The Eighth Circuit lastly ruled that the FCC's order did not abandon its policy of cost-based ratemaking by further extending the access charge exemption for ISPs.⁴⁹

The LECs cited *Competitive Telecommunications Association v. FCC*⁵⁰ (*CompTel I*) to support their argument that ISPs should pay access charges.⁵¹ In *CompTel I*, the D.C. Circuit struck down a decision by the FCC extending a set of transitional rules for setting access charges that favored small long distance carriers over incumbent long distance companies (i.e., AT&T). By designing a two-tiered rate structure, where the rates paid by smaller carriers were not based on the actual cost of providing the service, the FCC stated that its purpose was to encourage competition in the long distance market.⁵² The FCC extended these "transitional" rates for thirteen years, justifying the delay first as a grace period to allow small carriers to prepare for higher rates, and later due to a lack of sufficient cost information.⁵³ Despite these justifications, the D.C. Circuit held that the FCC had not adequately explained why the transitional rates were still necessary.⁵⁴

The Eighth Circuit distinguished *CompTel I* from the instant case on its facts. In *CompTel I*, the FCC had imposed differential rates for carriers, and extended them without reasonable justification, even though both types of carriers provided essentially the same services. Because the FCC has determined that ISPs utilize the local networks differently than do long distance providers, the court deemed that that reason alone justified differential treatment of ISPs and long distance companies.⁵⁵ Moreover, the court noted that the FCC has reasonably exercised its discretion in excluding ISPs from the current access charge regime.⁵⁶

III. ANALYSIS OF SOUTHWESTERN BELL V. FCC

Even if the LECs did not make a strong enough case for extending access charges to ISPs because of their alleged revenue shortfalls, there is still the more fundamental issue of regulatory neutrality. Failure to require

49. See *id.* at 543-44.

50. 87 F.3d 522 (D.C. Cir. 1996).

51. This case is unrelated to *CompTel II*, discussed *infra* Part III.A.

52. See *Competitive Telecommunications*, 87 F.3d at 530.

53. See *id.* at 530-31.

54. See *id.* at 526.

55. See *Southwestern Bell v. FCC*, 153 F.3d 523, 544 (8th Cir. 1998).

56. See *id.* at 541.

ISPs to pay access charges affects other stakeholders beyond the LECs. Yet the court fails to address this issue, in part due to the limited scope of the Order itself, and in part owing to its own erroneous interpretation and application of prior caselaw.

A. The FCC's Narrow Focus

The FCC made a strategic decision to limit discussion in the *Access Charge* proceeding to the narrow question of whether to allow local telephone companies to charge ISPs interstate access charges.⁵⁷ The effect of this choice was threefold. First, this choice restricted debate to LEC concerns of undercompensation for network traffic. While these concerns are legitimate, the LECs' arguments supporting imposition of interstate access charges on ISPs were less than compelling. The LECs lacked substantial evidence to support their claims of network overcongestion.⁵⁸ The LECs also have another forum in which to air their grievances: state public utility commissions.⁵⁹

Second, the choice focused the FCC's analysis on the manner in which ISPs use the local telephone network rather than the services that ISPs provide.⁶⁰ Although the manner in which an ISP uses the local network impacts the costs that a LEC incurs, cost-coverage by the LECs is not the only reason to reconsider the access charge exemption. If ISPs (or a subset thereof) use the local networks to offer services that compete with regulated carriers (i.e., interstate voice communications), then arguably the exemption gives ISPs an unfair advantage. This was essentially the argument made by America's Carriers Telecommunication Association (ACTA), a trade group of small and mid-sized long distance companies, who petitioned the FCC to regulate IP telephony providers as common carriers.⁶¹

57. See *In re Access Charge Reform*, 11 F.C.C.R. 21,354, ¶ 283 (1996) (Access Charge Reform Notice of Proposed Rulemaking).

58. Although the LECs could point to access charges as a source of revenue, they were unable to demonstrate that the incremental revenue attributable to Internet usage, such as higher demand for second lines, use of dedicated lines by ISPs, and even revenues from their own ISP services, was insufficient to cover their cost of service to ISPs. Moreover, the evidence did not show any service outages attributable to Internet usage. See *Access Charge Reform Order*, *supra* note 2, ¶¶ 346-47.

