VoIP Regulation – A "New Frontier"

By Andrew O. Isar

As interest in Voice over Internet Protocol ("VoIP") telephony has grown significantly from a battered telecommunications industry sector, new market entrants, and most importantly, from consumers, so too has regulators' interest in this emerging technology. According to research firm IDT, U.S. Hosted IP voice revenue stands to grow from $41M in 2002 to $6.7B by 2007.[1] This potential for VoIP to replace a major portion of conventional wireline telephony has regulators concerned that VoIP telephony may threaten the very regulatory "public interest" paradigms that have remained firmly entrenched for more than a century. Yet providers and vendors fear that regulation will undermine the promise VoIP holds as the future of communications. At issue in the growing debate among regulators, legislators, and VoIP providers is whether VoIP telephony should be regulated, and if so, to what extent? The regulatory implications are monumental and may carry significant consequences. This is the first in a series of articles that will examine VoIP regulation, its genesis, the arguments, regulatory action, and implications.

In the Beginning…

Today's growing tension between VoIP deregulatory and regulatory interests is symptomatic of a technologic convergence between what have historically been unregulated "information services" and regulated "telecommunications services." For more than three decades the Federal Communications Commission deemed "information services," – then "data processing technologies" - such as facsimile, conference calling, and most recently Internet services, unregulated. Regulatory concerns were not raised so long as "information services" and "telecommunications services" could be definitively distinguished and did not overlap.

Such was generally the case until 1998, when the Federal Communications Commission ("FCC"), for the first time, specifically considered the proper classification of emerging VoIP telephony services in the narrow context of universal service; long-standing regulatory policies intended to promote universal availability of conventional wireline telephone service to the public.[2] The FCC's findings set the stage for potential VoIP regulation.

According to the FCC's initial 1998 Report to Congress regarding VoIP telephony and universal service, "[c]ertain 'phone-to-phone IP telephony' services lack the characteristics that would render them 'information services' … and instead bear the characteristics of (regulated) 'telecommunications services.'" Yet having reached that

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[1] *SBC to Take VoIP Nationwide*, *X-change*, January 2004, page 16.

[2] *In the Matter of Federal-State Joint Board on Universal Service*, CC Docket No. 96-45 ("Report to Congress"), FCC 98-67 (April 10, 1998). It is important to note here the distinction between use of VoIP facilities that have been used as a transmission medium for conventional wireline telephony in conjunction with the public switched network, and VoIP telephony which encompasses a "phone-to-phone" communications medium. The regulatory debate focuses on the latter.

conclusion, the FCC was not yet ready to subject VoIP telephony to full regulation, leaving itself several "outs." The FCC concluded that VoIP telephony did not (then) threaten universal service, stressing that it was not appropriate to make any definitive pronouncements, "in the absence of a more complete record focused on individual service offerings."[3] More importantly, the FCC explicitly stated that it maintained statutory authority to forebear from imposing any rule or requirement on telecommunications providers.

But the FCC did plant some regulatory seeds. The FCC affirmatively determined that some forms of "phone-to-phone IP telephony are 'telecommunications,' and that to the extent that providers offer such services to the public for a fee," they would be subject to universal service fund payments. The FCC reasoned that

> If such providers are exempt from universal service fund contribution requirements, users and carriers will have the incentive to modify networks to shift traffic to Internet protocol and thereby avoid paying into the universal service fund or, in the near term, the universal service contributions embedded in interstate access charges. If that occurs, it could increase the burden on a more limited set of companies still required to contribute.

Although the FCC deferred on broader VoIP regulation, it did suggest that VoIP regulation would be considered in the future, when a more complete record had developed.

An early state decision may have also set the stage for VoIP regulation. In May of 2002, the New York Public Service Commission addressed a complaint filed by Frontier Telephone of Rochester, Inc. against US DataNet Corporation ("DataNet"), a VoIP provider.[4] Frontier alleged that it was due access charge payments from DataNet in that DataNet was using Frontier's network to route calls. DataNet argued, among other things, that its VoIP services were not subject to regulation or the payment of access charges. DataNet maintained further that the New York Commission lacked jurisdiction over DataNet's interstate Internet services. The New York Commission disagreed. Citing to the FCC's 1998 VoIP universal service Report to Congress, the New York Commission concluded that DataNet's VoIP services were indeed "telecommunications services" over which the Commission maintained intrastate jurisdiction; federal preemption was not a consideration. DataNet was held to be providing "transparent long distance telephone service, virtually identical to traditional circuit-switched [services], and required to pay access charges." Like the FCC's findings, the decision was narrowly crafted, but the implications were nevertheless unmistakable.

