Theoretically, this purpose could also be achieved by selling to customers with high levels of originating usage. In practical terms, however, driving up traffic volumes by means of customers with high originating usage suffers from two problems. The first is cash. Customers with high originating usage will generate call termination obligations to ILECs. This will require outlays of scarce cash that can be put to much better uses in developing the CLEC's business, as outlined above. Moreover, many existing ILEC pricing structures include large (and, in some cases, unlimited) "free calling" allowances. Driving up usage by targeting such customers will not generate cash in proportion to usage.[41]

Second, if the ILECs are to be believed, their end user loop rates are significantly underpriced as a result of implicit universal service subsidies embedded in their rates. Eventually, a fair and competitively neutral universal service mechanism will allow CLECs to have access to the same per-line subsidies as the ILECs enjoy. At present, however, the ILECs' implicit universal service subsidy mechanisms are not yet available to CLECs. As a result, it would make little sense for a CLEC, at this time, to base its business strategy on targeting customers with high levels of outgoing local usage.[42]

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[41] Flat-rated local calling is popular with customers, and actually works, economically, as long as (a) the flat-rated calling plan is priced high enough to cover the costs of the "average" user's usage; and (b) the firm offering the plan has enough customers with different calling patterns so that the assumed "average" will, over time, be approximately correct. The second condition is probably met for a typical ILEC with a large and established customer base. As to the first, *see infra.*

[42] Assuming for these purposes that the CLEC and ILEC are equally efficient, the CLEC, at least at present, would have to set its end user rates below the ILEC's subsidized rates in order to win customers from the ILEC. It is simply not rational to target such customers prior to the actual implementation of a competitively neutral universal service mechanism.

3. Market Factors Other Than Terminating Compensation Payments Make ISPs Especially Attractive Customers.

If a terminating compensation rate is set exactly equal to a CLEC's cost of terminating calls, from a cost perspective alone — that is, putting aside cash needs and economies of scale — it is probably true that the CLEC should be essentially indifferent between customers who generate high incoming usage, high outgoing usage, or a more balanced traffic pattern. If calls are received, the costs of terminating them are covered; if not, then those costs may be avoided.

But factors other than the terminating compensation rate may act to create an incentive for CLECs to target any particular group of customers. Where this situation exists, CLECs will focus their efforts on those customers. As a result, the fact that some CLECs are targeting ISPs as customers does not imply that anything is amiss with the system of terminating compensation or the level of terminating compensation payments. All it means is that some factor or factors other than the cost of call termination lead CLECs to view ISPs as desirable customers.

One obvious example of a factor unrelated to call termination costs that can make particular customer groups attractive is lower marketing costs. ISPs are, on the whole, large and relatively sophisticated consumers of telecommunications services. They are likely to be "early adopters" of new telecommunications alternatives, such as CLEC services. As a result, CLECs would probably find the costs of marketing to ISPs to be lower, on average (in terms of marketing dollars per revenue dollar generated), than the costs of marketing to "business customers" (or "residence customers") in general. Moreover, ISPs use a wide variety of telecommunications services, including POTS lines and more advanced data lines. It makes business sense for CLECs to target customers with a variety of growing telecommunications needs, and ISPs fit the bill. Unless terminating compensation payments are set so low that the CLEC loses money whenever it terminates a call, CLECs will naturally gravitate to ISPs as customers.

A second example of a legitimate business consideration not directly related to call termination costs is the fact that ISPs have pre-established groups of end user subscribers who are themselves relatively heavy users of telecommunications services and — even in the case of residential customers — relatively sophisticated users as well. This group of subscribers would be attractive to a CLEC seeking to eventually market to small businesses and individual end users (when, for example, alternative loop technologies for individual customer locations become widely available, or ILEC unbundled loop prices are established at affordable levels). In this circumstance, a CLEC's relationship with an ISP would provide an entree to the end user market, particularly if the ISP's subscribers view the ISP's telecommunications arrangements supplied by the CLEC (*i.e.*, dial-in lines and "back-end" connections to the Internet) to be reliable and of high quality.