59. ISPs lease phone lines from LECs to receive calls from their dial-up customers at the same tariffed rates paid by end user business customers. See discussion *infra* I.C. Because these connections are jurisdictionally intrastate, the tariff rates are overseen by state public utilities commissions.

60. See *Access Charge Reform Order*, *supra* note 2, ¶ 345 (commenting that "it is not clear that ISPs use the public switched network in a manner analogous to IXC's").

61. See America's Carriers Telecommunication Association, *In re Provision of Interstate and International Interexchange Telecommunications Service Via the "Internet"*

Finally, the choice allowed the FCC to employ a literal-minded definition of interstate access charges. The agency presumed for the purposes of this proceeding that imposition of access charges meant employing the *existing regime*⁶²—one that is still weighed down by the legacy of cross-subsidies. The FCC then concluded that it made little sense to extend an economically inefficient regime on an additional class of customers for access service.⁶³ Here the FCC's logic seems to prove too much. If everyone agrees that the current access charge regime is inefficient, and therefore including ISPs would not promote the public interest, why does the FCC pose the question so narrowly if not to summarily dismiss it?

Even if the FCC's reasoning in the Order was sound, the narrow focus is troublesome if only because it seems to have predetermined the result—furtherance of the regulatory status quo for ISPs.⁶⁴ By separating the ISP issue from the rest of access charge reform, the agency purposefully delayed discussion of regulatory neutrality.

B. The Court's Narrow Application of the *CompTel* Cases

For its part, the Eighth Circuit declined to widen the focus in *Southwestern Bell* through its own analysis. Although the court must conduct its inquiry within the deferential “arbitrary and capricious” standard of review,⁶⁵ that standard is not uncritical.⁶⁶ The *CompTel* cases offered the

by Non-Tariffed, Uncertified Entities (Mar. 8, 1996) <http://www.fcc.gov/Bureaus/Common_Carrier/Comments/actapet.html>. While the FCC realized that it would need to address the merits of this argument at some point, the agency specifically excluded discussion of this issue for a later proceeding, which it has yet to initiate. See *Access Charge Reform Order*, *supra* note 2, ¶ 316 n.438.

62. See *Access Charge Reform Order*, *supra* note 2, ¶ 343 (noting that the agency tentatively concluded in its Notice of Proposed Rulemaking that information service providers should not be required to pay interstate access charges *as currently constituted*).

63. See *id.* ¶¶ 345, 347.

64. Granted, the FCC did institute a Notice of Inquiry on the regulatory treatment of information services. But the proceeding was opened in late December 1996, 9 months after the ACTA petition first officially raised the issue of regulatory asymmetry with regard to IP telephony. By the time the Eighth Circuit reviewed the *Access Charge Reform Order*, the agency still had not released a tentative rulemaking on the subject.

65. See *supra* note 42.

66. See, e.g., *California v. FCC*, 905 F.2d 1217, 1230 (9th Cir. 1990) (“While our standard of judicial review is highly deferential, it may not be uncritical. Under the APA, an agency’s discretion is not boundless, and we must satisfy ourselves that the agency examined the relevant data and articulated a satisfactory explanation for its actions based upon the record. We must find agency action to be in violation of the APA if the agency has ‘failed to consider an important aspect of the problem’ or has ‘offered an explanation for its decision that runs counter to the evidence before the agency.’”) (citations omitted).

court two contexts in which to raise the issue of regulatory neutrality. But the court's superficial reading of these cases precluded this.

1. *CompTel II and Discriminatory Impact*

In *CompTel II*, the court upheld an FCC interpretation of a statutory term that had the effect of permitting local telephone companies to charge different rates to different types of carriers for the same service.⁶⁷ The *CompTel II* court reasoned that while the two types of carriers may have been purchasing technologically identical services from LECs, the services were nevertheless distinct if the carriers were using the service to provide *different* communications services to their own customers.⁶⁸ The *Southwestern Bell* court assumed that the situation in the present case was similar, and used this similarity to bolster its holding that the exemption does not discriminate in favor of ISPs.⁶⁹

The Eighth Circuit's cursory analysis is problematic because it fails to account for the existence of services offered by ISPs that compete with regulated providers who pay access charges—namely IP telephony providers. If a subset of ISPs provide services that are the same, from a customer's perspective, as regulated services, then differential treatment may indeed have a discriminatory impact.⁷⁰

