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Client Alert

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D.C. Circuit Upholds FCC Rules Requiring USF Contributions by VoIP Providers; Eases Some Burdens

In recent years, Voice over Internet Protocol (VoIP) services have become increasingly prevalent in the marketplace, and the Federal Communications Commission (FCC) has been grappling with developing an appropriate regulatory framework. The FCC has determined that "interconnected" VoIP services–which enable users to place calls to *and* receive calls from the public switched telephone network–should be subject to many of the requirements applicable to traditional telephone services, while other forms of VoIP services (such as peer-to-peer services that do not make use of traditional telephone numbers) have been left largely unregulated.

"The D.C. Circuit's ruling is likely to solidify the FCC's ability to regulate interconnected VoIP services."

Specifically, the FCC has subjected interconnected VoIP services to regulations concerning emergency communications (E911), telecommunications relay services for hearing-impaired individuals, customer privacy and the facilitation of wiretaps. In addition, the FCC ruled last year that providers of interconnected VoIP services must contribute to the Universal Service Fund (USF), a subsidy mechanism that supports the provision of telecommunications services in rural areas; to schools, libraries and rural health care facilities; and to low-income consumers. On June 1, 2007, the US Court of Appeals for the D.C. Circuit ruled in *Vonage Holdings Corp. v. FCC* that the FCC acted reasonably in requiring such contributions, but it vacated certain aspects of the FCC's order that uniquely burdened VoIP providers.[1]

Background

The FCC oversees the distribution of approximately $7 billion in annual universal service funding, most of which flows to carriers serving high-cost rural areas and to schools and libraries. Section 254(d) of the Communications Act *requires* contributions to these support mechanisms from "[e]very telecommunications carrier that provides interstate telecommunications services," and it also *permits* the FCC to extend contribution obligations to providers of "interstate telecommunications." 47 U.S.C. § 254(d).

The FCC's current contribution methodology requires covered telecommunications carriers to make monthly contributions based on a percentage of their interstate and international revenues from end-user telecommunications services, subject to limited exceptions. The FCC establishes this percentage–known as the "contribution factor"–each quarter by comparing projected demand for

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universal service support with total projected revenues from interstate and international telecommunications services. The current contribution factor is 11.7 percent. Carriers are authorized to recover contribution costs from customers but may not mark up such costs if they are recovered through a separate line item.

The FCC's *2006 Contribution Methodology Order*

The FCC determined that providers of interconnected VoIP services "provide" telecommunications within the meaning of section 254, regardless of whether they operate the underlying network facilities (as cable VoIP providers do, but "over the top" providers such as Vonage do not). Without determining whether interconnected VoIP services are telecommunications services or information services, the FCC relied on its permissive authority to extend USF contribution obligations.

While most interconnected VoIP providers conceded that the FCC could (and should) require some level of contributions, the manner in which such entities would participate was controversial. The FCC recognized that many VoIP providers would be unable to determine the interstate portion of their revenues, and it accordingly established a "safe harbor" interstate allocation of 64.9 percent. The FCC selected that figure based on studies suggesting that long distance traffic broke down into approximately 65 percent interstate toll calling, and 35 percent in-state toll calling. VoIP providers generally argued that this safe harbor should have been closer to the 37.1 percent safe harbor applicable to wireless services. The FCC disagreed, finding wireline long distance services more analogous, despite the fact that many VoIP subscribers use their service primarily to place local calls, just as wireless customers do.

As an alternative to using the safe harbor, the FCC ruled that VoIP providers may conduct traffic studies to determine the percentage of their *minutes* that are jurisdictionally interstate or international, using that figure as a proxy for the interstate portion of their revenues. But the FCC required that VoIP providers submit such traffic studies for preapproval by the agency, despite allowing wireless carriers to rely on traffic studies absent any such approval. Nor was there any assurance that a traffic study would be approved within a reasonable time frame.

