February 19, 2015

***Ex Parte* notice**

Ms. Marlene H. Dortch
Secretary
Office of the Secretary
Federal Communications Commission
445 Twelfth Street, SW
Washington, DC 20554

Re: *Protecting and Promoting the Open Internet*, GN Docket No. 14-28

Dear Ms. Dortch:

On behalf of the Ad Hoc Telecommunications Users Committee ("Ad Hoc"), the undersigned hereby submit this *ex parte* communication to further support Ad Hoc's position in the above-referenced proceeding and to provide additional analysis in response to various other parties' submissions herein, in particular that of AT&T in its *ex parte* letter of October 24, 2014 ("AT&T *Ex Parte*") and Verizon in its *ex parte* letter of January 15, 2015 ("Verizon *Ex Parte*").

In past communications and submissions in this docket, Ad Hoc has pointed out that, however much competition there may be in the market faced by a subscriber choosing among potential ISPs, that competition applies *only to the subscriber.* Once the subscriber selects its ISP, any edge provider seeking to communicate with or provide content to that subscriber has no choice in the matter: it can only use the ISP selected by the subscriber. Accordingly, enterprise customers (or any other edge providers) seeking to communicate with a subscriber inescapably face a "terminating access monopoly" on communications with the subscriber. Absent appropriate regulatory treatment, ISPs would be able to exploit this monopoly to extract "monopoly rents" from edge providers, causing a net welfare loss and harming the public interest.

The Verizon *Ex Parte* included a declaration authored by Andres Lerner and Janusz Ordover, entitled "The 'Terminating Access Monopoly' Theory and the Provision of Broadband Internet Access" ("Lerner/Ordover Declaration"), that purports to "confirm that there is no 'terminating access monopoly' for wireless broadband."[1] Verizon describes the Lerner and Ordover essay as an explanation of how "the basic premise for that case is both flatly inconsistent with the competitive reality of the mobile broadband marketplace and deeply flawed as a matter of economic theory".[2]

The Verizon *Ex Parte* and the Lerner/Ordover Declaration fail to make a case, much less a persuasive case, that terminating access monopolies pose no threat to competition and edge providers or lack theoretical integrity. Rather than offering evidence (empirical or economic) regarding terminating access monopolies, the Lerner/Ordover Declaration offers a series of untested and highly speculative hypotheses proffered as a "confirmation" that a terminating access monopoly does not exist. The attached Declaration prepared for Ad Hoc by its economic consultant Susan Gately ("Gately Declaration") identifies the complete lack of analytical rigor in the Lerner/Ordover Declaration and the substantial flaws in the superficial analysis contained in that document. The Gately Declaration demonstrates that the conclusions presented by Lerner and Ordover are supported neither by economic logic nor empirical evidence.

The Commission has grappled before in related contexts with how best to address the terminating access problem and concluded that, where a provider has a monopoly over terminating access to its subscribers, the best regulatory approach is to require a "bill-and-keep" payment model whereby the terminating provider recovers the cost of its terminating facilities from its subscribers using those facilities and not from edge providers or other third parties. As Ad Hoc showed in its Comments,[3] this conclusion requires the Commission to adopt a prohibition in this docket against ISPs charging edge providers – or indeed any party other than their own end user subscribers – for delivering Internet traffic and content to or from those end user subscribers. The instant *ex parte* presentation provides a further discussion of the Commission's previous – and consistent – analyses of this issue and the reasons why the same approach is clearly necessary to serve the public interest in the instant proceeding. This presentation also rebuts certain misconceptions raised by AT&T and Verizon in their *ex parte* presentations.

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[1] Letter from Kathleen Grillo, Senior Vice President, Federal Regulatory and Legal Affairs, Verizon, to Marlene H. Dortch, Secretary, Federal Communications Commission, GN Docket No. 14-28, at 2 (filed Jan. 15, 2015).

[2] Verizon *Ex Parte* at 2.

[3] Comments of the Ad Hoc Telecommunications Users Committee, filed July 18, 2014 ("Ad Hoc Comments"), at 16-23.

