Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of	
Access Charge Reform	CC Docket No. 96-262
Price Cap Performance Review for Local Exchange Carriers	CC Docket No. 94-1
Transport Rate Structure and Pricing	CC Docket No. 91-213
Usage of the Public Switched Network by Information Service and Internet Access Providers	CC Docket No. 96-263

COMMENTS BY PACIFIC TELESIS GROUP ON THE NOTICE OF INQUIRY

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Date: March 24, 1997

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Pacific Telesis Group has the following comments on the Commission's Notice of Inquiry ("NOI") in CC Docket 96-263.

I. INTRODUCTION AND SUMMARY

We agree with the Commission that the issues raised in this *NOI* proceeding concerning "the development of the Internet and other information services raise many critical questions that...[u]ltimately...concern no less than the future of the public switched telephone network in a world of digitalization and growing importance of

data technologies."[1] Since the beginning of telephony, few developments have been so significant as use of telephone networks to access the Internet. Few, if any, changes have occurred as quickly as those caused by this development. These changes offer great opportunities if, and only if, regulation and the industry can keep up with them by making corresponding changes in the way network services are regulated, offered, and used.

We strongly support the rapid growth in use of the Internet and the spread of its availability to all markets, including the mass market of consumers, businesses, and schools and libraries. We believe that the Internet is a key part of the global information infrastructure ("information superhighway") and essential to the economic health of the United States. Accordingly, we will continue to support the development of this important new information channel through use of Pacific Bell's and Nevada Bell's networks, through Pacific Bell Internet Services, and through Pacific Bell Network Integration's local area network and Intranet services.

Network Integrity Is Of Key Importance

Recent problems of congestion in both the LECs' and the ESPs' networks have brought general awareness that the Internet, like other areas of great opportunity, carries with it great risks. In this area, however, much of the risk could accrue to the public, in the form of deterioration of the public switched network, unless LECs provide significant incremental investment in the network. For instance, approximately one-third

[1] *NOI* at para. 311.

of Pacific Bell's switches serve Internet and other online service providers, which leaves these switches particularly vulnerable to Internet congestion.

Public switched network integrity is protected in Pacific Bell's and Nevada Bell's territories because we are dedicated to investing hundreds of millions of dollars over the next few years for the network expansion necessary to handle the massive increase in enhanced services traffic. Incremental costs for this network augmentation in 1997 alone are estimated to be over $100 million. Making this investment is crucial to protect the large number of telephone service subscribers whose service would otherwise be negatively affected by the unexpected increase in network traffic caused by the ESPs. One of the goals of this proceeding, and of the access reform proceeding, should be to eliminate unreasonably discriminatory access to the public switched network and to ensure that the cost causers, including ESPs, pay their share of the costs of access to the network.

The ESP Exemption Causes Misuse Of The Network

Currently, the ESP exemption from access charges ensures that ESPs pay nowhere near their share of these network costs, so long as they use traditional local business services (1Mb, Centrex, Primary Rate Interface or "PRI" ISDN) on the voice network to provide Internet access and other information services. Others are therefore subsidizing these ESPs. Because there is this substantial subsidy for services on the voice network, the movement of Internet access traffic to data networks is being unreasonably delayed. This delay is harming consumers by leaving them with

slower and less reliable services than could otherwise be available. Moreover, it could harm U.S. business as a whole because the lead that our nation has in deploying and using the Internet could be lost if public policy continues to provide economic incentives that keep data traffic on an inappropriate voice network, driven by the ESP access charge exemption.

The problem of network congestion is a warning that, in the face of continuing explosive growth in use of the Internet, significant changes are needed in the way networks are used to provide access to the Internet and other information services. Current methods are generally inefficient. The most inefficient aspect is using a voice network to transport Internet packet traffic. As noted, so long as the ESPs' use of local business services is heavily subsidized, they will have little incentive to seek faster and more reliable access via data networks.

Network Costs Caused By Internet Access Traffic Exceed Revenues From That Traffic

The nature of Internet access traffic is fundamentally different from the type of traffic for which the local voice network was designed and priced. The first difference is that ESPs' data communications on a circuit switched network are substantially greater in volume and duration, on average, than the average communications needs of ordinary business customers using the circuit switched network. ESPs require greater switch and interoffice network capacity, the provision of which substantially increases the LECs' costs. The second difference is a severe "traffic imbalance." Unlike business customers, ESPs do not use local business

services to originate calls and, thus, do not generate any outbound usage charges. ESPs use the services solely to receive calls from their subscribers, for which Pacific Bell and Nevada Bell receive no usage revenues.

