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The Economic Impact Of Free Conference Calling Services

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Free conference calling services have added a new dimension to the long-distance telecommunications marketplace in the United States and abroad. Accompanying the introduction of these services, there are a variety of business and public policy issues that have been raised here in the United States. These issues include access service charges imposed on Interexchange Carriers ("IXCs"), profits made or lost by IXCs and Local Exchange Carriers ("LECs"), fees paid by LECs to free conference calling companies, benefits accruing to the general public through the ability to efficiently collaborate and engage in business, political and religious activities, and the resulting positive byproducts: an expansion in economic growth; an increase in employment growth; and an increase in the availability of services such as broadband in these often underserved areas. This report will examine and evaluate the accuracy of the unsubstantiated economic and policy attacks, propagated by dominant IXCs that have been leveled at the free conference calling industry.

To date, most of the debate has focused on the Federal Communications Commission's ("FCC") access charge regime and the charges levied by LECs on IXCs for originating and terminating long-distance telecommunications services. Under the current regulatory framework in the United States, the costs for these access charges are necessarily imputed into the costs that IXCs incur while enabling their long-distance customers to make long-distance calls. Accordingly, the law requires IXCs to bill and collect from their customers and then pay

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[*] A prior version of this article is available at http://www.freeconferencecall.com/factreport.asp.

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LECs for the use of their network in transiting these long-distance calls. This report will examine this regulatory framework and the economics of LECs billing IXCs for terminating access charges associated with free conference calling services.

The report also includes a discussion of the economic structure of the long-distance telecommunication market and the implications of that structure on natural (market-based) pricing and level of telecommunications service. This is followed by data and analysis that demonstrates that long-distance calls to free conferencing services are profitable for the IXCs, despite their claims to the contrary.

The IXCs' position as to the profitability of calls made to free conference calling services necessarily implies that there is another motive behind the IXCs' attacks on free conference calling services. This report searches for and uncovers the IXCs' hidden motive, which stems from the fact that many IXCs have had to reduce the price of their own conference calling services and have had to develop and introduce new services in response to new entrants in the market. Generally, this is exactly how the competitive market should work; new entrants launch new, more innovative services in what has been an entrenched market dominated by a few large companies, thereby spurring competition and driving down prices. In the end consumers win, so long as dominant firms are not able to use their market power along with regulatory and public policy mechanisms to eliminate the emerging competitors. Finally, what is often left unsaid by those who attack the new entrants is that they actually fulfill the FCC's underlying public policy goal of providing advanced services to rural America, while simultaneously stimulating competition and creating employment opportunities.

I. Free Conference Calling Companies

A. *The Role of Free Conferencing Companies*

Free conferencing companies are third party service providers that provide LECs, both rural and non-rural, with innovative services. By subscribing to local exchange services offered by LECs, free conferencing companies allow competitive carriers to diversify their revenue streams and remain viable in the face of technological advancements and changing consumer preferences that have resulted

in decreased demand for traditional wire-line services.[1] Free conferencing companies have been the necessary catalyst that has allowed the affiliated LECs to build human capital, re-invest capital in operations, and provide more and better service to local customers. Farmers Telephone Company of Riceville, Iowa ("Omnitel") is an example of a LEC that did business with a free conferencing company from 2005 until 2007. Because of changing consumer preferences, Omnitel did not have much of a future before working with a free conferencing operation.[2] Today Omnitel is able to offer its rural customers a wide array of services, including high-speed Internet, toll-free numbers, a variety of long-distance plans, teleconferencing, cable TV, wireless and more.[3] Similar outcomes are possible for other rural LECs and are completely consistent with the FCC's vision for vibrant competition in rural America.

1. Broadband Expansion on American Reservations

Like rural Competitive Local Exchange Carriers ("CLECs"), American Indian tribes have also become increasingly interested in supporting the provision of free conferencing services as a way to diversify income streams and provide their nations with economic development opportunities, including the deployment of broadband and other modern telecommunication services. These reservations are located in some of the country's most remote areas, and until now, business models that respect the tribe's autonomy, while effectively providing those who reside in these remote areas with modern telecommunications and Internet service, have consistently failed. These failures have stemmed from a misunderstanding or lack of appreciation for the tribe's history and culture, excessive infrastructure costs, and lack of financial resources necessary to secure "luxuries" such as broadband Internet access. The result, as FCC Commissioner Michael Copps has noted, is a level of broadband access on Indian

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[1] Morgan Stanley, Telecom Services 5 (2009).

[2] Dionne Searcey, *Calling Riceville: How 2 Guys' Iowa Connection Took Big Telecoms for a Ride—Calls Sent to Their Area Piled Up Access Fees Until FCC Interceded*, Wall St. J., Oct. 4, 2007, at A1.

[3] Ex Parte Letter and Presentation on behalf of Omnitel Communications and Great Lakes Communications from Edward A. Yorkgitis, Jr., Kelley Drye & Warren, LLP to Marlene Dortch, Sec'y, FCC (Feb. 15, 2008), *in* FCC MC Docket 07-135, *available at* http://fjallfoss.fcc.gov/ecfs/document/view.action?id=6519841644.

reservations that is "shockingly low" and "a national disgrace."[4] Free conferencing services are already helping to turn this tide.

Tribes are now discovering that they can establish their own telephone companies and sell local exchange service to free conferencing companies and applications to the Federal Government. In doing so, the American Indian people can finance their own infrastructure build-out and internet libraries, and provide telecommunications and broadband services to all reservation residents, subsidized by American Indian-owned businesses and *not* by the United States Federal Government. They have discovered that their ability to operate viable telecommunications businesses provide them with the opportunity for economic growth and independence.

By way of example, the Crow Creek Indian Reservation of South Dakota was one of the most economically disadvantaged places to live within the United States boarders. The Crow Creek Indians now have their own phone company, Native American Telecom Enterprise LLC, that provides for broadband services, modern telecommunications services, and an internet library. They now have an impetus for economic expansion and personal pride. Jobs are being created, and a source of income for the Tribe has been created that will be used for further economic growth and the general welfare of their people. Without the ability to provide access service to other companies and realize the revenues, the American Indian owned telephone company business model would not be viable.

This business model is now being adopted in other remote locations, such as the Pine Ridge Indian Reservation, and many others have shown interest. This example helps to highlight the fact that the application of the rural exemption for other rural locations is a valuable stimulus to economic growth in rural areas, true to the FCC's intention.

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[4] Andrew Feiberg, *Copps Call State of Broadband for Native Americans 'A National Disgrace'*, BroadbandBreakfast.com (Dec. 11, 2009), http://broadbandbreakfast.com/2009/12/copps-calls-state-of-broadband-for-native-americans-a-national-disgrace.