In its 2011 *USF/ICC Transformation Order*,[4] the Commission recognized that bill-and-keep was the only mechanism for intercarrier compensation that would (i) "ensure that consumers pay only for services that they choose and receive," (ii) "impose[] fewer regulatory burdens"; (iii) "reduce[] arbitrage and competitive distortions inherent in the current system"; and (iv) "eliminate[] carriers' ability to shift network costs to competitors and their customers."[5] Accordingly, the Commission adopted bill-and-keep as the end state for all intercarrier compensation – and applied this change most immediately to terminating access, since that "will focus reform where some of the most pressing problems, such as access charge arbitrage, currently arise."[6] In its Comments in this proceeding, Ad Hoc discussed at length the Commission's rationale for arriving at this conclusion, and showed that it applied equally to the relationship among edge providers, ISPs and end users.[7]

But it is important to stress that the Commission had recognized much earlier than 2011 that, especially in a market characterized by terminating monopolists, bill-and-keep is clearly the most efficient and welfare-enhancing cost recovery structure, and that the long delay in arriving at that regulatory structure for landline telephone service[8] reflected only political and transitional issues affecting the long-standing system of implicit subsidies that had made universal service possible. The superiority of bill-and-keep for terminating access was recognized as early as 2000, in a pair of Working Papers issued by economists in the Commission's Office of Plans and Policy ("OPP"). The analyses in these Working Papers applies directly to the decisions facing the Commission in this proceeding.

In the first, *OPP Working Paper 33*,[9] OPP economist Patrick DeGraba laid out the specific case for adopting Central Office Bill and Keep ("COBAK") as the preferred cost recovery structure for terminating calls to end users. Under this mechanism, the calling party's carrier would bear the cost of delivering a call to the terminating central

[4] *Connect America Fund; A National Broadband Plan for Our Future; Establishing Just and Reasonable Rates for Local Exchange Carriers; High-Cost Universal Service Support; Developing a Unified Intercarrier Compensation Regime; Federal-State Joint Board on Universal Service; Lifeline and Link-Up; Universal Service Reform—Mobility Fund;* WC Docket Nos. 10-90, 07-135, 05-337, 03-109, CC Docket Nos. 01-92, 96-45, GN Docket No. 09-51, WT Docket No. 10-208, Report and Order and Further Notice of Proposed Rulemaking, 26 FCC 17663 (2011) ("*USF/ICC Transformation Order*").

[5] *USF/ICC Transformation Order* at para. 738.

[6] *USF/ICC Transformation Order* at para. 739.

[7] Ad Hoc Comments at 16-23.

[8] As the Commission noted with approval, functionally equivalent mechanisms had long been in place in the markets for wireless service and backbone interconnection for the exchange of IP traffic. *USF/ICC Transformation Order* at para. 737.

[9] P. DeGraba, OPP Working Paper Series 33, *Bill and Keep at the Central Office as the Efficient Interconnection Regime*, December 2000 ("*OPP Working Paper 33*").

office, but the terminating carrier would have no right to recover any compensation from the originating carrier for delivering the call from the terminating central office to the call recipient; instead, it would recover the cost of terminating the call from its own subscribers.[10] *OPP Working Paper 33* shows that COBAK would be superior to the then-current regime, which was based mostly on the "calling-party's-network-pays" or "CPNP" structure,[11] for a number of reasons.

First, the complexity and inefficiency of the then-current regime resulted in "significant opportunities to game the system through regulatory arbitrage,"[12] in that certain interconnection arrangements allowed parties to pay less (or collect more) for terminating traffic for reasons that had nothing to do with the underlying cost of service. In addition, the reciprocal compensation regime and terminating access rates that were higher than cost encouraged CLECs to seek customers who disproportionately received rather than originated calls to maximize their revenues, again for reasons that had nothing to do with building more efficient network facilities.[13] The result was to "distort the incentives of carriers to invest and deploy facilities efficiently and to offer services to customers."[14]

