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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

William F. Caton
Secretary
Federal Communications Commission
1919 M Street, NW, Room 222
Washington, D.C. 20554

Dear Mr. Caton:

RE: Ex Parte Notice Filing, CC Docket No. 96-98

On July 19, a USTA delegation met with John Nakahata, Special Advisor to Chairman Hundt, regarding USTA's comments filed in this proceeding. As a follow-up to that meeting, enclosed is an original and one copy of USTA's comments regarding the appropriate pricing of vertical services submitted to Mr. Nakahata. Please include a copy of this filing in the record of this proceeding.

Respectfully submitted,

A handwritten signature in black ink that reads "Keith Townsend".

Keith Townsend
Director
Regulatory Affairs & Counsel

cc: John Nakahata, Office of Chairman Hundt
Office of Commissioner Quello
Office of Commissioner Ness
Office of Commissioner Chong
Regina Keeney

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July 25, 1996

EX PARTE

Mr. John Nakahata
Legal Advisor to Chairman Hundt
Federal Communications Commission
1919 M Street, N.W., Room 814
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Re: Local Competition Proceeding (CC Docket 96-98)

Dear Mr. Nakahata:

We appreciated the opportunity to meet with you last Friday, on behalf of USTA, to discuss some of our concerns with regard to implementation of Section 251 of the 1996 Telecommunications Act.

One of the issues we discussed concerned the appropriate pricing standard for the purchase of so-called "vertical services," such as call waiting, three-way calling and other premium services. This letter has two parts. The first summarizes our arguments as to why vertical services should only be made available under the retail pricing provisions of the Act. The second explains how to separate the costs of vertical services from the costs of local switching.

A. **Vertical Services Are Retail Services, Not Part of Unbundled Local Switching**

One argument that has been raised in this proceeding is that competitors should be permitted to obtain access to all of the vertical services an incumbent LEC offers by purchasing unbundled local switching under Section 252(d)(1) of the Act. The Commission may not and should not permit this.

This argument rests on an incomplete reading of the Act's definition of "network element," which focuses only on that part of the definition that says a network element includes "features, functions and capabilities that are provided by means of such facility or equipment..." Read in its entirety¹, however, it is clear that the "features, functions and capabilities" covered by

¹ Under Section 3(a)(45) of the Act, a "network element" is defined as "...a facility or equipment used in the provision of a telecommunications service. Such term also includes features, functions and capabilities that are provided by means of such facility or equipment, including subscriber numbers, databases, signaling systems, and information sufficient for billing and collection or used in the transmission, routing or other provision of a telecommunications service."

the definition are those used in the transmission, routing or provision of a telecommunications service -- not the service itself. For example, the subscriber numbers, databases and signaling systems explicitly included in the definition are all required for basic local call routing and completion.

Vertical services are not network elements; they are the same telecommunications services that local exchange carriers offer to subscribers who are not telecommunications carriers. Under Section 251(c)(4), LECs have a duty to provide these retail services to interconnecting carriers at wholesale rates -- not at "cost-based" rates as part of unbundled network elements. Requiring inclusion of vertical services in unbundled local switching would effectively read the resale pricing provisions out of the Act for any profitable service. It is unlikely that any competitor would choose to pay wholesale rates for such services when it could simply obtain them as part of an unbundled switching element. If competitors need not invest a penny in any facility of their own, but instead may buy all of the incumbent's network elements and vertical services at incremental rates, they will succeed in simply reselling the incumbent's services while evading the Act's resale pricing provisions. Moreover, since the joint marketing prohibition on interexchange carriers under Section 271(e)(1) of the Act applies only to joint marketing of long distance and local exchange services obtained under the resale provisions of the Act, interexchange carriers could also evade the Act's joint marketing prohibitions by obtaining local premium services through the purchase of unbundled network elements and jointly marketing them with long distance services.

Permitting competitors to evade the Act's resale pricing provisions in this manner would have significant adverse economic impacts on consumers, LECs and the economy. Vertical services, which are primarily software-based, have significant fixed costs due to the research and development activities required to create them. But their incremental costs are very low because the cost created by an additional user is typically very small. As a result, if these services are not subject to the Act's resale pricing requirements and the Commission adopts the Hatfield method as a basis for pricing unbundled network elements, LECs would be forced to allow competitors to strip away these high contribution services without fair compensation.

As Jerry Hausman noted, this "give away" will deter innovation in new services, because incumbent LECs and their competitors will have little incentive to develop new services if competitors can simply "free-ride" by buying the incumbent LEC's services at forward-looking incremental cost. The incumbent LEC would be faced with Hobson's choice in deciding whether to develop and deploy a new and untried technology or service. If it makes the investment and the service is successful, free-riding competitors would be able to offer the same service without compensating the incumbent LEC for all of its cost. If the service is unsuccessful, only the incumbent LEC has taken the risk and incurred financial losses. The incumbent LEC's innovation in new telecommunications services would soon cease, and consumers would ultimately be the biggest losers. As fewer telecommunications services are offered over LEC networks, the economy will lose billions of dollars of increased consumer welfare.