B. *Access Charges, Long-distance Plans and Conference Call Pricing—Tracking the Cash Flow*

This section outlines the costs and pricing structures involved in the initiation of a telephone call to a conference call bridge. It includes the pricing of unlimited long-distance calling plans, because it is this aspect of conference calling that is most often misunderstood and misinterpreted by those who oppose free conference calling.

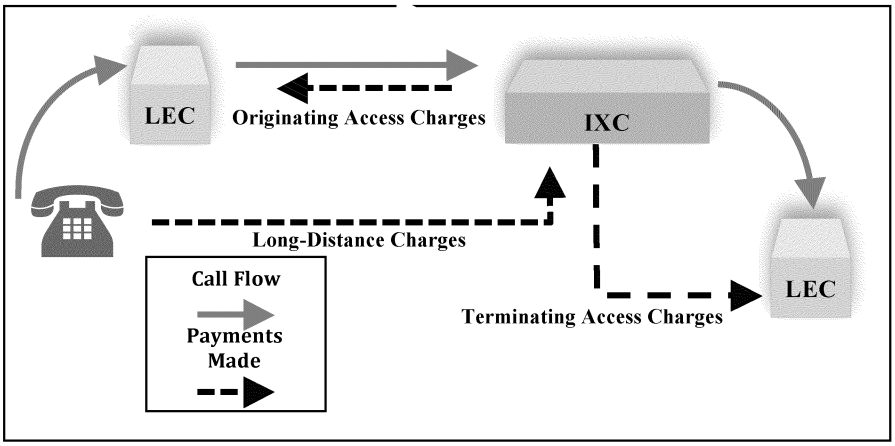

Figure 1: Free Conference Calling Traffic and Cash Flow

Conference call companies provide free conference calling services to consumers by entering into marketing agreements with the LECs whereby the conference call provider receives a marketing fee in return for generating conference call traffic. The free conference service model, shown in Figure 1, illustrates the typical cash flow scenario: (1) a call participant, who has already purchased a long-distance calling plan from an IXC, dials a long-distance number; (2) the IXC pays the call participant's originating LEC an originating access service payment for each minute of the call; (3) the IXC pays the terminating LEC that provides local exchange service to the conference call provider a per minute terminating access fee;[5] and (4) the Host, terminating, LEC pays the conference call provider a marketing fee in a manner determined by contract between the terminating LEC and the conference call provider. This cash flow

[5] For clarity and ease of reference, the LEC that provides local exchange service to the conference call provider will be referred to as the "Host LEC."

scenario is repeated for each call participant under the free conferencing service model.

The model in Figure 1 is modified in situations where there is an intermediate carrier between the IXC and the terminating LEC. Such a carrier is known as a transport company or centralized equal access tandem/transport provider and serves to aggregate and route traffic between the IXCs and smaller LECs. Transport companies often charge a large mark-up, explaining some of the arguments made that rural locations are high-cost. By way of example, Google recently defended its practice of blocking certain access to certain rural areas for its Google Voice service by stating that it would have to pay between 12 cents and 39 cents per minute to these locations.[6] Google contends that it blocks calls to these areas because they are cost prohibitive.[7] However, the LECs from which most of the free conferencing companies receive service, and where Google blocks calls, have tariffs that are only about 5 cents.[8] The difference is the mark-up charged by the intermediate carrier. It is note worthy that these intermediate carriers, and not the free conferencing companies, are the benefactors of these high transport fees.[9]

The traffic and cash flow diagram is also modified slightly if any of the call participants are also customers of an originating LEC that is owned by, or affiliated with, the customer's long-distance provider. In this instance, illustrated in Figure 2, the IXC would effectively retain the originating access charges collected from the customer.

Finally, it should be noted that another type of traffic and cash flow analysis results if the caller initiates its call to a conference bridge using a wireless phone or VoIP service. The imposition of access

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[6] Letter from Richard S. Whitt, Washington Telecom and Media Counsel, Google Inc., to Sharon Gillett, Chief, Wireline Competition Bureau, FCC (Oct. 28, 2009) (on file with the FCC), http://www.fcc.gov/wcb/archives/googleletter.pdf.

[7] *See Id.*

[8] *See* Letter from David Erickson, President of Free Conferencing Corporation, to Marlene Dortch, Sec'y, FCC (Nov. 4, 2009) *in* FCC WC Docket 07-135 & 07-52, *available at* http://fjallfoss.fcc.gov/ecfs/document/view.action?id=7020244588.

[9] Recently, alternative intermediate carriers in these "high-cost" areas have sprung up to offer competition in these markets, transporting this same traffic at a rate around 2 cents per minute, making the free conference calls affordable to the IXCs and other companies like Google, and negating the "high-cost" reason to block calls and/or use other methods of IXC self-help. *See generally* WideVoice Commc'ns, Inc., http://www.widevoice.com/services.html (last visited July 28, 2010).

charges on these calls remains an unsettled issue on the regulatory landscape and is largely beyond the scope of this analysis.[10]

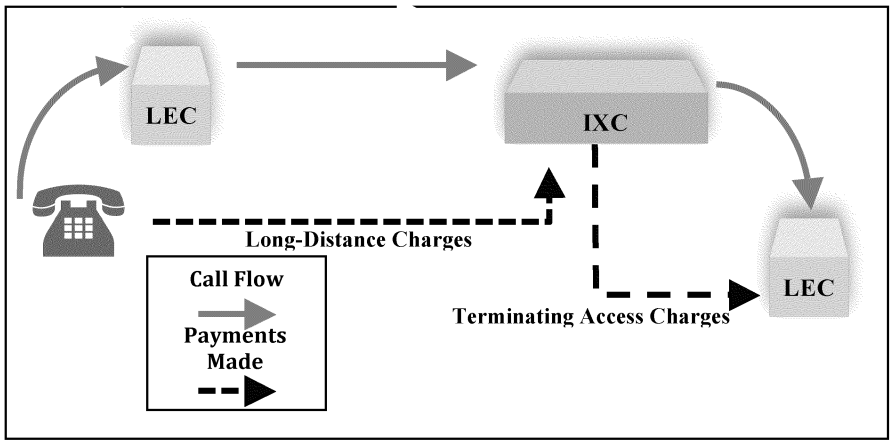

Figure 2: Modified Free Conference calling Traffic and Cash Flow

C. *Hosted vs. Free Conference Calling: Comparing the Economic Alternatives*

The pricing of access charges, long-distance calling plans and conference calling services are, in some ways, intertwined and the interplay between these various services needs to be explained fully, fairly, and completely. A primary objective of this report, therefore, is to explain and analyze the interplay, and the often complex and confusing characteristics of these telecommunication services.