COBAK would eliminate this problem, *OPP Working Paper 33* reasoned, because it would adopt a uniform, technology-neutral cost-recovery mechanism that would result in investment decisions being made on the basis of cost and efficiency rather than on regulatory considerations. [15] It would also eliminate the reciprocal compensation problem by taking away the inefficient profit-taking opportunity presented by above-cost terminating access problems. [16]

The problems identified in *OPP Working Paper 33* would inevitably arise again if the Commission were to allow paid prioritization arrangements for Internet access service which would then be evaluated for commercial reasonableness on a case-by-case basis. As Ad Hoc pointed out in its Comments, such a process would inevitably result in extreme complexity and likely inconsistency of treatment among various arrangements.[17] These complexities and inconsistencies would then give rise to their

[10] *OPP Working Paper 33* at paras. 5, 24.

[11] *OPP Working Paper 33* at para. 14.

[12] *OPP Working Paper 33* at para. 17.

[13] *OPP Working Paper 33* at paras. 81-82.

[14] *OPP Working Paper 33* at paras. 17, 77-79.

[15] *OPP Working Paper 33* at paras. 80, 84-87

[16] *OPP Working Paper 33* at para. 83.

[17] Ad Hoc Comments at 21-22.

own market-distorting arbitrage opportunities, which would be readily avoided by banning paid prioritization arrangements.

OPP Working Paper 33 identified a second key problem with a CPNP-based regime – that it failed to deal adequately with terminating carriers' market power: "This market power arises from the fact that interconnecting originating networks, including both local and interexchange carriers, have no alternative carrier that can terminate a call. In effect, each terminating carrier, no matter how small, has a monopoly over termination to its own customers."[18] *OPP Working Paper 33* was emphatic that this market power arose *regardless* of whether the terminating carrier's end user subscriber had a choice of providers, since once the subscriber had made his or her selection, the originating carrier had no choice in how to deliver calls to that subscriber. Moreover, existing rules would not give the called party any incentive to switch providers or even to complain about the high level of terminating access charges and would not even lead the calling party to complain to the called party about the terminating provider, since "the called party, by definition, will not incur the excessive termination charges, and, because of geographic rate-averaging requirements, the calling party will have little or no incentive to complain to the called party or ask him to switch carriers."[19] Under bill-and-keep, by contrast, the called party would bear all the costs of termination. Where the called party had a choice of carriers, above-cost rates would lead it to switch providers and so bill-and-keep would apply direct competitive pressure encouraging carriers to keep prices low and increase efficiencies.[20] In instances where the called party did not have a meaningful choice, of course, regulatory supervision over the terminating carrier's rates to its own end users would be appropriate as well.[21]

The same considerations justify a ban on paid prioritization in this setting, as Ad Hoc demonstrated in its Comments. Like the CPNP regime disfavored in *OPP Working Paper 33*, paid prioritization would allow terminating ISPs to exploit their market power by extracting rents from edge providers, thereby diminishing overall welfare and harming the public interest.[22] The edge provider would not have the bargaining power necessary to prevent this. At the same time, the terminating carrier's subscriber would

[18] *OPP Working Paper 33* at paras. 18, 90.

[19] *OPP Working Paper 33* at para. 18.

[20] *OPP Working Paper 33* at para. 91.

[21] *Id.*

[22] *OPP Working Paper 33* also noted (at para. 48) that an efficient regime would minimize regulatory costs, not only administrative costs but also costs resulting from regulatory mistakes or imperfect information, and noted that a bill-and-keep regime would also minimize these costs. As Ad Hoc's Comments showed at 21-22, both the administrative costs and the indirect costs of regulatory mistakes or imperfect information would be staggering if the Commission undertook case-by-case determinations of the commercial reasonableness of tens or hundreds of thousands of paid prioritization arrangements.

have no incentive to switch providers, since he or she would not incur a direct price increase from the ISP's monopolistic practice.