In addition, permitting inclusion of vertical services in unbundled local switching would significantly reduce -- by regulatory fiat, not market forces -- the contribution LECs receive from such services, which has historically permitted LECs to keep basic local rates low. Contribution from these services also permits LECs to maintain and upgrade the network infrastructure that will provide the foundation for local competition by many service providers, through resale or lease of LEC network facilities.

Finally, if competitors are allowed to obtain all of the services the incumbent LEC offers its own customers as part of unbundled switching, these competitors will have little incentive to invest in their own networks. As a result, there will be less infrastructure investment, fewer new jobs and less economic development than the Act would otherwise encourage.

For these reasons, the Commission should require competitors to purchase vertical services at wholesale rates, rather than as part of the unbundled switching element. There is no question that competing carriers will be able to offer their consumers a full competitive menu of services; the only question is what they will pay to be able to do so. If the Commission should nevertheless decide to allow carriers to obtain vertical services as part of unbundled network elements, it should at a minimum permit the states to determine the pricing standards for such unbundled network elements -- particularly the amount of joint, common and embedded costs that may be recovered and what constitutes a reasonable profit -- in order to balance at the local level these important public policy goals.

B. Separating Costs for Vertical Services from Unbundled Switching Costs

As explained below, the costs associated with local call routing and set up can be separated from those associated with vertical services in a fair and reasonable manner, without any danger that costs will be "double-counted." Costs associated with vertical services can be separated into three categories: (i) costs unique to vertical services that are switch-based; (ii) costs unique to vertical services (or shared by vertical and other services but not the unbundled switching element) that are not switch-based; and (iii) shared costs of the switch that are associated with both local switching and vertical services.

The first category of costs includes those switch-based costs that would not exist but for the provision of vertical services. In calculating the incremental costs associated with the unbundled switching elements, LECs would exclude these switch-related costs that are uniquely associated with the provision of vertical services. These costs would be directly assigned to vertical services and would be covered by the wholesale price charged for the vertical services. Such costs include:

- Right-to-use fees: Payments to vendors for activation of the software that provides the central control portion of the switch with the intelligence to provide vertical services. (In fact, such payments are not included today in determining the incremental costs associated

with local switching.) Most switch manufacturers sell switches in the American market with vertical services software already built in. That software, however, can only be activated by the switch vendor, and will not be activated until the local exchange carrier pays the vendor a right-to-use fee to do so.

- **Specialized equipment costs:** There are certain additional pieces of equipment in the switch that are used only to provide one or more vertical services. Examples of such equipment include: (i) the bridge used for three-way calling, conference or call transfer services, (ii) the line circuits and data transmitters used only to connect callers to the adjunct processors used for voice messaging services and (iii) the data transmitters used to transfer Caller ID information. The costs of each such piece of equipment would be recovered only from the particular vertical services that utilize that equipment.

In addition, certain pieces of equipment in the switch, such as the announcement frames and related trunks, have a finite amount of capacity that can be directly assigned to either call set up or particular vertical services. For example, an announcement circuit used for call set up may play the message: "Your call cannot be completed as dialed. Please hang up and dial your call again." Another circuit, used for a call blocking service, may play voice prompts to instruct the caller to enter the number of the call to be blocked. Costs associated with that portion of equipment used to provide vertical services would not be included in the cost of the unbundled switching element.

Of course, marketing and other expenses for the direct promotion of vertical services would also be excluded from any calculation of local switching costs.

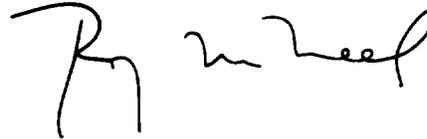
The second category of costs covers those costs required to provide vertical services (and perhaps services other than local switching) that utilize portions of the network external to the switch. Those non-switch costs that are incurred exclusively to support vertical services are directly assigned to the appropriate vertical service or services. Examples of such costs include the multi-service peripheral used to provide remote activation of call forwarding, and the speech recognition adjunct processor for voice dialing services. For those non-switch costs that support both vertical and other services, the Commission's existing rules require that the revenues from all of those services jointly recover those costs. For example, the costs associated with database queries to match caller name and number for Caller ID Deluxe services, such as the costs of the datalinks, and database processor usage and storage, would be recovered from the Caller ID Deluxe services as well as from the other services using that database.

This entire category of costs would never be part of the calculation of the cost of the unbundled switching element, because these costs are not associated with provision of local switching. The existence of significant non-switch-related costs related to the provision of vertical services underscores that vertical services cannot simply be considered to be encompassed in the unbundled switching element, but are appropriately treated as separate retail services subject to the Act's resale pricing provisions.

The final category of costs are the shared costs of the switch, such as its central control hardware and software, that support both vertical services and local switching. Central control has a finite capacity measured in milliseconds, the costs of which are allocated among all services on the basis of milliseconds of use. As a result, these costs are apportioned between vertical services and the unbundled switching element in proportion to their relative use. There would consequently be no double counting of these costs.

We believe that this comprehensive explanation provides sound economic, public policy, legal and technical support for a determination by the Commission that vertical services should not be available as part of unbundled local switching.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Roy M. Neel". The signature is fluid and cursive, with the first name "Roy" being the most prominent.

Roy M. Neel
President and CEO
USTA

cc: Ms. Belvin
Mr. Casserly
Mr. Gonzalez