There are generally three types of business arrangements for provisioning conference calling services in the United States: (1) large and often dominant IXCs that generally provide conference calling services in partnership with one or more nationwide conference call service companies (e.g., Genesys, a partner of Qwest), and that have traditionally utilized a host-pay system whereby all callers dial a toll

[10] *See* Ex Parte Letter and Presentation from Brian Benison, AT&T to Marlene Dortch, Sec'y, FCC (Aug. 5, 2008) *in* FCC CC Dockets 01-92, 96-45 & WC Dockets 05-337, 99-68, & 07-135, *available at* http://fjallfoss.fcc.gov/ecfs/document/view.action?id=6520036878. This is not to suggest that wireless and internet-protocol phone service is not a significant component of the market, but rather that the dispute regarding payment of access charges for conference calling services is predominantly discussed within the context of landlines. These dynamics are likely to continue to change as AT&T and others argue that the FCC should consider eliminating the Plain Old Telephone System ("POTS") in favor of an Internet Protocol based system.

free (1-8XX) number to access the call; (2) Incumbent or Competitive LECs that own their own conference bridges and may provide a combination of host-pay and free conferencing services; and (3) small independent conference call companies that secure local exchange service from ILECs, CLECs, and/or rural CLECs that generally, though not exclusively, provide a free conferencing service where each caller dials a long-distance number and incurs long-distance charges to participate in the conference call.

1. All Conference Calls Involve Access Charges

Despite the differences in business models, an important attribute unifies this complex set of business arrangements. That is, each conference calling model incorporates a long-distance charge, which necessarily includes originating and terminating access charges for the use of the LECs' network, is assessed. These originating and terminating access charges apply to *all* conference calls. For calls made to 1-8XX numbers, the access charges for all participants will be paid by the call's host. For free conferencing services, each participant will pay its own long-distance charge in order to access the call (*i.e.*, each individual caller pays for the long-distance call individually as part of his/her monthly local and long-distance telephone bill).

2. Free Conferencing Services Provide Consumers with More Choices

On the other hand, the free conferencing services are unique in providing a greater level of consumer choice. By way of example, those consumers using the free conferencing services have the option of: (1) dialing into a conference call bridge using a direct-dial phone number and their existing long-distance plan; (2) utilizing a 10-10 XXX "dial-around" number to select a specific IXC while dialing; (3) using a pre-paid long-distance calling card; (4) implementing a wireless device (e.g., a cell phone); or (5) utilizing a Voice-Over-Internet Protocol ("VoIP") service. These free conferencing services do not require a host to pay all of the costs but rather allow each participant to pay their own share of the call's cost. Hosted conference calls, on the other hand, are more expensive to the host and can be cost-prohibitive. This is an important distinction, because free conferencing services provide an *additional* economic alternative for would-be conference hosts, an alternative

that is an efficient, cost-effective method of mass communication, the absence of which would leave many with no viable alternative.

II. The Effect of Regulatory Pricing Decisions

A. *The Current Policy Issues*

The current policy issue before IXCs, the FCC, various state utility commissions, and Congress is whether IXCs should be required to pay tariffed terminating access charges to rural LECs that pay marketing fees to their customers that market, promote, and provide free conferencing services. Major IXCs, such as AT&T, Qwest Communications, Sprint, and Verizon, which are often vertically integrated with LECs and offer their own competitive conferencing services, have repeatedly claimed that terminating rural CLECs are charging too much for termination, or are "pumping" excessive volumes of traffic through these rural areas in order to take undue advantage of the existing regulatory framework that permits rural CLECs to operate under and receive higher tariffs than metro locations.[11] It is important to note that this is a result that the FCC contemplated and ultimately decided is acceptable and even desirable.[12]

B. *Pricing Discretion is Under the Complete Control of the IXCs*

As this report explains, the rural tariff rates present no profitability problem for IXCs resulting from long-distance calls to free conference calling services. To the extent that IXCs may not make a profit on any given customer or any particular call as a result of the IXCs' unlimited long-distance plans, that is not an issue for the FCC or Congress, but is a direct effect of the IXCs' own business plans and pricing, a matter within their complete discretion. A problem of their own making, the IXCs cannot be heard to complain when they have

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[11] In the case of Free Conferencing Corporation, the terminating access charges levied by the LECs are all less than or equal to the National Exchange Carrier Association's rate allowed under the FCC's "rural exemption." *See* Access Charge Reform, Seventh Report and Order and Further Notice of Proposed Rulemaking, 16 FCC Rcd. 9923, para. 65-73 (Apr. 26, 2001) [hereinafter Seventh Report and Order].

[12] AT&T admits that the CLECs they are challenging are charging around the NECA band 8 rates. *See* Ex Parte Letter and Presentation from Brian Benison, AT&T to Marlene Dortch, Sec'y, FCC (Dec. 3, 2009) *in* FCC Docket WC 07-135, *available at* http://fjallfoss.fcc.gov/ecfs/document/view?id=7020350996.

knowingly and intentionally adopted a business model whereby they sell unlimited long-distance plans for a fixed monthly charge, without regard to the volume or destination of the telephone calls placed by consumers.

C. *Shifting of Resources*

Under any regulatory pricing plan, the final prices are often arbitrary and subject to compromise and change over time. The regulator must weigh the costs and benefits of setting the price at any given level. At current levels, all service providers are profitable. Nevertheless, AT&T and others have suggested that the FCC should lower rural CLEC access rates, at least for the purpose of conference calling services.

A change in access rates will have little practical effect on the demand for free conference call services. As long as the new rate is sufficient to keep all current service providers profitable (although at different levels), and thus in business, then the only economic effect would be a transfer of wealth from one service provider to another. In this instance, the shift would transfer wealth from the smaller, less competitive companies to the larger, more dominant ones (the IXCs). This will produce negative results on future competition and product development. Therefore, the appropriate line of inquiry is a policy one: does the policy analysis underlying the rural exemption remain valid and does the FCC intend to continue to ensure that rural America has ubiquitous access to wire-line and emerging services (e.g., broadband)?

The FCC's intent is to stimulate the businesses of the rural LECs (both ILECS and CLECs) to invest in their markets and provide better and possibly cheaper, more imaginative and innovative services to customers, because these areas are generally underserved by the major and dominant nationwide companies. This ideally translates into more and better jobs, lower local telephone bills, and improved local and national telecommunications services. This is precisely what the rural LECs sponsoring free conferencing are doing. In general, they serve a relatively small number of customers and offer full local telephone service, VoIP, high-speed Internet, digital TV, and long-distance telecommunications.[13]

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[13] *See* Yorkgitis, *supra* note 3.

Meanwhile the large former Regional Bell Operating Companies ("RBOCs")—AT&T, Verizon, and Qwest—are assiduously divesting themselves of their small and rural ILECs.[14] This is evidence that the major IXCs are *not* interested in serving many rural markets in America.

D. *The Effect of Unlimited Calling Plans*

The strategic business issue concerning unlimited local and long-distance calling plans will now be explained and analyzed in more detail in order to understand the effects these plans are having on conference calling services. The overall profitability of long-distance services is also analyzed in detail.[15] This analysis concludes that because unlimited long-distance plans must be analyzed based on *average* costs and *average* revenue, the plans yield significant profits for IXCs, even when consumers utilize a relatively large quantity of free conference calling services.