In *OPP Working Paper 34*, also issued in 2000, FCC economists Jay M. Atkinson and Christopher C. Barnekov further analyzed the economic superiority of a bill-and-keep regime.[23] That paper provided additional mathematical analyses of why a bill-and-keep regime would be far more efficient and competitively neutral than the then-existing regime. It focused on "two criteria" by which to judge potential mandatory interconnection regimes. Do they result in "economically efficient inter-carrier compensation?" And "are regulators likely to get it right?" The paper points out that "[t]he first criterion means that the correct pricing signals are sent to networks making investment and make/buy decisions, and thus potentially also to consumers making subscription decisions. The second criterion means that regulators do not need many facts or much data to administer the regime."[24] *OPP Working Paper 34* proceeds to demonstrate that bill-and-keep is the best methodology for satisfying both criteria.

The bill-and-keep regime studied in *OPP Working Paper 34*, christened "Bill Access to Subscribers, (Incremental) Interconnection Costs Split," or "BASICS," is presented slightly differently from the COBAK method developed in *OPP Working Paper 33*. BASICS focuses more conceptually on differentiating between (i) the cost of access to subscribers, which is to be billed by an interconnecting carrier to its subscribers (and not to interconnecting carriers or any other third party), and (ii) the incremental cost of interconnecting two networks, which is to be split equally between the two carriers, each of which would, again, recover its half from its own subscribers.

While the methodological approach taken in *OPP Working Paper 34* differs somewhat from that used in *OPP Working Paper 33*, *OPP Working Paper 34* reaches essentially the same conclusion – that a bill-and-keep regime avoids several fundamental problems inherent in other methods of cost allocation and recovery among carriers. First, bill-and-keep "eliminates the ability of a network to shift costs from its subscribers to another network" by "eliminating the intrinsic monopoly of access."[25] Second, as a result, a network's costs, and therefore those of its subscribers, result from the network's *own* investment decisions, not those of another network. This means that appropriate price signals are transmitted to subscribers to make efficient use of services, and to exert competitive pressure on the network to which they subscribe (which, after all, is the only network they *can* exert pressure on) to provide

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[23] J. Atkinson & C. Barnekov, OPP Working Paper Series 34, *A Competitively Neutral Approach to Network Interconnection*, December 2000 ("*OPP Working Paper 34*").

[24] *OPP Working Paper 34* at para. 18.

[25] *OPP Working Paper 34* at para. 74.

more efficient service.[26] Third, bill-and-keep "reduces the artificial arbitrage opportunities by giving customers the correct market signals about whether to build a network and interconnect, or to subscribe to an existing network."[27] This reduces the "substantial inefficiencies and disruptions" caused when arbitrage is motivated by regulatory differences.[28]

In short, the Commission has a long history of understanding the clear benefits of a bill-and keep regime, especially where a provider has a monopoly on termination. And again, in the instant proceeding, all these considerations militate just as strongly in favor of rules that require terminating ISPs to recover their costs from their own customers – who must be given the right pricing signals to allow the market to function properly – and do not allow ISPs to leverage "paid prioritization" as a mechanism for recovering funds from edge providers, who have no choice in dealing with the terminating ISPs, and no ability to exert downward pressure on their prices through competition.[29]

For this reason, as Ad Hoc pointed out in its Comments, the *only* prioritization that should be permitted is that offered by ISPs *to their own subscribers*. Under this scenario:

> ISPs are free to offer subscribers an "a la carte" option whereby the *subscriber* could choose, for example, to download one or more streaming videos or music content at a higher bit rate while using slower speeds for e-mail and other websites. When ISPs offer such services directly to subscribers, the presence of marketplace competition and consumer choice can spur innovative, efficiency-enhancing service options, unlike ISP proposals to charge edge providers which merely exploit the ISP's terminating monopoly. The Commission can ensure that consumers have the benefits of pay-for-priority service, to the extent there are any, by requiring ISPs to offer the option directly to their subscribers rather than

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[26] *OPP Working Paper 34* at para. 75.

[27] *OPP Working Paper 34* at para. 76.

[28] *OPP Working Paper 34* at para. 85.