2. *CompTel I and Interim Rules*

In reviewing agency actions, the courts presume that an agency's decision is reasonable if it merely furthers a longstanding policy. This explains the Eighth Circuit's emphasis on the fact that the exemption had lasted for 14 years.⁷¹ But the holding in the *CompTel I* case directly challenges this

67. See *Competitive Telecommunications Ass'n v. FCC*, 117 F.3d 1068, 1073 (8th Cir. 1997).

68. See *id.*

69. See *Southwestern Bell v. FCC*, 153 F.3d 523, 542 (8th Cir. 1998).

70. In fact, the *CompTel II* court offered support for this point when it noted that there was *no rate differential* between the two types of carriers at odds in the case when they provided the same service to customers. See *Competitive Communications*, 117 F.3d at 1073 (offering that if a long distance carrier desires exchange access in order to offer the same service as a competitive local exchange carrier, there is *no rate differential*). A functional equivalency evaluation of long distance telephony services offered by long distance carriers and ISPs may reveal that there are still sufficient differences between the two services, from a customer's vantage point, to warrant differential treatment. But the court did not explore this line of analysis. See James W. Olson & Gregory F. Intocchia, *The Federal Communications Commission Has Addressed Whether Internet Telephony Providers Must Pay Access Charges, As Well As Other Internet Issues*, NAT'L L.J., July 13, 1998, at B4 (discussing the FCC's functional equivalency doctrine).

71. See *Southwestern Bell*, 153 F.3d at 541.

premise in the case of *interim* rules. The *CompTel I* court held that it is unreasonable for an agency to indefinitely extend an interim scheme without adequate justification.⁷² Since the exemption policy adhered to by the FCC in the instant case, by its own admission, is an interim one, the court should have dealt with the *CompTel I* precedent more thoroughly.

A closer analysis reveals that the situations in *CompTel I* and *Southwestern Bell* are similar. Both disputes are fundamentally concerned with balancing regulatory neutrality against an interest in fostering the development of competitive markets. At dispute in *CompTel I* was an access charge for a certain type of access service levied on all long distance carriers, regardless of the type of service a carrier purchased from the LEC.⁷³ AT&T argued that the charge essentially subsidized the costs for a type of service used primarily by smaller long distance carriers.⁷⁴ The FCC justified the interim rate structure as a necessary measure to ensure competition in this market, despite its disparate impact.⁷⁵ Similarly, a key dispute in *Southwestern Bell* is whether the exemption gives ISPs a subsidy. Just as in *CompTel I*, the FCC argued in the *Access Charge Reform Order* that the exemption is necessary to protect competition.⁷⁶

Another important similarity is that in both cases the FCC continued to extend allegedly interim regimes without making any future commitment to replace them with permanent rules. This sort of delay led the *CompTel I* court to hold that the FCC failed to provide a reasoned explanation for its continued use of an interim rate structure.⁷⁷ Although the court allowed that the interim rates "may have been a defensible compromise of two potentially conflicting objectives"⁷⁸ it recognized that when an agency is allowed to use interim rules indefinitely, by deferring to an unspecified, discretionary future review, accountability is sacrificed.⁷⁹

72. See *Competitive Telecommunications Ass'n v. FCC*, 87 F.3d 522, 532 (D.C. Cir. 1996).

73. See *id.*

74. See *id.*

75. See *id.* at 531-32.

76. See *supra* note 34 and accompanying discussion in text.

77. That the FCC issued a related Notice of Inquiry (NOI) requesting additional information on ISPs is not enough to make the FCC's choice reasonable. An NOI only facilitates information-gathering by the agency from industry stakeholders and interested parties; there is no duty to act on that information under a set timeline—the agency may even choose not to even act on it at all.

78. *Competitive Telecommunications Ass'n v. FCC*, 87 F.3d 522, 532 (D.C. Cir. 1996).

79. See *id.* at 531.

Under either application of the *CompTel* precedents discussed above, the Eighth Circuit could have granted the parties' petition for review of the ISP portion of the decision. A remand might well have forced the FCC to address the regulatory neutrality issue, since it would have had to explain more thoroughly why ISPs should not pay some sort of access charge.

IV. REGULATION OF ISPS ON THE HORIZON?

A. Recent FCC Policy Statements

Despite the outcome in *Southwestern Bell*, recent events suggest that the FCC is moving closer to regulating ISPs. Two major (unofficial) policy statements this year provide insight into the current FCC thinking on regulation of ISPs.

