IP, Telecom & Technology Sourcing Bulletin

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The Keller and Heckman *"IP, Telecom and Technology Sourcing Bulletin"* is written for telecom, IT, and procurement staff of corporations and government agencies responsible for sourcing IP and telecommunications services and equipment and managing the relationship with services providers. Keller and Heckman LLP represents corporate and government clients ("enterprises") through an expert, interest-based approach in negotiating these services agreements and in disputes arising under these agreements. In this edition of the *Bulletin* we discuss (1) the merits of including IP and Telecom Services in IT outsourcing deals, (2) carrier efforts to limit competitive pricing reviews, and (3) related policy matters before the Federal Communications Commission.

Mixing IP and Telecom Services with IT Outsourcing: Consider Carefully

Today's economy is driving firms to secure cost reductions and free capital for core businesses. IT outsourcing is often considered for reducing IT staff, transferring non-revenue producing assets and minimizing future IT capital expenditures. In evaluating outsourcing opportunities, a recurring question is whether wireline voice and data services ("IP and Telecom Services") should be included in the outsourcing deal. Based on our experience, the enterprise should remain the "customer of record" with the carriers. IP and Telecom Services should not be obtained indirectly through the IT outsourcer. (IT outsourcers typically do not repackage or resell wireless services).

What's the Value Proposition? From a service delivery perspective, the IT outsourcer is no more than a "simple reseller." The carriers make the service deployment, network technology and investment decisions, operate and maintain their networks, and set pricing and service levels. The IT outsourcer does not influence these decisions and does not improve or enhance the quality of carrier services. Conversely, an IT outsourcer is well-positioned to compete with carriers in providing network management services to enterprises. For convenient reference, a list of IP and Telecom Services often included in agreements is available by clicking on the following link: *"IP, Telecom and Technology Sourcing; Services and Equipment."*

When IP and Telecom Services are secured through the IT outsourcer, the enterprise still bears the disruption and costs of carrier transitions. The enterprise will pay for the IT outsourcer's staff managing the transition, but retains oversight and review responsibilities. Even if not transitioning to another carrier's network, the enterprise and the IT outsourcer must complete a detailed circuit and service inventory for the carrier to "transfer" the circuits and services from the enterprise's agreement to its agreement with the carrier.

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Are the Cost Savings For Real ? Securing IP and Telecom Services indirectly from the IT outsourcer may provide cost savings if the IT outsourcer (i) maintains substantially lower rates from the carriers, and/or (ii) qualifies for the "systems integrator exemption" to the FCC's Universal Service Fund ("USF"). Because the USF contribution factor is at an all-time high, the financial benefit of this exemption should be considered fully. *See* **USF Contribution Factor: To Infinity and Beyond**, *below*.

These potential savings are subject to offsets. The IT outsourcer must recover staffing costs for (i) reviewing/auditing the carriers' bills, (ii) billing the enterprise for these services, (iii) placing orders for moves, adds, changes and deletes ("MACDs") and, generally, (iv) acting as intermediary between the enterprise and the carrier. The IT outsourcer also incurs and recovers from the enterprise the cost of funds needed to ensure timely payment of the carriers' bills (while awaiting payment from the enterprise), and enterprise staff must continue to write checks, review and audit bills, and initiate or approve requests for MACDs.

IT outsourcers do not have the same incentives as the enterprise to keep rates for IP and Telecom Services at market prices because, typically, any cost savings are shared to some extent with the enterprise. Our experience has been that IT outsourcers' rates for IP and Telecom Services, while initially favorable, do not necessarily remain competitive for the duration of the outsourcing deal.

Does it Make Sense Strategically? A number of "structural considerations" militate against securing IP and Telecom Services indirectly. The economics of IT outsourcing agreements dictate contract terms well in excess of five years. Issuing RFPs for IP and Telecom Services every three to five years, historically, has provided enterprises with maximum bargaining leverage with the major carriers. As compared to agreements for IP and Telecom Services agreements, IT outsourcing agreements tend to be more complex, the services and functions are often described in detail, and negotiations are far more time consuming. By contrast, rates, service descriptions and SLAs in IP and Telecom Services agreements are expressed in standard formats.