Revenues from sales of second lines to subscribers have not produced enough additional revenues to cover the costs of accommodating Internet traffic. The average total use of a Pacific Bell residence line helps produce revenues that exceed the costs of the local loop, but only because the average residence customer purchases some optional features and incurs toll charges in connection with using the line. Thus, these additional services traditionally have subsidized the local loop costs. Our costs to provide second residential lines to be used for Internet access, however, exceed the flat rate charges we receive on the lines and are not offset by purchases of optional features or toll service used with the line. Thus, to the extent these additional lines are used for Internet communications, they do not contribute to the recovery of the investment that is needed to accommodate Internet traffic.

Regulatory Solutions Are Needed Now

Network congestion and economic problems created by the ESP exemption will not simply self-correct. Current policies only prolong the current situation where no economic rationale exists for ESPs to move dial-up Internet traffic off the PSTN and onto more efficient data networks.[2] Therefore, current policies pose a

[2] "Dial-up" Internet traffic uses the PSTN to connect to ISPs; "dedicated" Internet traffic uses private line facilities to connect to ISPs. "Internet traffic" refers to connections made directly to ISPs and via an online service (*e.g.*, AOL).

significant obstacle to just sustaining, let alone accelerating, the development of Internet access. Solutions are needed now to make widely available, high-speed Internet access a reality. These solutions are:

- **Remove the ESP exemption** -- The most important solution is the removal of the ESP exemption immediately upon the Commission's adoption of access reform, in order to apply post-access reform rates to ESPs. This change should occur in the Access Charge Reform Order (CC Docket No. 96-262). If the Commission does not remove it there, then it should do so on a very quick timeline in this NOI proceeding. In addition, the Commission must establish a means to enforce the requirement that ESPs purchase appropriate access services.[3] Removal of the exemption would be expected to initially result in ESP use of federally tariffed usage-based, circuit-switched access services that would allow ESPs to provide LATA-wide access to their end user customers with facilities at as few as one POP per LATA. Expansion of use of other access services, including fast-packet data services, would be expected to follow quickly. Removing the ESP exemption is the simplest and most direct solution for treating all access customers the same and creating the incentive for investments in, and use of, data access networks. In addition, usage charges resulting from removal of the ESP exemption would most likely have a very minimal impact on the vast majority of end users. For example, assuming a hypothetical access charge of 1.0 cent per MOU (fully passed through to the end user by the ISP), about 80% of end users would face price increases of less than $5.00 per month.[4]
- **Create a special class of services for ESPs** -- If the Commission cannot order access charge reform quickly enough to accommodate the pace of Internet growth, it should recognize the unique nature of dial-up Internet

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[3] *See* Part II C: "Federal Interconnection Proceeding And Local Competition Issues Are Related."

[4] *See* White Paper at 28, Exhibit A.

traffic (as shown throughout these comments) and create a special class of service for ESPs. The FCC could waive subsidies in current access charges -- carrier common line charges ("CCCL"), transitional interconnection charges ("TIC"), and reserve deficiency amortization payments -- and immediately institute this lower rate. This option would require a means of recognizing ESPs (*e.g.*, registration) as a special class of user.[5]

- **Provide a framework for the States to implement necessary change** -- If , contrary to our recommendation, the Commission does not immediately remove the ESP exemption in the access reform order, it should provide States a framework for making the necessary change. To do this, the Commission should modify the ESP exemption and allow the States to treat ESPs differently from regular business subscribers. For example, in California, which has the highest Internet traffic levels and household penetration rate in the nation, Pacific Bell might ask the PUC to approve a new local service for ESPs that includes terminating usage charges on dial-up Internet calls above a certain duration. This service would not be available to general business customers and, therefore, would require the California PUC to recognize ESPs as a special class of user and establish a means for ESP registration.
- **Provide incentives for investment in data networks and technologies** -- Regardless of what federal or state solutions are implemented to assure that Internet growth achieves its full potential, regulation must strongly support the investment and innovation required to develop high-speed data access networks. In addition to removing the ESP exemption, the Commission should allow all data access providers to have pricing flexibility (*e.g.*, contract pricing that allows term and volume discounts). In Part V B, we discuss two examples of data access services that Pacific Bell is developing.