The first is the FCC's *Report to Congress*,⁸⁰ delivered on April 10, 1998. Congress directed the agency to report on its interpretation of certain provisions of the 1996 Act dealing with universal service in a recent Appropriations Act.⁸¹ In its Report, the FCC defended its interpretation of "telecommunications service" and "information service" as mutually exclusive categories that fundamentally carry forward the old basic/enhanced dichotomy.⁸² But the agency also made a significant concession to its critics. It observed that some Internet-based services—including a certain form of IP Telephony—more closely resemble traditional basic transmissions offerings than information services.⁸³

By conceding that certain Internet-based services may fall under the "telecommunications service" category, the FCC indicated that it would consider regulating some ISPs in the future. The agency justified this policy change by stating that its rules "should not create anomalies and loopholes that can be exploited" by those seeking to avoid regulation.⁸⁴ What form that regulation might take is still a mystery. The FCC indicated in its

80. See *supra* note 28.

81. See Departments of Commerce, Justice, and State, The Judiciary, and Related Agencies Appropriations Act, 1998, Pub. L. No. 105-119, § 623, 111 Stat. 2440, 2521 (1998).

82. See *Report to Congress*, *supra* note 28, ¶ 13.

83. See *id.* ¶ 3 (acknowledging that "[t]he record currently before us suggests that certain of these [Internet-based] services lack the characteristics that would render them 'information services' within the meaning of the statute, and instead bear the characteristics of 'telecommunications services'").

84. *Id.* ¶ 4.

report that it would evaluate Internet services on a case-by-case basis,⁸⁵ but no cases have yet been initiated.⁸⁶

The second statement came in the form of a white paper written by Barbara Espin, a senior FCC staff member, on the regulatory problems created by Internet service over the cable TV network.⁸⁷ As with telecommunications, technological convergence in the cable industry is forcing the FCC to consider whether cable-based Internet services should be subject to the rules governing cable systems. Released in September 1998, the *Internet Cable* white paper marks a significant policy shift from the *Report to Congress*. Espin opines that in the not-so-distant future a single provider will offer customers cable broadcast services, telecommunications and information services in digital format over the same network.⁸⁸ Therefore, regardless of the FCC's previous stance, old regulatory categories "must necessarily collapse of their own weight in the digital communications world of tomorrow."⁸⁹

Espin further offers that the 1996 Act gives the FCC a way out of its dilemma through the creation of a new regulatory framework based on the statutory category of "advanced telecommunications capability." Section 706 of the 1996 Act, which introduces this term, states:

The Commission and each state commission with regulatory jurisdiction over telecommunications services shall encourage the deployment ... of advanced telecommunications capability to all Americans ... by utilizing, in a manner consistent with the public interest, convenience and necessity, price cap regulation, regulatory forbearance, measures that promote competition in the local communications market, or other regulating methods that remove barriers to infrastructure investment.⁹⁰

85. *See id.* ¶ 55 ("We do not believe...that it is appropriate to make any definitive pronouncements in the absence of a more complete report *focused on individual service offerings.*") (emphasis added).

86. But some LECs have taken the report as a sign that they may begin charging some IP telephony providers access charges. *See, e.g.,* Susan O'Keefe, *Access Fees for IP Calls?*, TELECOMMUNICATIONS, June 1998, at 18.

87. *See* BARBARA ESPIN, INTERNET OVER CABLE: DEFINING THE FUTURE IN TERMS OF THE PAST (FCC Office of Plans and Policy Working Paper No. 30, 1998).

88. *See id.* at 117.

89. *Id.*

90. 47 U.S.C. § 157(a) (Supp. II 1997).

Espin suggests that the FCC could interpret Internet services to fall under the “advanced telecommunications capability” category because it is defined “without regard to any transmission media or technology.”⁹¹

Both of these policy statements are trial balloons from the FCC on the future course of regulation in the face of convergence. The *Report to Congress*, on the one hand, suggests a status quo approach: the agency would merely fine tune its classification of certain services within the existing dichotomy as necessary to avoid blatant attempts to circumvent regulation. The *Internet Cable* white paper, on the other hand, seeks a more revolutionary outcome in the creation of a new regulatory regime.