These examples show that, if call termination rates are properly set to recover CLEC call termination costs, CLECs will then be free to focus their marketing efforts on customers who are attractive for reasons ***other than*** call termination rates. Since ISPs are plainly attractive customers for other reasons, the fact that some CLECs are targeting ISPs as customers does not imply that established call termination rates are too high or the terminating compensation system in general is functioning improperly.

* * * * *

The considerations discussed in this section show that a CLEC will logically and, from a regulatory and competitive perspective, legitimately target ISPs and other customers with high levels of incoming usage, particularly in the early years of ILEC/CLEC competition. This is true even if the terminating compensation rate the CLEC is receiving is an economically "perfect" cost-based rate. As a result, if some CLECs are targeting ISPs, that does not show that there is anything wrong with the terminating compensation system, either in general or applied to those customers. To

competitor expects to implement), with regard to the terminating compensation rate, matters are actually quite simple. A LEC that expects to be a net originator of calls will prefer either a bill-and-keep system (which eliminates call termination liabilities) or the lowest possible call termination rate (which minimizes those liabilities). A LEC that expects to be a net receiver of calls will prefer the highest call termination rate that can be negotiated or arbitrated. Finally, a LEC that expects its incoming and outgoing traffic to be roughly balanced will be indifferent to most reasonable variations in the call termination rate, since the rate will effectively apply to only a small number of "net" minutes either way.[44]

The ILECs repeatedly opposed bill-and-keep arrangements before this Commission and in state arbitration proceedings. In addition, the ILECs generally objected to the call termination rate levels proposed by the Commission on the grounds that those rate levels were too low. The logical implication of these positions is that the ILECs in general believed that they would be net receivers of calls. Otherwise, their negotiating and regulatory positions would not make any sense.

Now consider the matter from the CLECs' point of view. A CLEC could reasonably conclude, based on the ILECs' strong opposition to bill-and-keep, that some form of terminating compensation payments would be established. And CLECs could readily observe that many ILECs were seeking the highest remotely plausible rate for call termination. The ILECs' own negotiating position, therefore, presented the CLEC with a situation that contained both risk and opportunity: if the CLEC accepted a high call termination rate, the CLEC would face large call termination obligations to the ILEC if — as the ILECs obviously expected — the CLEC was a net originator of calls.

[44] In this regard, SNET has it exactly backwards when it states that "the main assumption behind reciprocal compensation is that originating and terminating usage would balance out between the parties." SNET Comments at 2. If it was generally assumed that traffic would "balance out," the most logical "compensation" mechanism is actually bill-and-keep, since with balanced traffic there is no need to incur the cost of tracking and billing for usage.

But if the CLEC could market effectively to customers who receive calls, then the CLEC would be able to turn the ILEC's own negotiating plan into an advantage.[45]

The ILECs' own negotiating strategy, therefore, created the conditions in which customers with high levels of incoming calls became especially desirable to CLECs. It is theoretically possible that the ILECs were so naive about how competition works that they simply did not understand the consequences of their actions. More likely, however, they were either over-confident in their own abilities to retain customers or under-appreciative of the competitive attraction of CLECs to some end user groups. Either way, what has apparently occurred is the result of the ILECs' betting that CLECs would be unable to attract the business of customers who receive large volumes of calls — and then losing the bet.

From this perspective, the ILECs' current effort to exempt calls to ISPs from terminating compensation obligations is nothing more than an effort to get regulators to relieve the ILECs of the consequences of their own poor business judgment. The ILECs misjudged the likely balance of calls, and misjudged the competitive abilities of the CLECs to perceive and focus on the customers who were made most attractive as a result of the ILECs' own negotiating position. Rather than accept (and possibly learn from) the business consequences of their mistakes, however, the ILECs are attempting to bully the CLECs into submission by unilaterally declaring that calls to ISPs are not subject to call termination payments.