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[5] *See* Part II C: "Federal Interconnection Proceeding And Local Competition Issues Are Related."

We urge the Commission to consider these solutions and move quickly to invoke the "Second-Wave" of Internet growth.

Overview Of These Comments

In these comments, we discuss the regulatory changes needed to address the challenges of developing a powerful "Second Wave" of Internet growth -- the need for incentives to develop and move traffic to faster and more reliable data networks. The most important of the needed changes is removal of the ESP exemption from payment of access charges. Removal of the ESP exemption, and some of the other necessary changes, should occur in the access reform order, or on as rapid as possible a timeline in this proceeding. Other important and needed changes relate to issues in various other proceedings, including the Commission's Interconnection and Universal Service proceedings and potential State Regulatory proceedings. Next, we provide data on the characteristics of the explosive growth of information service usage and its effects on the public switched network, including problems of network congestion. We provide data on Pacific Bell's costs and revenues resulting from ESPs' traffic, which demonstrate substantial losses. Finally, we describe examples of types of services which we are developing to improve the efficiency and reliability of ESPs' services, and the need to remove the ESP access charge exemption in order to provide incentives for ESPs to use these new services. Most of the data in these comments are provided in the attached Exhibit A, a White Paper: "*Surfing the 'Second-Wave' -- Sustainable Internet Growth and Public Policy.*" Exhibit B describes "*Access*

Services Employed By Telemessaging ESPs," which relates to the issue of treatment of different categories of enhanced service providers that we discuss in Part II.

II. THE REGULATORY CHALLENGE

The Commission seeks comment on "what regulatory barriers -- at either the state or federal level -- might prevent provision of alternate network access arrangements for information service providers, or might create artificial disincentives against use of such arrangements when they become available."[6] The Commission also seeks comment on whether or not it should distinguish between different types of enhanced services.[7] In addition, it seeks comments on related issues in its Interconnection and Universal Service proceedings that may affect the issues in this proceeding.[8] We respond to these questions below in the context of the Commission's historical policies to encourage the use and evolution of the public switched network to stimulate development and growth of the enhanced/information services market.

A. The Commission Has Accomplished Its Goal To Use "Existing" Network Services To Help Develop A Mass Market For Enhanced Services

Growth Of Internet Use Has Been Tremendous

Growth of the Internet has been truly remarkable, especially in California. At the end of 1996, there were an estimated 2.3 million dial-up Internet users in Pacific Bell's territory. Without a change in the ESP exemption and, thus, without a change in

[6] *NOI* at para. 314.
[7] *Id.* at para. 316.
[8] *Id.* at para. 314.

the network service architecture used by most ESPs, by 2001 we expect these dial-up Internet users in Pacific Bell's territory to grow to at least 4.7 million, for a 5 year commulative average growth rate of 15.4%.[9]

At the end of 1996, Internet usage accounted for approximately 27% of Pacific Bell's total residential traffic, or 30 billion minutes of use.[10] If the ESP exemption is not removed, we anticipate that by 2001 there will be almost as much residential Internet dial-up traffic as residential voice traffic.[11] Removal of the ESP exemption would provide the incentive for dial-up Internet traffic to move to data packet networks, relieving congestion on the dial-up voice network and providing the opportunity for greater Internet growth.

This Commission's Decisions Stimulated Expansion Of Enhanced Services

This expansion of demand for use of the existing circuit switched networks to provide enhanced services was largely the result of the combination of two regulatory steps that the Commission took in the 1980s -- the creation of the ESP exemption from access charges and the creation of Comparably Efficient Interconnection for the provision of enhanced services by all providers. In 1983, the Commission exempted ESPs from the access charge plan that it established "to remedy discrimination and

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[9] This figure is based on conservative assumptions for Internet growth and allows for the migration of some users to new technologies, such as xDSL and cable modems. *See* White Paper at 1, 5, Exhibit A.

[10] *See Id.*at 5, Exhibit A.