B. The (Practically Nonexistent) Threat of Common Carrier Regulation of ISPs

If the FCC decides to retain the private/common carrier dichotomy, but reclassify certain ISPs as “telecommunications carriers,” as its *Report to Congress* suggests, a threshold consideration will be the extent of regulation imposed. Arguably, classification of a carrier as a telecommunications carrier under the 1996 Act would presumptively subject that carrier to the full panoply of common carrier regulation.⁹² The question then becomes whether regulatory neutrality requires imposition of the full weight of common carrier regulation. Probably not, for two reasons.

First, such a decision would contradict the deregulatory trend in telecommunications witnessed since the break-up of AT&T, which both Congress and the FCC believe promotes the public interest. Imposition of common carrier regulation arguably goes against the agency’s mandate in the 1996 Act to establish a deregulatory national policy framework. Further, the FCC has shown its willingness to remove asymmetric regulatory schemes when it can *reduce* the regulatory responsibilities of carriers.⁹³ But the agency is understandably reluctant to impose a mature regulatory regime, originally designed for monopolies, on new market entrants for fear that overregulation will stifle competition and innovation.

Second, the arguments offered by stakeholders (other than the LECs) for imposing full common carrier regulation do not appear sufficiently strong to overcome the FCC’s predisposition against regulating ISPs. Long distance carriers, for example, argue that ISPs which provide competing services have an unfair competitive advantage because they are not

91. *Id.* § 157(c)(1).

92. *See supra* note 28.

93. *See generally In re AT&T*, 11 F.C.C.R. 3271 (1995) (deregulating AT&T by reclassifying it as a non-dominant carrier, which placed it on a “level playing field” with other long distance carriers such as Sprint and MCI).

subject to the same level of regulation.⁹⁴ While this level playing field argument has a certain superficial appeal, the FCC will not impose regulations on a new group of market participants for this reason alone. The FCC must be concerned with protecting the public from market failures, rather than protecting competitors from competition.

A stronger argument voiced by beneficiaries of universal service subsidies is that continuation of the exemption from access charges for IP telephony in particular could harm universal service funding.⁹⁵ The fear is that new market entrants will engage in regulatory arbitrage: they will seek to exploit regulatory asymmetry by offering the functional equivalent of a regulated service, but do so in a way that takes advantage of loopholes. Universal service funding could be impacted if enough customers bypass providers who pay access charges. But as the FCC notes in its *Report to Congress*, the relative size of the Internet access industry is so small compared to long-distance industry that the impact of excluding ISPs from the universal service funding base is not significant.⁹⁶ And even if bypass became an issue, there is a strong argument for attacking the problem in a more narrowly tailored fashion. For example, the agency could impose some sort of access charge on IP telephony providers if the occurrence of bypass rises to a level where universal service is threatened. Commentators within the FCC and outside observers have even hinted that the destabilizing effects of bypass may actually work to *promote* the public interest by driving down telephone rates.⁹⁷

In sum, there is little chance that the FCC will choose to impose the full responsibilities of common carrier regulation on any ISP—even IP telephony providers, who currently pose the closest case for common carrier regulation. A more plausible scenario, should the FCC choose to re-

94. See, e.g., ACTA petition, *supra* note 61.

95. See Senator Ted Stevens, *The Internet and the Telecommunications Act of 1996*, 35 HARV. J. ON LEGIS. 5, 7 (1998) (arguing that “[t]he FCC’s disparate treatment of hybrid services and its flawed interpretation of the definitions in the 1996 Act will result in an unnatural migration of telecommunications traffic to preferentially treated communications mediums, undermining the goal of universal service.”).

96. See *Report to Congress*, *supra* note 28, ¶ 97 (comparing the \$5 billion dollars in retail revenues made by Internet access providers in 1997 to the \$100 billion made by long-distance carriers during the same period). See also Olson & Intoccia, *supra* note 70 (reporting that optimistic estimates of IP telephony growth suggest that the service will constitute only 2% of the total long distance telephony revenues by 2001).

97. See, e.g., WERBACH, *supra* note 30, at 46 (suggesting that new technologies like IP telephony are valuable “because of the potential competitive pressure they may exert on incumbent providers”); Robert M. Frieden, *Dialing for Dollars: Should the FCC Regulate Internet Telephony?*, 23 RUTGERS COMPUTER & TECH. L.J. 47, 68-9 (1997) (analogizing bypass to “self help”).

tain its private/common carrier dichotomy, would be to recategorize some ISPs as telecommunications carriers as necessary to avoid egregious forms of regulatory arbitrage. The agency could then exercise its forbearance authority under the 1996 Act,⁹⁸ which allows it to refrain from imposing most (if not all) of the regulatory rules governing common carriers.