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[3] *Id*. At 50.

[4] *Complaint of Frontier of Rochester Against US DataNet Corporation Concerning Alleged Refusal to Pay Intrastate Carrier Access Charges*, New York Public Service Commission, Case 01-C-119 (May 21, 2002)

Renewed Interest in VoIP Regulation

What had been a fairly clear regulatory distinction between unregulated Internet information services and conventional telecommunications services was now blurred, following the FCC and New York Commission decisions. But it wasn't until the latter part of 2002, four years after the FCC's universal service fund VoIP decision and nearly a year after the New York DataNet issue arose, that regulatory pressure on VoIP telephony began to mount. Industry media began reporting on new VoIP telephony companies, including Vonage, 8x8, and other VoIP providers, and their novel flat-fee "all you can eat" VoIP telephony market successes. Technologic barriers to VoIP telephony were being overcome, and more consumers were reacting favorably to the concept of being able to place reasonable quality worldwide calls and talk as long as they desired at a mere fraction of the cost of conventional wireline telephony. Regulators, legislators, incumbent local exchange carriers, and major carriers including AT&T and MCI, also began to acknowledge VoIP market potential. VoIP had ceased to be a novel, limited-quality communications experiment, and now stood to replace conventional landline telephony as an inexpensive, high-quality, and highly reliable mainstream communications medium. From a public policy perspective, however, incumbent networks, market share, established subsidy programs, and the future of conventional telecommunications regulation and consumer protection were at risk.

AT&T launched the opening salvo in the current federal debate in late 2002.[5] Under mounting pressure from incumbent local exchange carriers to pay access charges for phone-to-phone VoIP calls, AT&T petitioned the FCC for a declaratory ruling that would exempt VoIP traffic from existing "above cost" access charges, and maintain the FCC's "wait and see" policy.[6] AT&T's petition remains pending, although the FCC has been the subject of intense lobbying.

In July 2003, the Minnesota Public Utilities Commission initiated an investigation into VoIP regulation, taking specific aim at services provided by Vonage Holdings Corporation ("Vonage"). The Minnesota Commission alleged that Vonage had failed to (1) obtain a proper certificate of authority required to provide telephone service in Minnesota; (2) submit a required 911 service plan; (3) pay 911 fees; and (4) file a tariff. On September 11, 2003, the Commission rendered its decision, and asserted jurisdiction over Vonage's service, citing to Commission authority under state law.[7] Vonage – and by implication, other companies offering VoIP services like Vonage – would be required to apply for certification and comply with Commission rules before providing service in

[5] In 1999, U. S. West (now Qwest) had petitioned the FCC for a declaration that VOIP providers employing "private networks" would be obliged to pay carrier access charges. The FCC rejected the petition. *See Petition of U S WEST, Inc. for Declaratory Ruling Affirming Carrier's Carrier Charges on IP Telephony*, Petition for Expedited Declaratory Ruling, filed Apr. 5, 1999.

[6] *Petition for Declaratory Ruling that AT&T's Phone-to-Phone IP Telephony Services Are Exempt from Access Charges*, WC Docket No. 02-361 (2002).

[7] *See*, *In the Matter of the Complaint of the Minnesota Department of Commerce Against Vonage Holding Corp Regarding Lack of Authority to Operate in Minnesota*, Minnesota Public Utilities Commission, Docket No. P-6214/C-03-108 (Sept. 11, 2003)

Minnesota. This was the first time that any state regulator had expressly asserted jurisdiction over the entirety of a VoIP provider's services.

Immediately following the Minnesota Commission decision, and in likely acknowledgement of the growing state regulatory interest in VoIP regulation, other VoIP providers, including Vonage, Pulver.com, and Level 3, petitioned the FCC for federal preemption of state VoIP regulation. Vonage's petition specifically referenced the Minnesota Commission's September 11, 2003 decision in arguing that VoIP regulation was contrary to the FCC's long-standing policy of deregulating information services, such as VoIP and must be preempted. Vonage stressed that the FCC had already deemed VoIP regulation as unnecessary and contrary to the public interest. Citing to the FCC's universal service Report to Congress and a separate decision regarding unbundling of cable modem services, Vonage argued that VoIP services were and should remain, unregulated Internet information services. Comments and reply comments have been filed with the FCC, but Vonage's petition, and other similar petitions remain pending.