[11] *Id.* at 8.

preferences."[12] The exemption was to be a part of a set of "transitional" rules designed to avoid "rate shock" by phasing-in access charges for interexchange resellers and ESPs, two classes of providers who had depended on low-priced business services to obtain local access.[13] Although ordinary resellers soon lost their access charge exemption,[14] ESPs maintained theirs.

During the same general time period, in *Computer Inquiries II and III*, the Commission was exploring how to expand enhanced services to the mass market of consumers.[15] To encourage that expansion, in 1986 the Commission adopted non-structural safeguards to ensure that all competitors had a fair opportunity to provide enhanced services using AT&T's and the BOCs' networks, while encouraging the efficiencies that came from allowing AT&T and the BOCs to offer enhanced services integrated with network services.[16] The initial regulatory safeguard the Commission established in *Computer III* in order to bring enhanced services to the mass market was the Comparably Efficient Interconnection requirement ("CEI"). The goal of CEI is to

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[12] *MTS and WATS Market Structure*, CC Docket No. 78-72, Phase I, *Third Report and Order*, 93 FCC 2d 241, 265 (1983) ("*Access Order*"), *modified on reconsideration*, 97 FCC 2d 834 (1984) ("*Access Reconsideration Order*"), *aff'd in principal part and remanded in part*, *National Ass'n of Regulatory Util. Comm'rs v. FCC*, 737 F.2d 1095, 1137 (D.C. Cir. 1984), *cert. denied*, 469 U.S. 1227 (1985), 110 FCC 2d 1222 (1985), *further reconsideration denied*, 102 FCC 2d 849 (1985).

[13] *See Amendments of Part 69 of the Commission's Rules Relating to Enhanced Service Providers*, CC Docket No. 87-215, *Notice of Proposed Rule Making*, 2 FCC Rcd 4305 (1987) ("*ESP Exemption NPRM*").

[14] *See ESP Exemption NPRM*, p. 4305.

[15] *See, e.g., Amendment of Sections 64.702 of the Commission's Rules and Regulations ("Third Computer Inquiry")*, CC Docket 85-229, *Report and Order*, 104 FCC 2nd 958, paras 72-77, 88-99 (1986) (*"Computer III first Report and Order"*).

[16] *Id.*

permit the fair and efficient use of existing network services in connection with computer processing services to enable ESPs to offer these services bundled together. ESPs have relied on the ESP exemption from access charges to maintain artificially low prices for their use of the existing networks.

As the FCC had hoped, this combination of CEI and the ESP exemption worked extremely well to expand the size of the enhanced services market, with two particular success stories. First, the combination brought voice mail to the mass market.[17] Second, the combination helped unleash the incredible expansion of the market for Internet access and related online electronic messaging and gateway services.

B. For The "Second Wave" Of Enhanced Service Expansion, The Commission Should Unleash Market Incentives For The Creation Of New Network Services And New Networks

The Commission expressly designed both the ESP exemption and CEI as transitional mechanisms aimed at use of the existing circuit switched networks as they existed in the 1980s. The ESP exemption strongly encouraged continued use of the more traditional local business services, without the addition of new features. CEI ensured nondiscriminatory access to existing networks, but was not designed to encourage the development of new network services or new types of networks. The Commission designed ONA to bring these latter benefits. The transition away from the ESP exemption never occurred, however, and its continuation has prevented the

[17] *See Computer III Remand Proceedings*, CC Docket No. 90-623, *Report and Order,* 6 FCC Rcd. 7571, para. 103 (1991).

development of the market forces that are needed to fully use ONA and to develop alternatives to the circuit switched network.

In response to ESP arguments that they were participating in an "infant industry," the Commission initially reasoned that continuation of the ESP exemption was justified for a time because of 1) the impending introduction of ONA requirements, 2) the uncertainty and need for ESPs to have time to adjust their activities caused by the BOCs' pending initial entry into the information services business pursuant to a partial modification of the MFJ, and 3) the relatively fragile and volatile state of the emerging enhanced services industry.[18] Even after ONA was in place and the BOCs' entry into the information services business had occurred and no longer caused uncertainty or a need for time to adjust, the Commission continued to justify retention of the exemption as appropriate to avoid "disrupt[ing] the enhanced services industry during a time of rapid transition."[19]

Now the ESP exemption itself is disrupting the industry and preventing the necessary transition and further expansive growth. The exemption is 1) causing rapid increases in traffic on the public switched network which are creating network congestion, 2) causing LECs to make significant investments to increase PSTN capacity, and 3) frustrating the transition from use of the circuit switched network for Internet access to the use of more efficient fast packet networks. The ESP exemption

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[18] *Amendments of Part 69 of the Commission's Rules Relating to Enhanced Service Providers*, CC Docket No. 87-215, *Order*, 3 FCC Rcd 2631 (1988).