This sort of piecemeal regulation would also seem to satisfy the demands of regulatory neutrality. Regulatory neutrality does not necessarily require that all carriers receive exactly the same treatment. Rather, it dictates that regulations should not unfairly burden one type of service or technology to the point that customer choice is distorted. Moreover, the FCC is steadily removing requirements from regulated carriers, witnessed by the agency's move to reclassify AT&T as a non-dominant carrier,⁹⁹ and detariff long-distance carriers.¹⁰⁰ In the words of one commentator, those who call for full common carrier regulation seek a contrarian result in the present deregulatory climate.¹⁰¹

C. *Ad Hoc* Decisionmaking and the Threat of Arbitrary Classifications

Even though the forbearance authority allows the FCC to pick and choose which regulations to impose on ISPs deemed "telecommunications carriers," this status quo solution is far from perfect. Continued reliance on the private/common carrier dichotomy poses a significant policy risk in the face of technological convergence. That risk is that case-by-case decisionmaking will inevitably lead to the problems faced by the FCC after the *Computer I* proceeding—i.e. difficult classification reviews.¹⁰² The FCC's new approach, according to the Report, is to categorize hybrid Internet-based services on an *ad hoc* basis, this time using a functionality analysis from the perspective of the user.¹⁰³ But the functionality analysis will not eliminate the threat of arbitrary distinctions.

98. Section 10 of the 1996 Act provides that the FCC may forbear from applying any provision of the 1934 Act, the 1996 Act, or existing regulations, if it determines that forbearance is in the public interest, and is not necessary to ensure just and reasonable rates and protection of consumers. See 47 U.S.C. § 160(a) (Supp. II 1997). Moreover, if the FCC determines that forbearance will promote competition, this goal is presumptively deemed in the public interest. See 47 U.S.C. § 160(b).

99. See generally *In re AT&T*, 11 F.C.C.R. 3271 (1995).

100. See generally *In re Policy and Rules Concerning the Interstate Interexchange Marketplace, Implementation of Sec. 254(g) of the Communications Act of 1934, as amended*, 11 F.C.C.R. 7141 (1996) (Notice of Proposed Rulemaking).

101. See Frieden, *supra* note 97, at 68.

102. See *infra* Part I.B.

103. See *Report to Congress, supra* note 28, ¶ 86.

Take the example of IP telephony. Applying a functionality test to IP telephony led the FCC to conclude in its Report that a specific type of service may warrant regulation: *phone-to-phone* IP telephony.¹⁰⁴ A customer using this type of service perceives only that she is making a phone call using a normal phone; she is probably unaware of the information service element of the service—the transformation of voice communications into IP packets at a remote gateway. By contrast, the FCC analogized *computer-to-computer* IP telephony, where an end user employs software or hardware to convert voice communications to IP packets,¹⁰⁵ to the sale of telephone equipment (which does not require carrier regulation).¹⁰⁶ Although the end user in the second case is making a phone call over the Internet, the ISP itself does not perform the conversion. To the FCC, this means that the ISP in this second case is not providing *telecommunications* because it is not marketing a service that is perceived by the customer as pure transmission capacity.

This functional approach will not do the work the FCC envisions. It will not get rid of loopholes, and more importantly it will not provide a natural break between telecommunications services and information services. Aided by changes in technology, ISPs will simply develop new ways to avoid fees. Commissioner Furchgott-Roth provided just such an example in his dissent to the Report: a new breed of phones that convert voice communications to IP packets.¹⁰⁷ To the end user, the equipment will look like a normal phone, yet to the FCC the equipment will be a “computer” because the phone does not function as a traditional phone does (i.e., converting sound to analog waves).¹⁰⁸ Thus, the ISP that provides an Internet connection to a customer using one of these hypothetical computer phones would still be classified as an information service provider, even though customers of both types of ISP services are using the Internet to make phone calls.