E. *Average Cost Should Not Be Confused With Marginal Cost*

The IXCs' tendency to conflate *marginal* and *average* cost is not trivial, and has, in fact, resulted in significant misperceptions regarding the free conference calling service industry. Indeed, ILECs are required to base their prices and profit calculations on average costs, rather than marginal costs. It is understood that less profitable service offerings, generally in rural America, must be subsidized by earnings from the more profitable densely populated areas (where call volume is high and costs low) in order to foster the FCC's mandate of ubiquitous services.[16] This is a critical business and policy matter as large ILECs are actively divesting themselves of their rural properties in an effort to lower their average costs and then concentrate their business strategies on the high-density, high-volume, low-cost, high-profit areas. Indeed, this exact scenario was one of the underpinnings that resulted in the FCC's creation of the rural exemption for CLECs.

The introduction of unlimited long-distance calling plans, successfully launched by the ILEC-IXC combinations, has become a

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[14] Brian Osborne, *Verizon Sells Rural Local Wireline Assets to Frontier*, GEEK.COM (May 14, 2009), http://www.geek.com/articles/mobile/verizon-sells-rural-local-wireline-assets-to-frontier-20090514/.

[15] *See infra* Section IV.

[16] *See* Seventh Report and Order, *supra* note 11.

major aspect of conference calling that is frequently misunderstood and misinterpreted by those who oppose free conference calling. With these increasingly popular unlimited plans, where both local and long-distance services are bundled into a fixed monthly rate, the IXCs and LECs/IXCs (e.g., AT&T and Verizon) *may* lose money on any given marginal call that is placed by one of their customers to any long-distance number. Indeed, this is true of any fixed price service, where those who choose to use more of the "unlimited" services gain, but this does not mean that free conference calling has made IXCs, generally, or unlimited long-distance plans, specifically, unprofitable. In other words, it is the *average* profit per user multiplied by the *number of users* that determines the IXCs' profit, and free conference calling services may have the tendency to impact both of these factors differently.

It is important to note that the LECs that work and collaborate with free conferencing companies charge less, on average, for termination access than most rural ILECs. Indeed, many of the LECs that work with free conferencing companies have commercial agreements, with some of the same IXCs that have been so vocal in the debate, at rates substantially lower than the tariff rates for those areas.[17] The implication raised by the adoption of these commercial agreements is that natural market forces self-regulate the industry, and that additional regulation by the FCC or Congress is unnecessary. If an IXC claims that it is losing money due to terminating access charges, then it can only be due to a faulty analysis used to determine the pricing of unlimited calling plans. Notably, despite continued claims that free conferencing services are ruining the profitability of unlimited long-distance plans, the IXCs have continuously refused to produce data to backup these claims. And anecdotal evidence would suggest that the contrary is true. Indeed, AT&T, Verizon, Sprint and Qwest, the four dominant IXCs, continue to aggressively promote their unlimited long-distance plans, which are increasingly popular with consumers.[18] The profitability related to the use of unlimited calling plans is discussed in detail in Section IV.

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[17] David Erickson states that alternative rates are frequently available below the tariff rates. *See supra* note 8.

[18] Unlimited plans come with many of AT&T's U-Verse plans, Verizon's FIOS, and virtually all cell phone plans.

III. Pricing Models for Long-Distance Calls

A. *Marginal versus Average Cost*

There has been some confusion between average cost and marginal cost in arguments and disputes before the FCC, the courts, and Congress.[19] AT&T in particular has made a claim that the *marginal* costs of switching an additional call for rural CLECs is close to $0, and therefore a rural exemption to charge higher tariffs is unnecessary.[20] Marginal costs are irrelevant, however. As has been outlined and demonstrated above, only *average* cost is relevant.

AT&T's conclusion that marginal cost is close to zero assumes that there is unlimited capacity in each switch. If indeed the number of calls is growing, as the evidence suggests, then LECs providing local exchange service to conference call providers must therefore continue to upgrade and improve the quality of their switching equipment in order to meet the increased demand. This has been the case for many LECs. For example, Omnitel used its profits from offering free services, including free conferencing, to upgrade and improve services for all of its rural customers.

To further illustrate the critical relationship of marginal cost to average cost, consider a hypothetical switch that costs $1,000,000. As long as the switch is below capacity, it has zero marginal cost. In other words, the LEC would incur no additional cost to add an additional call to the switch. Further assume that the switch can handle 100,000 calls at any given time. As the call volume increases over time, the short-run average cost falls as the volume increases. Now suppose that the call volume is, on average, 99,000 calls at any given time. In this scenario, the *marginal and average* cost per call is extremely low, because the switch is near capacity. However, as soon as call volumes get at or near the 100,000 call volume limit, the LEC will be required to buy an additional switch in order to accept the next call. Assuming this additional switch also costs $1,000,000, the *marginal* cost for accepting that next call will be $1,000,000. With the purchase of the additional switch completed, however, the *marginal* cost per call will return to near $0.00, while the short-run *average* cost for all calls will remain

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[19] *See* Establishing Just and Reasonable Rates for Local Exchange Carriers, Notice of Proposed Rulemaking, 22 FCC Rcd. 17989, para. 14 (Oct. 2, 2007).
[20] *See* Benison, *supra* note 12.

somewhat high, decreasing again as the volume of traffic increases, until such time as both switches are near capacity and the purchase of a third switch is required. If this cost is averaged over a longer period of time, it is possible to measure the company's long-run average cost, which is certainly not $0.00, as the IXCs imply.

Arguments that the cost of switching additional calls for LECs is equal to $0.00 are clearly and obviously a *marginal* cost argument. Since the switching equipment is expensive, the long-run average cost is not falling quickly with each new call. Indeed, the same arguments can be applied to the IXCs. IXCs have an expensive network of switches, transmission lines, and transmitters. They too have (close to) zero marginal cost for each additional call. Would they argue, however, that there is *no* additional cost for a call, such that their rates to consumers should be approaching zero, given the significant volume of calls that they carry on their network? If this logic is followed by regulators, one or more interested parties would suggest that the IXCs should be required to sell their services to consumers for a fraction of a cent per minute if they have almost zero marginal cost. Clearly, this argument is flawed, and thus has no relevance to the issue of free conferencing services. How then can the IXCs justify their demand that rural LECs sell access to their networks for a faction of a cent per minute merely because the volume of calls to these networks has increased?

If the long-distance callers do not have an unlimited long-distance plan but rather are paying a per-minute rate, then even on a marginal cost basis the IXC will make a profit for *each and every* call. It is known that these calls make a profit because IXCs pay access charges for every call, not just those that connect to free services, so the IXCs must price long-distance services to make a profit. More evidence of their rates and profitability is given below.