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[45] In this regard, nothing in the law requires that a call termination rate strictly reflect either the ILEC's or the CLEC's cost of terminating calls. In a negotiated agreement, the parties can agree to any rate they want. And even in an arbitrated agreement, all that is required is that the call termination rate be based on a "reasonable approximation" of cost, a standard that plainly allows some leeway to establish a rate somewhat above or below what would result from a precise determination of cost. *See* 47 U.S.C. §§ 252(d)(2)(A)(ii), 252(d)(2)(B)(2).

In this regard, if losing the ISPs as customers is such a problem for the ILECs, they have — and have always had — a simple solution: compete for the ISPs' business. If CLECs offer ISPs special deals for local exchange lines, the ILECs should respond in kind. If CLECs offer ISPs improved service quality (*e.g.*, special network monitoring or maintenance arrangements), the ILECs should respond in kind. These are the normal business responses one would expect to see from competitors. There is no explanation — other than entrenched monopolistic thinking — for the ILECs' paradoxical position of bemoaning the effectiveness of CLEC competitive efforts while making no competitive counter-moves of their own.[46]

The Eighth Circuit's recent decision emphasizes the critical role that negotiated interconnection agreements play in developing the competitive local exchange market envisioned by Congress.[47] It would make a mockery of the negotiation process, and of the Eighth Circuit's order, for regulators to sanction the ILECs' effort to be relieved of the consequences of their own negotiating mistakes. To the contrary,

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[46] As the Joint Commenters noted, the Commission has not been persuaded by ILEC claims that network congestion or other network-related effects from calls to ISPs warrant special regulatory treatment for such calls. *See* Joint Comments at 13. To the extent that the ILECs are complaining about network-related problems that arise from ***losing*** ISPs as customers as well as network-related problems that arise from ***having*** them as customers, they should not be permitted to have it both ways. If losing ISPs as customers causes problems for the ILECs, then the ILECs should compete for their business. If keeping the ISPs as customers causes problems for the ILECs, then the ILECs should be happy to see them go. In fact, to the extent that the ILECs have network-related problems related to calls to ISPs, those problems are caused by the fact that the ILECs' ***individual end users*** place many calls to ISPs. This is not a problem with the terminating compensation system, however. *See* Section IV.B.2, *infra.*

[47] Slip Opinion at 97; *id.* at 114-117 (discussing Section 252(i)); *id.* at 116 (Sections 252(a)(1) and 252(b)(1) "reveal that the Act establishes a preference for incumbent LECs and requesting carriers to reach agreements independently ... .").

the only response to the ILECs' effort that is consistent with the statute is for regulators to reject it out of hand.[48]

2. The ILECs Should Not Be Permitted To Manipulate Terminating Compensation Requirements To Alleviate Unrelated Regulatory And Business Problems.

Ameritech suggests that requiring that local calls to the Internet be subject to reciprocal compensation would be "contrary to the Commission's espoused goal of establishing cost-based rates."[49] This claim is baseless. If the ILECs think that they are not recovering the costs of calls to ISPs (or other local calls with long holding times), they should propose tariff changes to state regulatory bodies to alleviate that problem (*e.g.*, mandatory measured local service, special charges for local calls of unusual length, etc.). This is exactly the conclusion the Commission reached in the *Access Charge Order.*[50]

Many ILECs, however, probably are not literally "free" to adjust their local rates, because they have previously committed to state-level regulators that such rates will remain capped.[51] ILECs with capped local rates generally claim (as in the case of

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[48] This is particularly true in light of the fact that bill-and-keep is an option specifically recognized by the statute and specifically addressed by numerous CLECs during the regulatory process. From the very first day negotiations began under Section 251 and 252, the ILECs have had it in their power to absolutely insulate themselves from any possibility that they might have to make terminating compensation payments. All they had to do was propose bill-and-keep, or accept bill-and-keep when CLECs proposed it. They did not do so for one simple reason: they thought that, on balance, they would be net recipients of calls. The fact that the ILECs misjudged the market is no reason to relieve them of the consequences of the negotiating posture they actually adopted.

[49] Ameritech Comments at 15 (footnote omitted).

[50] *Access Charge Order* at ¶ 364.