Other than enhanced route diversity at its data centers, the IT outsourcer is not in a position to improve or enhance the reliability of IP and Telecom Services. The benefits of a direct relationship with the enterprise's carriers are lost when IP and Telecom Services are secured through IT outsourcers. The carriers will shift their focus to enterprises with whom they have a direct relationship because these customers are more likely to purchase additional services from the carriers.

Weighing All the Factors . . . an enterprise should evaluate carefully the projected cost savings of rolling its IP and Telecom Services into an IT outsourcing deal. If the savings for the IP and Telecom Services are not substantial and sustainable, neither the value proposition nor possible strategic benefits support adding IP and Telecom Services to IT outsourcing agreements.

Challenges to Meaningful Competitive Pricing Reviews

A core element of IP and Telecom Services agreements is the competitive pricing review. At a minimum, one competitive pricing review is conducted under a three-year agreement. Recently, one of the major carriers has embarked on a not-so-subtle strategy to hamstring telecom consultants in assisting customers during competitive pricing reviews. The principal tactic is aggressive use of NDAs and confidentiality clauses. The apparent objective is to limit the ability of consultants to provide meaningful and relevant pricing benchmarks—based on other agreements with which they are familiar—in competitive pricing review negotiations. This trend calls for more thoughtful drafting of competitive pricing review provisions and different strategies for conducting competitive pricing review negotiations.

New FCC Leadership Signals a Fresh Look at Policies Impacting Enterprises

In late June, the Senate confirmed President Obama's nominee, Julius Genachowski, as the new Chairman of the FCC. Initially, he will focus on broadband, particularly the National Broadband Plan the purpose of which is to "ensure that all people of the United States have access to broadband" services. The FCC must submit its report to Congress by February 17, 2010. The FCC is expected to revisit spectrum policies and consider expansion of the Universal Service Fund ("USF") program to support broadband deployment. Under Chairman Genachowski, the FCC's agenda likely will diverge more noticeably from those of AT&T and Verizon.

End of Exclusive Deals Between Wireless Carriers and Handset Manufacturers?? In the near future, the FCC may initiate a proceeding to determine whether exclusive handset arrangements between wireless carriers and handset manufacturers (AT&T and Apple) should be limited, prohibited or continue without restriction. The "uncoupling" of handset sales and wireless services could provide new wireless pricing options for enterprises.

USF Contribution Factor: 'To Infinity and Beyond.' The FCC has set the Universal Service Fund contribution factor at an all-time high of 12.9% for 3rd quarter of 2009. While assessed directly against AT&T, Verizon and other wireline and wireless carriers—based on their net end user revenues for interstate and international wireline telecommunications services, the carriers recover their USF payments from their customers. An adjusted, lower percentage applies to wireless services. High speed Internet access services are not subject to USF.

In response , AT&T filed on July 10, 2009, **its "Petition for Immediate Commission Action to Reform its Universal Service Contribution Methodology,"** requesting the Commission adopt its previously filed proposal to recover carrier USF contribution obligations based on the total number of assigned telephone numbers to the carrier's customers. As opposed to the current methodology, the overall number of in-service wireless and wireline numbers is growing significantly thereby lowering the potential per customer USF pass through charges. This proposal would be beneficial to enterprise customers, more predictable and far easier to administer.

In another USF matter, the FCC recently requested comment on a filing by 2nd tier carrier Masergy Communications, Inc. urging that multi-protocol label switching ("MPLS") services not be classed as a "telecommunications service" so as not be subject to USF contribution obligations. This petition underscores the importance of confirming whether the principal services in IP and Telecom Services agreements are subject to USF contribution obligations.

Rates for Interstate Special Access—Reductions?? The FCC is also expected to take a "fresh look" at the rates for interstate special access services, particularly DS-1 and DS-3 services, provided by the so-called "price cap ILECs," including AT&T, Verizon and Qwest. These are "tail circuits" for virtually all enterprise networks. For much of this decade, AT&T, Verizon and Qwest successfully prevailed upon the FCC not to review these rates on the misguided theory that ample competition exists for these services. During the past six months a coalition of consumer groups, enterprise customers and wireless carriers have been pressing the issue before the FCC and Congress.

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