[19] *Amendments of Section 64.702 of the Commission's Rules relating to the Creation of Access Charge Subelements for Open Network Architecture*, CC Docket No. 87-313, *Report and Order*, 6 FCC Rcd 4524, 4535, ¶ 60 (1991).

retains a substantial subsidy for use of the wrong services and, in the case of Internet access, the wrong network.

Thus, the ESP exemption is disrupting the achievement of the Commission's goals for network development. To help achieve those goals, the Commission augmented the CEI nondiscrimination safeguard with ONA so that the networks would fully evolve to produce new service offerings and new Intelligent Networks to meet all types of enhanced service needs.[20] The full success of ONA, however, depends on market incentives to generate ESPs' requests for new services,[21] exactly the type of activity which the ESP exemption strongly discourages. Normal market incentives would encourage economic investment in new services and networks because the BOCs would have to respond to ESP requests based on whether or not the new services would be technologically and economically feasible, including whether there is likely to be sufficient demand for the services so that expected revenues will cover anticipated costs.[22] Now BOC competitors could also consider ESPs' requests for services, including new packet services, and use LECs' unbundled network elements to help meet those requests. The ESP exemption has frustrated this economic development because ESPs can retain use of local business services without providing LECs enough revenues to cover their costs, and because ESPs have little incentive to meet the economic criteria for new services. This frustrates development of

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[20] *See Filing and Review of Open Network Architecture Plans*, CC Docket No. 88-2, Phase I, *Memorandum Opinion and Order*, 4 FCC Rcd. 1, paras. 378-381 (1988) ("ONA Plans Order").

[21] *ONA Plans Order* at paras. 396-397.

[22] *See id.*

new packet network services not only by the BOCs but by other network services competitors.

Thus, the ESP exemption blocks the operation of market incentives. Removal of the ESP exemption is required to release their potential. By allowing LECs to charge ESPs based on costs they cause, ESPs will demand the most economical and efficient services. To meet the needs of Internet Access Providers, investment will be driven toward fast packet services. This economic expansion of capacity will produce the faster and more reliable network services that are needed for the "Second Wave" of Internet access growth.

C. The Commission And The Industry Are Well Positioned For Rapid Changes In Regulation

Federal Access Reform Is The Paradigm

Fortunately, the Commission can move quickly because it already has the paradigm for initial regulatory change before it. The paradigm is access reform. The initial regulatory changes that are needed are the same, whether they are made in the access reform NPRM proceeding or in this NOI proceeding. The paradox is that the public interest requires these changes at least as urgently concerning the NOI issues as concerning the access reform issues in general. The Commission should not let the extra step of an NOI slow it down. The Commission should make necessary initial changes for resolving the NOI issues in the access reform order itself and then move this NOI quickly forward.

The necessary initial changes in regulation have been discussed by parties and regulators for years. They are centered around allowing and encouraging competition to flourish, thereby bringing the benefits of new technologies to consumers. As we have discussed in our comments on access reform, the Commission should take a number of steps:

- -- remove implicit subsidies, while ensuring the opportunity to recover all costs. Implicit subsidies include the ESP exemption from access charges
- -- forbear from regulating fully competitive services
- -- allow contract pricing flexibility for access services
- -- allow term and volume discounts on all aspects of access services, switching as well as transport
- -- simplify the price cap structure to allow more pricing flexibility
- -- avoid any tests which delay the offering of new services.

These changes will provide incentives for the development of competitive new services that will better meet the needs of customers, including Internet Access Providers and other ESPs. At the same time, these changes will facilitate the more efficient use of networks and encourage movement of data traffic off the congested circuit switched networks, and onto packet networks designed for data traffic.