If, on the other hand, the caller uses an unlimited calling plan to connect to a free conferencing service, then the IXC will incur the same marginal cost (i.e., the terminating access charge), but will have no marginal revenue (i.e., increased revenue from its customer). This does not mean, however, that there is no profit, since the profit is determined by *average* cost and *average* revenue. Accordingly, if there is a problem with profitability associated with free conference calls, it has nothing to do with the cost, which remains constant, but rather the

problem is on the revenue side, and therefore in the pricing of the long-distance plans. It is also true that not only are the IXCs earning a profit on average, but their profits have actually been growing since free conference calling and unlimited long-distance plans have become popular with consumers, as is explicitly and graphically demonstrated in Figure 4.

Furthermore, terminating access charges paid by the IXCs to the Host LEC participating in free conferencing services plays only a minor role in the overall business operations of AT&T, Verizon, Sprint and Qwest. In principle, any LEC could purchase a conferencing bridge and thereby increase the volume of minutes and thus costs to the IXCs. This only becomes a "problem" for the IXC if it charges a flat monthly rate for unlimited long-distance and local calling. Otherwise, if the IXC charged its customer per minute of use, the business incentives would immediately change and the IXC would have every incentive to encourage its customer to make lengthy calls to the conference calling bridge.

Nevertheless, the IXCs might still complain, since profits would be larger if they paid lower access charges, but the same is true of any access costs. The same is also true if IXCs reduced labor costs by withholding pay from employees or reduced infrastructure cost by refusing to pay vendors that provide switches or other infrastructure. These activities would be *unlawful methods* of increasing profits, just as the IXCs' refusal to pay switched access charges is an *unlawful method* by which the IXCs increase profits and eradicate competition.[21] Despite their claims, the IXCs are not "losing" money. In fact the IXCs are actually experiencing increased profits as these new services bring new unlimited long-distance customers to the IXCs, thereby enlarging the overall market, to use, and pay for, more IXC services.

B. *Profit Maximizing Pricing by IXCs*

The IXCs offer services with a number of pricing plans and various types of bundling with other products. Furthermore, this happens at both the residential and commercial level. Though individuals generally pay the same price for any given bundle, larger

[21] *See* 47 U.S.C. § 201(b) (2006) ("All charges, practices, classifications, and regulations for and in connection with such communication service, shall be just and reasonable, and any such charge, practice, classification, or regulation that is unjust or unreasonable is declared to be unlawful. . .").

businesses buy bulk minutes at a discount, more like a wholesale rate, and are also offered bundled services. Therefore rates vary depending on minutes bought and by the ability of a consumer to negotiate lower rates. For an IXC to be profitable, average prices *overall* must be above the IXC's long-run *average* costs.

1. Why do IXCs Choose Different Pricing Philosophies for Voice and Data?

A signal of IXCs' pricing problem is that AT&T is reconsidering its pricing for unlimited data on cell phones. AT&T has discovered that 40% of its data traffic is coming from 3% of AT&T Mobility's Smartphone users.[22] According to AT&T's use of the term, one might expect the company to accuse its customers of "traffic pumping." AT&T is considering tiered pricing plans that will resemble the traditional voice plans, that were in place before the proliferation of unlimited calling plans; a customer pays for a certain amount of minutes and then pays a per minute rate once that limit is exceeded.[23] AT&T and other IXCs could similarly modify their unlimited long-distance plans to charge a premium to those long-distance customers that, in the IXCs' opinions, consume excessive quantities of unlimited long-distance services.

2. Fixed Pricing for Unlimited Service has a Preconceived Business Purpose

A fixed price for unlimited service is not an unusual situation for many businesses. The following analogy may shed further light on the fallacy of the IXCs' arguments. Consider, for example, tire stores, which frequently offer free balancing and rotation for the life of the tires if you buy a complete set of four tires for your car. Does that mean that the tire store loses money each time a customer comes in to balance and rotate the tires? What if the stores are owned independently and franchise the tires from a major national supplier?

Further assume that tires must sell for the same price everywhere, but the national supplier must compensate stores with higher rent and labor costs to help them cover the costs associated with this service.

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[22] *See* Jenna Wortham, *AT&T to Urge Customers to Use Less Wireless Data*, N.Y. TIMES, Dec. 10, 2009, at B6.
[23] *Id.*

What if the customer chooses to balance and rotate at the downtown store instead of the suburban store? Does that mean the customer is ruining the profitability of the national chain? Surely the chain will account for this in their pricing model and charge sufficiently for the original tires to cover their costs.

What if the downtown tire store only sells tires, but a small company contracts to do the balance and rotation services at its neighboring downtown location? The supplier may prefer customers go to the suburban store since providing service through the contractor costs more, but does that mean they are losing money? Can the tire store simply refuse to pay the contractor, because too many customers use the contractor's services?

How many new customers will the tire store draw in because it offers this balance and rotation service as part of the bundle that consumers buy with their new tires? This draws more revenue to the store but also to the chain by attracting more customers away from competing tire brands—and they are likely to be loyal, satisfied customers that purchase other products and services from the tire store. If the supplier felt the services were being abused, they could limit the number of free balances and rotations or impose a small incremental service fee on the work done in the downtown store. Just like the tire store, the major IXCs have tremendous flexibility to offer consumers a variety of plans with varying terms. For example, per minute long-distance rate plans from the major IXCs range between $5.00 flat fee per month, plus 5 cents a minute at AT&T, to $1.99 flat fee per month, plus 15 cents a minute at Qwest. Verizon's rates are $6.00 per month, 5 cents per minute, with a $9.99 minimum per month. Sprint no longer advertises residential long-distance (anyone who is interested must call an 800 number to ask for pricing information), but, according to SaveOnPhone.com, Sprint is charging 5 cents per minute plus $8.95 per month and MCI (now a part of Verizon) offers 4 cents per minute plus $6.99 per month. [24]

[24] *Rate Comparison Chart*, SaveOnPhone.com (2008), http://www.saveonphone.com/chart.aspx (last visited Sept. 9, 2010).

3. IXCs Have the Market Power to Implement Various Pricing Plans

Some companies also have started introducing hybrid plans, similar to wireless plans, where consumers pay a flat fee for a certain volume of minutes and then pay for each minute by which they exceed the predetermined volume. MCI, for example, offers 200 minutes of long-distance for $12.99 plus 5 cents per minute for minutes used over the initial 200.