The *Report to Congress* suggests that the FCC would justify this distinction on the fact that the ISP providing phone-to-phone IP telephony is holding itself out as a provider of pure transmission services, in competi-

104. A “phone-to-phone” IP telephony provider offers voice telephony service by using a local gateway to transform the communication from an analog signal to IP packets. *See id.* ¶ 83. The packets are sent over the Internet (or a private IP network), and then terminated at the receiving end. *See id.*

105. *See id.*

106. *See id.* ¶¶ 86-7 (analogizing sellers of IP telephony software or hardware to vendors of PBX equipment).

107. *See Report to Congress, supra* note 28, Dissenting Statement of Commissioner Furchgott-Roth, at 138.

108. *See id.*

tion with traditional phone companies.¹⁰⁹ But what if an ISP markets voice services by selling a package that includes a computer phone described by Commissioner Furchgott-Roth? That provider would also seem to be holding itself out as a provider of telecommunications. Essentially, the FCC's argument is that an ISP marketing an integrated services package including voice services (through the use of a special phone provided by the ISP) would still be an information provider because the service could also be used by the customer to surf the web. This may be so, but making such a fine-line distinction brings the FCC closer to drawing arbitrary lines in order to preserve an aging regulatory framework ill-suited to integrated service offerings.

D. Towards a New Regulatory Framework

Although the FCC is presumably aware of this risk, its desire to preserve the private/common carrier dichotomy is clearly evident in its *Report to Congress*. The status quo approach will prove inadequate in the long run, however, because technological convergence will continue to push against the categories.

A better solution is found in casting aside the old regulatory categories. By making liberal use of the "advanced telecommunications capability" category, as the *Internet Cable* white paper suggests, the FCC could free itself from the intellectual contortions it must make to continue a regulatory regime based on pure transmission capacity versus information services. The new category is defined in terms of capabilities rather than services, so it can encompass the new integrated services that are problematic in an either/or regulatory regime. Therefore, this solution still provides the FCC with the flexibility to pick and choose regulatory requirements as the need arises, but without the problem of arbitrary decision-making.

Moreover, this solution answers some of the concerns raised by the FCC in its *Report to Congress* regarding the creation of a new regulatory regime. Prior to the release of the *Internet Cable* white paper, the FCC rejected a solution offered by commentators and critics that the agency widen the scope of the telecommunications carrier classification to include all hybrid entities and services whose service offerings meet the statutory definition of telecommunications.¹¹⁰ Proponents of this option argued that

109. See *id.* ¶ 88 (listing four conditions for finding that an IP telephony service should be classified as a telecommunications carrier).

110. See, e.g., Frieden, *supra* note 97; Stevens, *supra* note 95; Jamie N. Nafziger, *Time to Pay Up: Internet Service Providers' Universal Service Obligations Under the Telecommunications Act of 1996*, 16 J. MARSHALL J. COMPUTER & INFO. L. 37 (1997).

it would allow the agency to bring previously unregulated services like IP Telephony under its regulatory wingspan without necessarily imposing onerous regulations (because of the Act's forbearance authority provision), while divorcing itself from the legacy of the outmoded basic/enhanced dichotomy.¹¹¹

The FCC's justifications for rejecting this solution, while grounded in statutory interpretation and legislative history, seem driven by policy concerns. Despite the forbearance option, the agency feared that the presumption of common carrier regulation could create market uncertainty, and encourage states and foreign countries to impose onerous and unnecessary common carrier-like regulations on ISPs.¹¹² Regardless of the merit of these concerns, use of the "advanced telecommunications capability" classification for Internet and other integrated service offerings would seem to avoid them, since it is a new category without any history or presumption of common carrier regulation.

V. CONCLUSION

The battle over the exemption enjoyed by ISPs from paying access charges did not end with *Southwestern Bell*. The issue serves as only one example of the problems the FCC will continue to face as technological convergence blurs the lines between the old regulatory categories designed for discrete services. Even if the agency can justify asymmetric regulatory schemes in the near term out of concern for fostering competition, regulatory neutrality will continue to be a concern for stakeholders. The rapid growth of the Internet and the proliferation of competing services from unregulated providers suggest that the threat of bypass cannot be ignored indefinitely. The *Internet Cable* white paper offers a timely solution to the agency's dilemma. By creating a new regulatory regime around the "advanced telecommunications capacity" category, the FCC can craft a flexible regime that only regulates carriers as needed to promote the public good, without the presumption of full common carrier regulation.

111. See Frieden, *supra* note 97, at 75-6.

112. See *Report to Congress*, *supra* note 28, ¶¶ 46-8.

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