The competitive offering of new services that meet the particular needs of ESPs depends on removal of the ESP exemption. The ESP exemption discourages all telecommunications service providers from offering new services to ESPs. Prices for new services cannot compete on a widespread basis with the extremely low, subsidized

prices available to ESPs under the exemption. When the Commission removes the ESP exemption, all types of competitive providers will have the incentive to offer new services of interest to ESPs, and those services will be fully competitive. Accordingly, price restraints on incumbent LECs will need to be removed for these new services so that the LECs can compete with other providers.

If the Commission cannot order access charge reform quickly enough to keep up with the changes needed to accommodate Internet access traffic, then it should design changes aimed specifically at the use of the networks for Internet access and other information services. The Commission could create a special class of access charges just for ESPs in the following manner. If the Commission finds that removal of subsidies from access charges will take time, in the access reform order it can require ESPs to pay access charges, but with the waiver of carrier common line charges, transitional interconnection charges, and reserve deficiency amortization payments.

With those waivers, ESPs can finally and immediately be brought into a new access regime and pay usage-based prices to the extent that the ESPs cause usage-based costs on the circuit switched networks. This cost-based pricing will give ESPs the incentive to seek services that avoid usage costs, including new fast packet network services that can be offered by an array of competitors.

The Commission should treat different categories of enhanced services the same. The economic key to charging for a particular network service is not to consider the type of ESP involved but what types of network architecture the ESP uses

and, thus, the costs the ESP causes for that particular service.[23] If the costs are usage sensitive, the charges should be usage sensitive. If the costs are non-usage sensitive, the charges should be flat rated.

State Local Exchange Reform May Need To Be Considered

In California, the need for regulatory change is particularly urgent for two reasons. First, California has a disproportionate amount of Internet traffic. Pacific Bell's territory in California had the highest online household penetration rate of any BOC in 1995 (17.9%) and 1996 (23.2%). That 1996 household penetration rate was almost 33% higher than the next BOC. Clearly, California is at the front of the Internet wave.[24]

Second, California has intrastate price structures that ensure that Pacific Bell cannot recover the costs of ESP traffic under the ESP exemption. The Commission must consider the effects of the differing forms of price regulation in California and other states so long as the ESP exemption from access charges is in place. Under the ESP exemption, an ESP may subscribe to local business services in the same manner as any business customer in that state.[25] Thus, the effect of the exemption on a LEC depends on the rate structure of local business service in the state that the LEC serves. Moreover, the LEC's ability to recover its costs of serving ESP traffic is significantly affected by the rate structure for end users in the state that the

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[23] *See* Exhibit B.

[24] White Paper at 4, Exhibit A. Every BOC will face the same challenges and opportunities as Pacific Bell even if conservative predictions of continued robust Internet growth are accurate.

[25] *ONA Plans Order* at para. 318.

LEC serves. Pacific Bell faces state rate structures for local business service and residential service that combine to ensure that it has no opportunity to recover its costs of serving ESPs and their subscribers so long as those state rate structures and the ESP exemption stay in place. *See* Section IV concerning "The Economic Challenge."

The Commission created the discrimination between IXCs and ESPs. The only way the Commission can eliminate this unreasonable discrimination is to remove the ESP exemption. The Commission should do so in its access reform order, with waivers of subsidy payments if needed.

If, contrary to our recommendation, the Commission does not remove the ESP exemption in the access reform order, it should at least modify the ESP exemption, or its interpretation of it, in that order so that states can determine how to apply local charges to all of the ESPs' traffic using local services and can have the option of treating ESPs differently from business subscribers.[26] This modification would allow states like California, which face an urgent need for regulatory changes, more flexibility to begin correcting the problems caused by non-cost based pricing under the ESP exemption, while the Commission further considers its removal. For instance, the

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[26] In 1988, when Bell South tried to correct the distortions through its state tariffs, the Commission disapproved the portion of Bell South's ONA plan that restricted ESPs from taking existing local business service in the same manner as other business customers. The Commission found that restriction to be contrary to the ESP exemption. *ONA Plans Order* at para. 318. Given the largely interstate nature of Internet access traffic, a deferral to the states is likely to raise some jurisdictional legal disputes. However, the Commission has traditionally allowed states to regulate local exchange services and taken care of federal concerns via the subscriber line charges. *See, e.g., Id.* at para. 85. The Commission could do so here while it further considers the ESP exemption if it does not adopt our recommendation of removing the ESP exemption.

state might approve a new local service expressly for ESPs to use instead of the existing business service. The new service might include some level of terminating usage charges that is not applicable to general business customers. Modification of the ESP exemption to allow the states full flexibility to design local exchange services would provide the most reasonable opportunity for a timely solution, if the Commission does not choose the best solution -- its own removal of the ESP exemption.