Each IXC also offers "unlimited" plans as well. For example, Qwest and AT&T both advertise $25 per month for unlimited plans. Similarly, the major IXCs offer bundled services tied to various home services offered by their captive ILECs. With bundled services, the price of each additional service, like unlimited long-distance, is even less depending on what else a customer buys. This is another example of averaging used in pricing models. [25]

4. Unlimited Calling Plans Lure Consumers

Another inquiry that is relevant to the profitability of IXCs is how many customers with per minute long-distance bills (for example, averaging, between $10–$30 month, but varying across months) switched to unlimited plans (for say $25 per month) just to substitute a higher expected, but predictable bill, in exchange for eliminating the risk that they might have an occasional extremely high monthly bill that results in "sticker shock." In these circumstances, the major IXCs are increasing profits by having people switch from per minute plans to monthly plans.[26]

It is likely that many customers who were on per-minute plans switched to unlimited plans *because* they saw the availability of free conferencing, and other free telecommunications services and wanted

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[25] The "price" that is produced by the necessary average cost method is a form of hybrid, or aggregate, pricing. Aggregate pricing can also create problems for the IXCs because it tends to skew economic incentives and natural market forces, as we have noted with the "unlimited" pricing model that desensitizes consumers to the actual costs of using the service and may even encourage additional usage that serves to drive up the average costs to the IXCs.

[26] Evidence suggests IXCs are using such bundling as their major marketing strategy. *See, e.g.*, AT&T, AT&T, Annual Report 2008, 37, http://www.att.com/Common/about_us/annual_report/pdfs/2008ATT_FullReport.pdf.

to have worry-free access to them. Granted, many of these customers may not use the free services, or use them to a lesser degree, if they had to pay per minute rates, but that does not mean that the IXCs are negatively affected merely because a consumer wants to use some free services in conjunction with their unlimited long-distance plans. In fact, the record demonstrates that customers use only 21 minutes of free conferencing services per month, on average.[27]

5. Why are the IXCs Complaining?

Taking another look at this, Figure 3 demonstrates, according to FCC and Bureau of Labor Statistics ("BLS") data, that the average revenue per minute for long-distance telephone calls is currently about 7 cents, plus or minus 1 cent.[28] This suggests that the IXCs are earning between 4 cents and 6½ cents per minute on every call made to a free conferencing service, or 24 cents per minute in the case of the customer in Exhibit B. Even at 3 cents per minute for access charges, which is at the high end, and accepting the lowest possible estimate for profit, the IXCs are making 4 cents per *minute* of increased conference traffic, which is an extremely generous profit on these calls.

This, then, begs the question: Why are the IXCs fighting against the free conferencing companies? Is the real intention to eliminate competition and then take advantage of a business niche created by the free conferencing companies?

One theme becomes clear. The claims about "losing money" on calls made to free conferences are bogus. Of course, the IXCs would prefer lower access charges, but then they would like lower taxes and lower labor costs as well. In short, this argument is merely another way for these powerful economic interests to get a larger share of the market.

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[27] *See* Ex Parte Letter and Presentation from Ross A. Buntrock, Counsel, Free Conferencing Corporation to Marlene Dortch, Sec'y, FCC (Oct. 16, 2009), *in* FCC WT Docket 07-52, *available at* http://fjallfoss.fcc.gov/ecfs/document/view.action?id=7020142308 (letter), http://fjallfoss.fcc.gov/ecfs/document/view.action?id=7020142310 (presentation).

[28] Bureau of Labor Statistics, Consumer Price Index (2010), http://www.bls.gov/news.release/pdf/cpi.pdf; Telecommunications Industry Revenues: 2007, http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-293261A2.pdf.

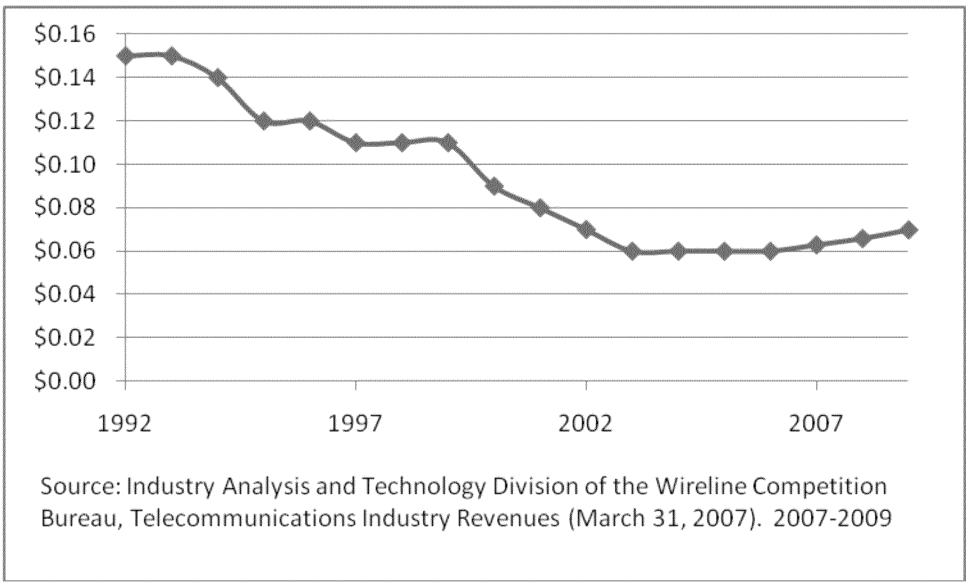
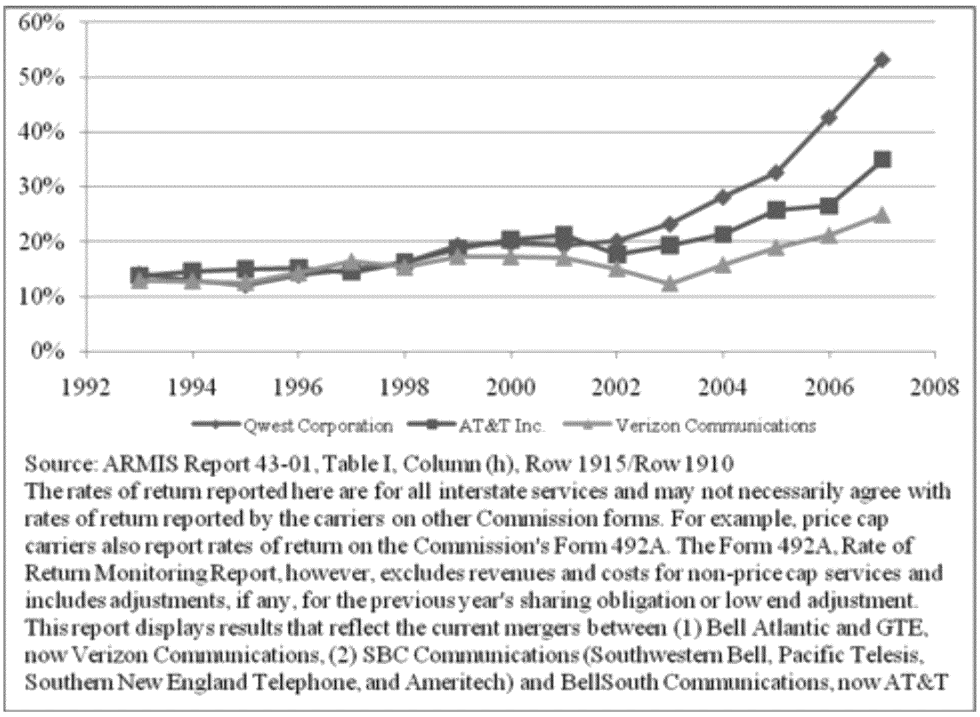