While seeking federal preemption of state VoIP regulation, Vonage successfully appealed the Minnesota Commission decision to U.S. District Court for the District of Minnesota.[8] The Court sided with Vonage, concluding that Vonage was an information service provider, exempt from Minnesota Commission regulation. According to the decision, "[T]he Court applie[d] federal law demonstrating Congress's desire that information services such as those provided by Vonage must not be regulated by state law enforced by the (Minnesota Commission). State regulation would effectively decimate Congress's mandate that the Internet remain unfettered by regulation." This decision is now on appeal by the Minnesota Commission.

Minnesota was not the only state to initiate VoIP regulatory action in 2003. In Washington and Oregon, smaller independent incumbent local exchange carriers filed suit against Oregon-based VoIP provider Local Dial Corporation ("Local Dial") through their state associations, seeking to compel Local Dial to pay access charges.[9] The Court remanded the matter to the Washington Utilities and Transportation Commission in late September 2003.[10] The Washington Commission, which had already conducted a preliminary VoIP investigation in late 2002, was careful to narrowly focus the proceeding to whether Local Dial should pay access charges. It rejected Local Dial's request for broader Commission consideration of whether Local Dial's services were subject to Commission regulation: "We will consider in this proceeding only the service placed at issue by [the Washington Exchange Carriers Association's] complaint, regardless of whether LocalDial offers other services that may or may not be subject to our

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[8] *See e.g., Vonage Holdings Corporation v. The Minnesota Public Utilities Commission, and Leroy Koppendrayer, Gregory Scott, Phyllis Reha, and R. Marshall Johnson, in their official capacities as the commissioners of the Minnesota Public Utilities Commission and not as individuals*, Civil No. 03-5287, Memorandum and Order (October 16, 2003).

[9] *Washington Exchange Carriers Association et al. v. Local Dial Corporation*, U.S. District Court for the Western District of Washington, CV03-5012 RBL.

[10] *Washington Exchange Carriers Association et al. v. Local Dial Corporation*, Washington Utilities and Transportation Commission, Docket No. UT-031472.

jurisdiction" The Commission wished to avoid making the case a referendum on VoIP regulation. That case too remains pending. A decision is anticipated in 2Q04.

Last September the California Public Utilities Commission contacted Vonage and seven other known VoIP providers, requesting that the companies apply for a Certificate of Public Convenience and Necessity to provide service in California. The companies respectfully disagreed with the Commission's request, although they ultimately agreed to cooperate with the Commission in addressing issues of concern. Following a round of hearings in November 2003, the California Commission in January 2004 elected not to pursue action against the companies. Commissioner Susan Kennedy, the most vocal of California's Commissioners regarding VoIP regulation, stated in a *San Jose Mercury News* op-ed piece, "Someday these new technologies will be mature enough to carry their share of the social contract expected of other indispensable utilities. But until then, regulators should just keep their hands off."[11] Her sentiment was echoed by Missouri Public Service Commission Commissioner Connie Murray, who of her Commission's VoIP investigation stated, "[I]t would be insufficient, unproductive, and burdensome to open a contested case addressing issues that are almost certainly beyond this commission's jurisdiction…a Pandora's box."[12]

Other states including Alabama, Colorado, Florida, Illinois. Missouri, New York, North Dakota, Ohio, Pennsylvania, and Texas, have also initiated investigations into VoIP regulation, but with no definitive result.[13] Just this month, the Colorado Public Utilities Commission closed its investigation into VoIP regulation, noting, "Because of the legal uncertainty of whether a state may regulate VoIP services, as well as the host of policy issues involved with VoIP, we believe the most prudent course is to take no action with respect to VoIP pending FCC action."[14] Colorado Commission Chairman Gregory E. Sopkin went even further in stating that "nascent VoIP industry should not be subject to death-by-regulation, which could well occur by having 51 state commissions imposing idiosyncratic, inconsistent, and costly obligations." Save for Minnesota and New York, state regulators have appeared reluctant to pursue VoIP regulation pending further deliberation by the FCC.

Framing the Debate.

Industry petitions and regulatory investigations have sparked a ferocious debate that among VoIP telephony service providers, regulators, legislators, incumbent local exchange carriers, federal and state law enforcement officials, universal service fund administrators, and others, as to how, or if, VoIP services should be regulated. Fundamentally, the arguments go something like this: VoIP providers, including the

[11] *San Jose Mercury News*, Op-Ed, October 20, 2003. In early January, California Commissioner Kennedy was named to the FCC's national commission on advanced telecommunications services.