Federal Universal Service Proceeding Issues Are Related

In the Universal Service proceeding, we explained that under §254 of the 1996 Act telecommunications services used by schools and libraries, and by ESPs serving schools and libraries, could be offered by telecommunications carriers at discounted prices that would be directly supported by the universal service fund.[27] We also explained that the prices for the primary telecommunications services that ESPs currently use already receive implicit support through the ESP exemption from access charges.

If that subsidy is retained where it benefits schools and libraries, it should be made explicit, with telecommunications service providers receiving support from the fund for the discounts they provide to the ESPs. The amount of support would be calculated based on the payments the ESPs would have made if they paid access charges, minus what they are actually paying because of the ESP exemption (i.e., the rates for local business services). Both independent ESPs and ESPs owned by carriers

[27] Reply Comments of Pacific Telesis Group, January 10, 1997, at 20-26, *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45.

would benefit from the discounts in the same competitively neutral manner. Competition should ensure that the ESPs pass the discounts on to schools and libraries.

Federal Interconnection Proceeding And Local Competition Issues Are Related

ESPs and Competitive LECs ("CLECs") are joining together in arrangements under which the CLECs are able to offer access to ESPs on extremely favorable terms. These arrangements are based on taking advantage of a combination of the longstanding ESP exemption and the new interconnection requirements to take full advantage of use of the incumbent LECs' networks, without paying for that use, and with the CLEC receiving payment from the LEC. We believe that currently at least 10%, if not more, of ESP traffic originating in Pacific Bell's network is passed to CLECs for delivery to ESPs.

Because under the ESP exemption ESPs are treated like end user business customers, ESPs can move their local exchange service to CLECs. In return, ESPs can obtain a local telephone number that can be dialed as a local call by both the CLEC customers and incumbent LEC customers. In California, this means that all Pacific Bell flat-rate service residence customers within a 12 mile radius could access their ESP via the CLEC by placing a no-charge local call.

CLECs can establish codes (prefixes) in each local calling area, and their physical presence is usually an interconnection at the serving Pacific Bell tandem switch. These interconnections can then be connected to a single CLEC switch serving

an entire region, such as the San Francisco Bay Area. The CLEC then sells connections from its switch to ESPs. This arrangement allows the CLEC to provide access from a single point that covers multiple local calling areas.

This arrangement has adverse and uneconomic traffic effects on Pacific Bell's network, even though the exchange business services are provided by the CLEC. Adverse effects occur because of the high volume of end-user to ESP traffic that is routed to the CLEC through Pacific Bell's network to the tandem switch that provides interconnection to the CLEC. Pacific Bell's interoffice trunks and interconnecting switch experience the same traffic loads as if the ESP's business services were provided on Pacific Bell's own switch. In other words, Pacific Bell incurs essentially the same costs as it does when the ESP is a Pacific Bell customer and yet receives no revenue from the ESP. Moreover, under many interconnection arrangements, Pacific Bell incurs the cost of paying the CLEC to terminate the traffic to the ESP.[28] In addition, in the case of ESP traffic, there is no reciprocal originating traffic, terminating on a Pacific Bell switch, to provide compensation to Pacific Bell.

As a result of this opportunity for a better than free ride on Pacific Bell's network, there are already several CLECs in Pacific Bell's territory offering wide-area access at per-line equivalent rates that are below Pacific Bell's basic business service rates. In fact, one CLEC is using the Internet to advertise full Northern California access for ESPs out of a single switch in Stockton at $10.00 per month per-line.

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[28] Pacific Bell has differing interconnection agreements with each CLEC. Our concern is with those instances where Pacific Bell is paying terminating compensation to CLECs who are aggressively marketing "access" to ESPs.