Figure 3: Average Revenue per Minute for Residential Interstate Toll Calls

More evidence can be derived from the rates of return for the IXCs. Figure 4 shows that the rate of return for the interstate services business has been increasing to high levels since at least 2003. This fact is supported by the 10Qs filed with the Securities and Exchange Commission ("SEC") that also point out higher profit margins with unlimited plans.[29] In fact, the complaints from the IXCs about "traffic pumping" that are the subject of several ongoing legal battles have given the IXCs cover to raise rates, because they continually claim—and complain—to the FCC, the state regulators, and to Congress that their asserted lack of profits compel them to raise prices. Since, in fact, there is no evidence to support a lack of profit, this argument is baseless, as demonstrated by the increasing rates of return for the major IXCs.

The claims that the IXCs are "losing money" on long-distance are false. It is raised merely as an argument designed to distract regulators from the IXCs' efforts to quash competition stemming from new entrants to the conference calling market.

[29] *See* FCC, ARMIS ANNUAL SUMMARY REPORT, 43-01 (2008).



Source: ARMIS Report 43-01, Table I, Column (h), Row 1915/Row 1910
The rates of return reported here are for all interstate services and may not necessarily agree with rates of return reported by the carriers on other Commission forms. For example, price cap carriers also report rates of return on the Commission's Form 492A. The Form 492A, Rate of Return Monitoring Report, however, excludes revenues and costs for non-price cap services and includes adjustments, if any, for the previous year's sharing obligation or low end adjustment. This report displays results that reflect the current mergers between (1) Bell Atlantic and GTE, now Verizon Communications, (2) SBC Communications (Southwestern Bell, Pacific Telesis, Southern New England Telephone, and Ameritech) and BellSouth Communications, now AT&T

Figure 4: Holding Company Interstate Rates of Return

F. Competition from New Market Entrants

A. *New Competitors and New Markets*

Conspicuously absent in the complaints filed by the IXCs is the fact that services offered by free conferencing companies are effectively competing with services offered by the IXCs. Until 2005 the only teleconferencing service offered by the big telecoms was a host-pay toll-free dial-in service. This service was prohibitively expensive for many consumers that desired to use conference calls to collaborate on entrepreneurial ventures (i.e., small business), for philanthropic or religious purposes (i.e., nonprofits), or to deal with the government. Free calling services were pioneered as a response to this market failure.

Indeed, starting in 2006, many IXCs were forced to adopt a consumer-friendly model similar to free conferencing, that is, participant-paid conferencing. Though many still charge the host per minute, per caller, these new offers are significantly cheaper than the traditional host-pay toll-free services. Over the intervening years, the price for these service offerings have continually declined from 25

cents per minute in March 2007 (AT&T) to 8½ cents per minute, as of November 2009.[30]

B. *IXCs are Engaged in Unfair Competition*

The IXCs' complaints and refusals to pay for access charges associated with free conference call services, is an example of unfair competition whereby IXCs leverage their nationwide market power and corporate strength to control, and perhaps eliminate, emerging and increasingly vibrant competition, much as the "Robber Barons" did in order to build and assert their monopoly power in the late 19th and early 20th centuries.

Another issue appears to underpin the complaints of the IXCs': the fundamental shift of consumers away from traditional landlines to wireless and VoIP services. According to an analysis by *Cable and Satellite*:

> While wireline voice continues to lose customers to wireless, the loss was slightly less this quarter. The telcos saw a 7% decline in y/y losses as fewer people moved given difficulties in the housing market (also partially caused by a relatively easy comp from 2Q08). Cable saw an accelerated slowdown in phone additions for the 5th consecutive quarter.[31]

The shifting preferences of consumers, raises three further issues that must be explored to fully understand the economic impact of free conference calling services. First, what is the purpose of the FCC's policy that allows rural CLECs to charge more for access services than urban ILECs? Second, what has been the effect of the implementation of these rules? Finally, what is the effect on the LECs, the IXCs, and consumers, particularly rural telecommunications consumers? These issues will be explored in detail.

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[30] *See AT&T Conference Calls-More Than Just a Call*, BLOGSHARP: Cutting Edge Posts (Mar. 3, 2007 10:33:40), http://www.blogsharp.com/news_2054.html.

[31] Todd Rethemeier & Jeff Wlodarczak, Hudson Square Research , Cable and Satellite Telecom Services: 2Q09 Video, Voice and Data Industry Review (2009).

C. *FCC Regulations and Statements: IXCs use "TRAFFIC PUMPING" in Order to Mislead Legislators*

Rules relating to access charges collected by LECs are enumerated in the FCC's Seventh Report and Order and further Notice of Proposed Rulemaking, adopted on April 26, 2001.[32] In that document, the FCC clearly and unequivocally concluded that LECs serving exclusively rural areas are entitled to tariff access charges at rates generally exceeding those of ILECs. In reaching that decision, the FCC articulated several reasons for this rural LEC exemption:

> . . . to encourage the deployment to rural areas of the infrastructure necessary to support advanced telecommunications services and of the services themselves. . . .
> . . . [rural CLECs] experience much higher costs, particularly loop costs, when serving a rural area with a diffuse customer base . . .
> . . . the exemption we adopt today is not properly viewed as an implicit subsidy of rural CLEC operations. Instead it merely deprives IXCs of the implicit subsidy for access to certain rural customers that has arisen from the fact that non-rural ILECs average their access rates across their state-wide study areas.[33]

As a result of the *Seventh Report and Order*, rural CLECs must follow one of two pricing rules: (1) if the CLEC competes with a *non-rural* ILEC, then it may tariff at the highest NECA rate,[34] or (2) if the CLEC competes with a *rural* ILEC, then its tariff rate is limited to the maximum of the competing rural ILEC (which may also be the highest NECA rate).[35]

The IXCs' complaints wrongly allege that free conference calling services violate the FCC's intent in setting rural access charges. Their arguments either fail to address the actual intent of the FCC in their entirely, or to analyze the FCC's intent in light of current market realities and the positive impact that conference calling services can have on other aspects of the rural CLECs' business operations.

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[32] *See* Seventh Report and Order, *supra* note 11.
[33] *Id.* at para. 65–67.
[34] *See id.* at para. 73.
[35] *See id.* at para. 79.

