

Firm Advisory

March 14, 2008

**U.S. DISTRICT COURT ENJOINS ASSESSMENT
OF STATE USF ON VONAGE**

*COURT FINDS VONAGE'S PENDING CHALLENGE
"VERY LIKELY" TO SUCCEED*

A U.S. District Court last week enjoined the Nebraska Public Service Commission from assessing state Universal Service Fund ("USF") fees on Vonage's VoIP service. The Court determined that Vonage's pending challenge to the Nebraska Commission decision to assess USF fees on Vonage's VoIP service is "very likely" to succeed, and therefore granted to Vonage the requested injunction. The decision is a significant win for Vonage, which has vigorously challenged state commission attempts to regulate its service. More generally, the decision is another factor to be weighed in evaluating the question of state commission authority to regulate VoIP services.

Federal law permits both federal and state USF programs to co-exist, provided the state plan does not interfere with the federal rules. In a 2006 Order, the FCC extended federal USF requirements to interconnected VoIP providers, establishing a "safe harbor" rule which presumes that 64.9% of interconnected VoIP traffic is interstate and therefore subject to federal USF contribution calculations. A federal Circuit Court upheld these FCC rules.

Applying the FCC presumption, the Nebraska PSC determined that interconnected VoIP constitutes a "telecommunications service" under Nebraska law, subject to state USF contribution. The PSC ordered such VoIP providers, including Vonage, to contribute to the state USF program, based on the assumption that 35.1% of VoIP traffic is jurisdictionally intrastate.

The U.S. District Court has now determined that the FCC preempted state regulation of VoIP service where the traffic cannot be distinguished along intrastate and interstate lines, that Vonage's "DigitalVoice" service cannot be so distinguished, and that the Nebraska PSC cannot rely on the FCC's presumed 65/35 interstate/intrastate split to impose state USF fees on Vonage.

This court decision represents just the latest development in the continually evolving area of VoIP regulation. To place this decision in the proper context, we provide a brief summary of several major legal and regulatory developments, including the following:

- Federal Communications Act Authority for Federal and State USF Programs (1996)
- The FCC VoIP Preemption Order (2004)
- The FCC USF Contribution Rules for VoIP (2006)
- The Nebraska PSC Decisions (2005 and 2007)

Federal and State USF Programs under the Federal Communications Act

The federal Communications Act, as amended by the 1996 Telecom Act, requires USF contributions from "[e]very telecommunications carrier that provides interstate telecommunications services" and authorizes the FCC to demand USF contributions from "[a]ny other provider of interstate telecommunications...if the public interest so requires."

State commission authority to impose USF charges is, however, also explicitly preserved in the Act. The Act provides that states may "adopt regulations not inconsistent with the [FCC's] rules to preserve and advance universal service," and that "[e]very telecommunications carrier that provides intrastate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, in a manner determined by the State[.]" Currently, about half of all states have USF programs.

The FCC's VoIP Preemption Order

In resolving a dispute between Vonage and the Minnesota PUC, the FCC preempted states from imposing certain state regulatory requirements on VoIP service in 2004. While avoiding the issue of whether VoIP is a "telecommunication service" or "information service" under federal law, the FCC determined that it was "impossible or impracticable" to separate VoIP traffic along intrastate and interstate lines. The FCC therefore held that it – and not state

commissions – was responsible for the regulation of VoIP. The U.S. Court of Appeals for the Eighth Circuit upheld this decision.

The FCC's USF Contribution Rules for VoIP

To account for the growth of VoIP as a competitive technology, the FCC updated its USF contribution rules in 2006 to require contributions from providers of “interconnected VoIP” services – VoIP services that allow end-users to access the Public Switched Telephone Network (“PSTN”). Again, the FCC did not classify VoIP as a “telecommunications service,” but instead required interconnected VoIP providers to contribute as an “other provider of interstate telecommunications” under the authorizing statute. The FCC reasoned that interconnected VoIP providers “provide” telecommunications, since they enable end users to place calls that, in some part, cross the PSTN.

Further, while Federal USF contributions are based on a provider's interstate revenues, and the FCC previously held that VoIP services cannot be distinguished along intrastate and interstate lines, the FCC nonetheless determined that 64.9% of a VoIP provider's revenue is presumed to be interstate for the purpose of determining USF contribution levels. The FCC's extension of the USF requirements to VoIP and its safe-harbor rule were upheld by the U.S. Court of Appeals for the D.C. Circuit.

The Nebraska PSC Decisions

The presumption that just 64.9% of VoIP traffic is interstate led states to consider state USF contribution for the remaining, presumably intrastate, traffic. With state authority to regulate VoIP unclear, some states opted for a “wait and see” approach. The Nebraska PSC, however, ordered interconnected VoIP providers to contribute.

Finding that the FCC's *Preemption Order* did not factor state USF into its decision, the PSC held that the FCC's VoIP Preemption Order did not prohibit states from regulating VoIP service for the purpose of USF contribution. The PSC also took the further step of determining that interconnected VoIP service constitutes a “telecommunications service” under Nebraska law, subjecting it to state USF contribution. In so holding, the PSC ordered all interconnected

VoIP providers, including Vonage, to contribute based on the assumption that 35.1% of VoIP traffic is jurisdictionally intrastate – the invert of the FCC’s safe harbor rule.

The District Court’s Decision and Its Implications

Vonage appealed the Nebraska PSC order in federal court, arguing principally that the state commission is preempted from requiring VoIP contribution to its USF. Based on the FCC’s *Preemption Order* and the Eight Circuit’s decision upholding that order, the District Court determined that Vonage’s preemption argument was “very likely” to succeed, and enjoined the PSC from assessing USF fees on Vonage during the pendency of the case. While recognizing that the Commission’s contribution rules were simply the invert of the FCC’s rules, the Court found that “the [FCC’s] safe-harbor ruling does not negate the fact that there is no way to distinguish between interstate and intrastate DigitalVoice service; nor does the adoption of safe-harbor rules affect the characterization of VoIP service as an information service.” Finding the separation of traffic issue determinative, the Court appears ready to vacate the PSC’s decision when it reaches the merits.

The decision is the first to address the impact of the FCC’s 2006 “safe harbor” rules on state authority to impose USF fees on VoIP. To date, only Nebraska, New Mexico and Kansas have explicitly required VoIP providers to contribute to their USF funds. In light of this District Court decision, we would anticipate that other states with USF funds will likely continue to refrain from the assessment of USF fees on VoIP services in the near term.¹

If your company would like further information regarding any of these issues please contact one of the following attorneys:

Andy Klein	202-289-6955	AKlein@KleinLawPLLC.com
Larry Blosser	301-664-6330	LBlosser@KleinLawPLLC.com
Allen Zoracki	301-664-6329	AZoracki@KleinLawPLLC.com

¹ Klein Law Group, with the assistance of regulatory consultants Miller Isar, Inc., recently surveyed state laws and regulations affecting VoIP providers in 10 states, including USF, E-911, Telephone Relay Service, utility tax laws, and pending legislation. The two firms have partnered together to provide a comprehensive legal, regulatory and compliance practice.