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TELECOMMUNICATIONS LAW UPDATES

Local Carriers' Court Victory on Access Rates May Prove Hollow

On May 21, 1999, the U.S. Court of Appeals for the D.C. Circuit released a decision striking down the FCC's formula for calculating the rates that incumbent local telephone carriers may charge long distance carriers for delivering long distance calls to customers' premises. The decision ostensibly was a victory for the incumbent local carriers. However, the benefit of the legal victory was sharply reduced and perhaps eliminated altogether when the Court agreed on June 21, 1999 to stay the effect of its decision until April 2000.

At issue are the fees that long distance carriers must pay local carriers for the service of originating and terminating long distance calls. These fees, known as "access charges," total over \$20 billion per year and have been the source of considerable political debate. Long distance carriers have waged a public relations campaign arguing that access charges are greatly inflated and result in unnecessarily high long distance prices for consumers. Local carriers naturally dispute this, arguing that current access charge levels are warranted in light of the costs of providing service and policy-driven cross-subsidies mandated by regulators.

The FCC regulates access charges by establishing caps on the rates that local carriers may charge. These "price caps" are carrier-specific and are adjusted downward each year on the assumption that, over time, increasing carrier productivity lowers the cost of providing access service. The percentage by which local carriers are required to reduce their price caps each year has been dubbed the "X-Factor." Because the overall amount of access charges is so large, even small changes in the X-Factor have a substantial impact: A 0.1 percent change in the X-Factor results in a \$23 million change in industry-wide access charges.

Before 1997, each incumbent carrier was subject to an X-Factor of either 4.0, 4.7, or 5.3 percent, depending on whether the carrier elected to make itself subject to certain other rate-related regulatory obligations. In May 1997, the FCC adopted a single, industry-wide X-Factor of 6.5 percent using a new methodology purportedly intended to estimate expected productivity gains more accurately. The FCC's 6.5 percent figure was promptly challenged in court from both sides, with the incumbent local carriers arguing that the figure was too high and long distance carriers arguing that it was too low.

On May 21, 1999, the D.C. Circuit upheld the challenge of the local carriers and rejected that of the long distance carriers. The Court ruled that the FCC's treatment of the data in calculating the X-Factor was in certain respects "mystifying" and "irrational." However, the Court offered no opinion as to what the X-Factor actually should be; instead, it ordered the FCC to reconsider the matter.

The Court's decision raised an immediate problem. Incumbent local carriers are required to file annual access charge tariffs each June, to take effect July 1. The amount of access charge reductions embodied in these filings depends directly on the X-Factor. With the June filing deadline approaching, there was little time for the FCC to select a new X-Factor to replace its discredited 6.5 percent figure.

As a result, the Court agreed on June 21, 1999 to stay the effect of its decision until April 2000. The result is that access charges for the period July 1999 through June 2000 were calculated using the 6.5 percent X-Factor. The FCC need not adopt a new X-Factor until April 2000, in time for the June 2000 access charge tariff filings. Thus, despite the local carriers' apparent victory in their court challenge, current access charges reflect the relatively large 6.5 percent price cap reductions. And there is no guarantee that the revised X-Factor to be adopted in 2000 will be any lower: Given its desire to reduce access charges, the FCC may be inclined to use

new calculation methodologies and/or incorporate new data that would tend to support a relatively high X-Factor. So long as the agency offers a better explanation of its reasoning, a court may sustain even an X-Factor in excess of 6.5 percent.

Local exchange carriers still could benefit from the Court's decision. Specifically, if the FCC ultimately adopts an X-Factor lower than 6.5 percent, local carriers may be entitled to a retroactive rate adjustment to compensate for the millions of dollars of revenue losses caused by the application of the unduly high 6.5 percent X-Factor during the tariff year beginning July 1999. However, the FCC probably will seek to avoid such an outcome. In short, the local carriers' court victory may well prove hollow.

This letter is for general informational purposes only and does not represent our legal advice as to any particular set of facts, nor does this letter represent any undertaking to keep recipients advised as to all relevant legal developments. For further information on these or other telecommunications matters, please contact one of the lawyers listed below:

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