Since the FCC was specific in its intent in adopting the rural exemption, failing to address all of the factors enumerated by the FCC, while focusing exclusively on only one variable, reveals little about whether a specific rural LEC is or is not violating the spirit of the FCC's policy and its intent. For example, rural ILECs often have outdated switches. The ILECs involved with free conferencing services purchased soft switches capable of handing off VoIP traffic. Furthermore, AT&T has submitted that the FCC should eliminate circuit switches entirely in favor of wirepods. This will only put more pressure on the rural LECs, especially ILECs. Without revenue sources to pay for the new switches, how can the rural LECs continue to provide universal service?

D. *The Economic Impact of the IXCs' Refusal to Pay for Access Services*

In a variety of complaints before the FCC, rural CLECs and free conferencing service providers have alleged that large IXCs, with dominant market power (e.g., AT&T, Verizon, Qwest, and Sprint) are committing various anti-competitive practices against small, non-dominant LECs and related service providers.[36] These practices include, but are not limited to, not paying for access charges, routing calls through low quality or exhausted lines, or outright call blocking. At the same time, the relative size and financial strength of large IXCs, such as AT&T, Verizon, and Qwest, provide an enormous advantage over the small firms.

E. *IXCs' Abuse of Market Power*

To illustrate, AT&T is worth approximately $152 billion, which is more than half of the Standard & Poor's market capitalization for the entire Telecommunications Sector. Furthermore, they have increased their dividend each year since 2004, and continued that

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[36] *See, e.g.*, MHJP, Inc., Forfeiture Order, 23 FCC Rcd. 18497 (Dec. 19, 2008). The following parties have filed comments under Docket 07-135: Free Conferencing Corporation, ZipDX, Hypercube, Tekstar Communications, Northern Valley Communications, Sancom, Global Conference Partners, Futurephone.com, FeatureGroup IP, Great Lakes Communication Corp, Baraga Telephone Company, All American Telephone Co, e-Pinnacle Communications, ChaseCom, Omnitel Communications, M/C Venture Partners, Columbia Capital, Citynet, LLC, Granite Telecommunications, Inc., PAETEC, RCN Telecom Services, Inc., U.S. TelePacific Corp., MetroPCS Communications, Windstream Communications, DISH Network, DeltaCom, Level 3 Communications, COMPTEL.

trend by raising it again in January of 2010. Small LECs, on the other hand, are worth less than 1% of AT&T's value. Further, rural LECs, like IXCs, are experiencing shifting consumer demands and thus are expected by UBS analysts to experience continued revenue declines.[37]

To continue to provide a sustained or improved quality of service to rural consumers, rural CLECS must diversify their service offerings and revenue streams. Many are beginning to offer wireless service, while others are providing facilities to conference call providers. Regardless of their business strategies, the business reality remains the same: rural CLECs are in increasing jeopardy as consumer preferences shift toward more modern services with the concomitant higher costs. Consequently, the FCC's goal of ubiquitous access services is similarly jeopardized when rural CLECs are the victims of unfair competitive practices.

Similarly, free conferencing companies are also significantly smaller than any of the IXCs, serving a small percentage of the total conference call market. Accordingly, the IXCs' practice of withholding access payments, thereby forcing LECs and conference call providers to expend considerable sums on litigation expenses, has a proportionally greater negative effect on these much smaller competitors of the dominant IXCs. Stated differently, a small, start up conference call provider places far greater value on $100,000 than does an AT&T, a Qwest, a Verizon, or a Sprint.

F. *Consumers Ultimately Pay the Price for Abuse of Market Power*

Moreover, as rural CLECs and conference call providers are harmed by the refusal of IXCs to pay access charges, so too are consumers. Notably, IXCs generally refuse to pay for both traditional call traffic and conference call related traffic. Consumers will ultimately be the biggest losers, as the availability of innovative services is diminished for rural consumers and as competitive conference call service providers are choked off by the IXCs. In the end, consumers will experience higher prices and less choice, as the dominant firms in this oligopolistic market push pricing to suit their urban and high-density markets.

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[37] Batya Levi, et al., UBS Inv. Research, The Rural Telecom Monitor (2009).

G. Conclusions

This leads to some straightforward observations:

- Conference calling services are currently provided by an array of entities ranging from the very large, (e.g., AT&T, Verizon, Qwest, Sprint, et al.), to the very small, (e.g., rural telephone companies and small competitive local exchange carriers).
- Broadly speaking, there are two major types of conference calling. First, host-paid conference calling where the calling-in party pays nothing because the host pays all of the telecommunications expenses. Host conference calling arrangements were developed, and are still dominated by, the giants of the industry. Second, in free conferencing services the conference attendee pays for the long-distance call. These conference calling arrangements are generally used by charities, small and large businesses, and political organizations, where the calls are generally terminated in a rural area.
- When the dominant ILECs/IXCs complain to the FCC about "traffic pumping," "access stimulation," and refuse to pay terminating access charges, there is a hidden motive and agenda on their part, namely to frustrate and weaken the competitive positions of the small, non-dominant companies that offer conferencing services competing with the dominant companies.
- Despite claims to the contrary, the dominant IXCs are not confronting either a loss of business opportunities or profit as a result of the free conferencing competition. If they are suffering at all, it stems from their unlimited long-distance pricing models, which they are free to modify.
- Conference calling competition introduced and promoted by the free conferencing companies has resulted in lower prices for all conferencing services. As a result, all customers of these services have benefitted, along with the companies that provide them.
- Free conference calling services have expanded the market for unlimited long-distance plans.
- The average revenue per minute and rate of return for the IXCs' long-distance services have been increasing, not decreasing.
- The evidence supports a conclusion that unlimited long-distance plans are, on average, profitable for the IXCs. Thus, it can be

concluded that free conference calling services have, on average, resulted in increased profits for the IXCs.

- FCC regulations and statements have consistently and categorically concluded that the policy goal for rural America should encourage the deployment of the infrastructure necessary to support advanced telecommunications services. In order to support that laudable and widely supported goal, the access charges for originating and terminating long-distance traffic in rural areas can be higher than the nationwide average. Referred to as "the rural exemption," this policy is designed to overcome the technological and capital costs of providing advanced services in rural America—services that if they were withheld would result in severe economic and employment suffering.
- If the FCC eliminates the rural exemption or places regulatory constraints that result in tariffs that are simply too low, the action would have a negative impact on future competition and product development, thus eviscerating the FCC's policy underlying the rural exemption while impeding the provision of available and affordable broadband services.
- The dominant IXCs are assiduously divesting themselves of their own rural ILECs, adding further evidence that these major, profitable companies are no longer interested in serving rural American markets.
- Some rural communities are being so poorly served by incumbent telephone service providers that they are forming their own CLECs because they cannot get service from existing IXCs/ILECs. Perhaps the least served communities in the nation are those on Native American Reservations. In fact, a number of them have formed CLECs and offer up-to-date telecommunications-information services at affordable rates. This trend should be encouraged by the FCC.