[51] *See, e.g.*, Letter from J.G. Cullen (Vice Chairman, Bell Atlantic) to *Business Week*
(continued...)

federal price cap regulation) that, when their local rates cannot be increased on the basis of cost increases, the ILECs have healthy incentives to operate their businesses so as to meet their customers' needs in the most efficient way possible. Doing so produces profits; failure to do so produces losses.

Here, their customers want to call the Internet — a lot more frequently than the ILECs may have planned for.[52] Dealing with that customer demand, however, is exactly the kind of business challenge the ILECs claimed they were ready for when they advocated, and received, capped local rates. It would be totally inappropriate — and, indeed, unhealthy for the ILECs' own development into businesses that are actually responsive to their customers' needs — for the Commission (or, for that matter, state regulators) to relieve the ILECs of the consequences of their failure to anticipate the nature of their customers' demand for calls to the Internet and to engineer their networks in a manner to handle such calls efficiently.

In reality, therefore, the ILECs' problem does not arise from the requirement that they pay terminating compensation on calls their end users make to the Internet. The problem arises from their own failure to anticipate their customers' demand and to engineer their networks accordingly. There is absolutely no public policy basis for "solving" these ILEC-generated problems by manipulating and distorting their terminating compensation obligations.

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[51](...continued)
(published July 28, 1997) ("Bell Atlantic hasn't raised basic residential rates a cent since the passage of the Telecommunications Reform Act of 1996. And we won't, ***because those rates are capped almost everywhere***.")

[52] *See* Joint Comments at 8-10 & n. 15.

V. CONCLUSION.

Everyone except the ILECs agrees that local calls to the Internet are subject to compensation under Sections 251(b)(5) and 252(d)(2) of the Act. That conclusion is supported by the Act's definitions of "telephone exchange service," "telephone toll service," and "interstate communications." Moreover, because local calls to the Internet are jurisdictionally interstate, the Eighth Circuit's recent decision does not limit, and actually affirms, the Bureau's authority to rule that such calls are subject to reciprocal compensation. Finally, there is no merit to Ameritech's claim that it would be unfair to the ILECs to allow compensation for calls to the Internet. Even with cost-based rates, any number of legitimate business factors would lead CLECs to target ISPs as customers. Moreover, the ILECs could have avoided the entire problem by negotiating for bill-and-keep.

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the extent that the ILECs did not expect this to occur, that only means that they had not fully anticipated and analyzed the economic forces affecting their new competitors.

B. The Telecommunications Act Of 1996 Provides No Basis For Relieving ILECs Of Any Consequences They May Suffer By Virtue Of Being Out-Negotiated By CLECs.

The discussion above shows that CLECs will have legitimate and powerful business reasons to target customers with high incoming call levels even if the call termination payments they receive from ILECs are strictly cost-based. But even assuming that CLECs are being significantly over-compensated for terminating calls from ILECs, that is no reason for regulators to step in. To the contrary, the Telecommunications Act of 1996 relies heavily on negotiations for establishing interconnection arrangements, including call termination rates. As a result, even if it is concluded that some CLECs have successfully obtained call termination rates that exceed their costs, the statute's primary reliance on negotiations between ILECs and CLECs shows that — particularly where the claim is that the new competitors may have out-negotiated the incumbents — there is no reason to use the regulatory system to "correct" any such alleged "problem."[43]

1. The ILECs Should Not Be Relieved Of The Consequences Of Their Own Failure To Negotiate Wisely Or To Compete Effectively.

Although the considerations that go into negotiating an interconnection agreement are complex (and vary greatly with the precise business plan the new

[43] Ameritech flatly claims that some CLECs with whom it has interconnection agreements have "opted into" the higher interconnection rates available, out of a range that apparently goes from $0.002 to $0.015. *See* Ameritech Comments at 17. Given the range of termination rates that Ameritech itself has accepted in negotiations, it is odd indeed for Ameritech to be advancing an argument that is based on a complaint that CLECs are responding to allegedly non-cost-based termination rates.