[12] Missouri Public Service Commission Case No. TO-2004-0172

[13] Other states have considered VoIP regulation within the context of applications for intrastate operating authority filed by Time Warner Telecom, but have narrowed deliberation exclusively on the merits of Time Warner Telecom's certification.

[14] Colorado Public Utilities Commission Docket No.03M-220T.

incumbent local exchange carriers argue that VoIP telephony is an unregulated Internet information service that has not, and should not now, be regulated. They stress that the Internet's success has been fueled by a lack of regulation, which should be maintained. Consistent with arguments in favor of broadband deregulation, VoIP providers maintain that regulation of VoIP will create new costs and "regulatory uncertainty" that will stifle deployment of desirable VoIP services and competition, engines for badly needed economic development. In so doing, consumers will be the ultimate losers as they will be deprived of access to innovative services and cost savings, among other benefits.

Incumbent local exchange carriers have a unique perspective on VoIP regulation. The regional Bell operating companies in particular, view VoIP as their "silver bullet" toward achieving the deregulation they have sought for decades. To incumbent local exchange carriers, VoIP is an inherently competitive service. They too maintain that VoIP regulation will stifle deployment and the benefits of wide-spread availability. Yet they argue that VoIP should be subject to payment of access charges by interconnecting VoIP providers. Their arguments resurrect decades old network "bypass" arguments, which maintain that access charges are necessary to maintain a rate-payer funded network and universal service subsidies.

Regulators argue that when VoIP replaces conventional land line telephony, VoIP becomes a regulated "telecommunications service." The California Public Utilities Commission, in reply comments to Vonage's federal preemption petition, argued that, "It is the nature of the service offered, not the technology deployed to transmit the service, that is dispositive in classifying a given service."[15] Barring regulation, regulators maintain that consumers may not well protected and may be subject to abuse. Regulators are also concerned about maintaining universal service funding and current program subsidies that may be lost if VoIP services remain outside of the regulatory fold; a concern shared by fund administrators. And state regulators inherently fear federal preemption from regulation on the principal of "states rights."

Law enforcement and emergency services officials too wish to see VoIP services regulated. They are concerned that unless VoIP services are regulated, they will be precluded from effectively meeting public safety obligations. And, there are taxing authorities who view unregulated VoIP as a threat to tax bases. Over the coming months we will examine these arguments in greater detail.

Now What?

On December 1, 2003, the FCC hosted a public hearing to address VoIP. The hearing was intended as a precursor to FCC VoIP rulemaking (details are available at the FCC's web site, http://www.fcc.gov/voip/). FCC rulemaking will likely encompass the issues AT&T, Vonage, Level 3, and others have raised in their VoIP petitions and may ultimately determine the future course of VoIP regulation. Clearly, there is no way of projecting an outcome with any certainty. But we do have some recent signs of current FCC thinking.

[15] Comments of the California Public Utilities Commission, WC Docket No. 03-211 (October 27, 2003).

FCC Chairman Michael Powell's senior legal advisor, Christopher Libertelli, was quoted as telling U.S. Telephone Association conference attendees in October 2003, "We might have different rules for the different flavors." This is consistent with his boss's opening remarks at the FCC's December VoIP hearing, where Chairman Powell stated, "No regulator, either federal or state, should tread into this area without an absolutely compelling justification for doing so. Innovation and capital investment depend on this premise. The entrepreneurs seated before us depend upon this premise. In my view, we should come to this forum with a sense of regulatory humility - mindful that it is entrepreneurs, not governments, who came up with the idea of making high-quality, inexpensive phone calls over the Internet."

Chairman Powell and Commissioner Kevin Martin seem to agree on this issue. In a January 6, 2004 *BusinessWeek Online* interview, Commissioner Martin opined, "Each kind of [VoIP] service raises different competitive issues. The one that's effectively a computer-to-computer call may need one set of rules. Other services, which take advantage of and plug into the public service telephone network, may need another set of rules that treat them more like a traditional phone provider."

It is clear that the FCC intends to develop a robust record on VoIP regulation before venturing into promulgating rules. The FCC will also likely look at giving states a role. Initial statements from the FCC, coupled with intense pressure from state regulators and others to impose regulation on VoIP telephony would suggest some form of streamlined regulation. We are at a proverbial regulatory crossroads. The path taken will have a profound impact on consumers, providers, regulators, and the future of telephony. Stay tuned!