The FCC also suspended application of the "carrier's carrier" rule to VoIP providers for two quarters, purportedly to guard against any net decrease in the USF. That rule prevents duplicative USF contributions by exempting wholesale carriers from any requirement to pay when their reseller customers contribute independently. Otherwise, resale carriers would pay directly and would pay again when their wholesale supplier passed through its contribution costs. By suspending the rule, the FCC subjected some VoIP providers to that very fate.

Vonage Holdings Corp. v. FCC

Vonage and other petitioners sought review of the FCC's order in the D.C. Circuit, focusing primarily on the aspects of the ruling that imposed disproportionate burdens on VoIP providers. In addition to disputing the FCC's statutory authority to require contributions, the petitioners argued that the safe harbor level, the preapproval requirement for traffic studies, and the suspension of the carrier's carrier rule were arbitrary and capricious.

The court upheld the FCC's determination that VoIP entails the "provision" of telecommunications, notwithstanding the agency's previous

determination that broadband providers do not *offer* telecommunications separate and apart from their offering of Internet access.[2] The FCC asserted that VoIP providers "provide" telecommunications irrespective of whether they "offer" it, because "provide" is a more inclusive term, and the court found this analysis reasonable under the deferential *Chevron* standard. The court also refused to disturb the FCC's establishment of the 64.9 percent safe harbor. While recognizing that the Commission's reliance on long distance calling data was imperfect (as VoIP subscribers also make many local calls), there was no other evidence in the record, and the court was particularly reluctant to second guess the expert agency's line-drawing.

While deferring to those aspects of the FCC's order, the court vacated the requirement that VoIP providers–unlike any other category of contributor–obtain agency approval before calculating contributions based on a traffic study. The FCC's order asserted that requiring preapproval of wireless carriers' traffic studies would be "disruptive," but it failed to advance any reasonable explanation of why such a requirement was any less disruptive to VoIP providers. Indeed, especially since the FCC had found fault with some wireless traffic studies, it was arbitrary and capricious to rule that VoIP providers alone must obtain regulatory consent before relying on a traffic study.

Just as the court found the FCC's efforts to justify its disparate treatment of VoIP providers wanting with respect to the traffic study issue, it vacated the suspension of the carrier's carrier rule only for those wholesale providers that serve VoIP providers. The resultant imposition of a double payment on some VoIP providers, but not on any other contributors that resell telecommunications, was arbitrary and capricious. The only justification that the FCC offered for this double payment was that permitting VoIP providers to invoke the rule could result in a "net decrease in the [Universal Service] Fund in the short term."[3] But the court found that assertion unpersuasive; indeed, unless interconnected VoIP providers sold services for less than the cost of a single wholesale input, there would be no reason for net contributions to go down as VoIP providers took over the direct responsibility for making USF contributions.

Potential Implications Arising from *Vonage Holdings Corp.*

Looking ahead, the D.C. Circuit's ruling is likely to solidify the FCC's ability to regulate interconnected VoIP services. The court's endorsement of the FCC's holding that VoIP entails the provision of telecommunications could enable the FCC to classify VoIP as a "telecommunications service." At a minimum, it confirms the FCC's authority to include VoIP providers in any USF contribution mechanism, whether based on revenues, telephone numbers or anything else.

At the same time, the court's decision to vacate the traffic study preapproval requirement should provide significant relief to VoIP providers. For those service providers that determine their actual interstate revenues, the ability to contribute based on a traffic study rather than the 64.9 safe harbor is likely to lead to substantially lower USF payments. In addition, any VoIP providers that have been subject to double payments as a result of the suspended carrier's carrier rule might be able to pursue refunds, in conjunction with their wholesale suppliers.

Taken together, the affirmance of the contribution obligation and the vacatur of the discriminatory aspects of the FCC's order point toward an endorsement of placing interconnected VoIP services on equal footing with

traditional telephone services. The FCC increasingly has been moving in that direction, and the court decision may provide a further impetus to avoid making any technology-based distinctions.

Endnotes

[1] *Vonage Holdings Corp. v. FCC*, No. 06-1276; consolidated with No. 06-1317, 2007 U.S. App. LEXIS 12634 (D.C. Cir. June 1, 2007).

[2] *See Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 990 (2005).

[3] *Vonage Holdings Corp.* at *30

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