[29] *OPP Working Paper 34* makes a strong case for the proposition that previous bill-and-keep-like proposals would likely have been adopted from the outset were it not for the "driving policy objective of protecting subsidy flows to local carriers" that were the legacy of older monopoly regulation. *OPP Working Paper 34* at paras. 86-90. Had history been different in the way posited by *OPP Working Paper 34*, we might well not even be having this conversation, since the paid prioritization now touted by the ISPs would have been completely foreign to established regulatory doctrines and structures.

> compelling content providers to pay more under the threat of inferior connections to subscribers.[30]

And this brings us to the AT&T *Ex Parte.* At a superficial level, the policy espoused by the AT&T *Ex Parte* seems unobjectionable.[31] AT&T claims that it merely wants to be sure that the Commission does not adopt a flat ban on "user-directed prioritization," observing that Ad Hoc, among other parties, agrees with AT&T there.[32] On closer examination, however, AT&T's *Ex Parte* is a classic "bait and switch." AT&T blurs the concept of "user-directed" arrangements to include not only those where the consumer "directly request[s] (and… pay[s] for)" prioritization[33] – which are those supported by Ad Hoc – but also instances in which "edge providers negotiate arrangements [with ISPs] for the provision of user-directed prioritization."[34] How arrangements negotiated by two parties could be deemed to be "directed" by a third is a mystery which AT&T does not explain. But these latter are the very arrangements that Ad Hoc showed in its Comments would be both economically unsound and antithetical to the principles of an open Internet.

Rather than being the product of arm's-length negotiations between parties of equal bargaining power, any arrangement between an ISP and an edge provider would allow ISPs to essentially dictate terms as the monopoly providers of access to their respective subscribers. As Ad Hoc showed in its Comments, this would allow ISPs to establish supposedly "prioritized" service as the bare minimum needed for an edge provider to survive, and to extract payments from edge providers for the privilege.[35] Only prioritization options chosen and paid for *by the end user* – and which allow the end user to choose among *all* edge providers rather than restricting their options to

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[30] Ad Hoc Comments at 23.

[31] This letter does not address in detail AT&T's non-substantive argument, that the Commission should continue its attempts to regulate broadband providers under Section 706 of the Act rather than Title II. Ad Hoc has already addressed in other submissions the issue of which part of the Act is appropriate for use here, and has demonstrated that, in fact, Title II is the applicable statutory avenue for regulation here, given the facts of today's market, technology, and industry structure. *See, e.g.,* Ad Hoc Comments at 2-7; Letter from Colleen Boothby, Counsel, Ad Hoc Telecommunications Users Committee, to Marlene H. Dortch, Secretary, Federal Communications Commission, GN Docket No., 14-28 (filed Nov. 7, 2014). We do note that AT&T's claim that Section 706 actually gives the Commission *more* power to regulate in this space than does Title II (AT&T *Ex Parte* at 6) is bizarre given that the Court of Appeals struck down the Commission's previous effort to rely on that very argument.

[32] AT&T *Ex Parte* at 2-3, text and note 4.

[33] AT&T *Ex Parte* at 4. AT&T actually says "and/or pays for" but it is unclear whether AT&T means by the "or" to simply include instances in which the ISP allows the user to prioritize as a free option or whether AT&T has something else in mind.

[34] AT&T *Ex Parte* at 5.

[35] Ad Hoc Comments at Part III.

those edge providers singled out for favorable treatment by ISPs[36] – would avoid the fundamental problems arising from the ISPs' terminating monopolies.

Pursuant to Section 1.1206(b) of the Commission's Rules, this letter is being filed electronically in the above-referenced proceeding. Please feel free to contact the undersigned with any questions or concerns regarding this filing.

Respectfully submitted,

Colleen Boothby

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[36] One guess as to what AT&T might mean by "user-directed" prioritization in the context of arrangements between edge providers and ISPs might be that an edge provider could pay the ISP to be included in a list of edge providers for which user-selected priority is available. But this would still allow ISPs to extract payments from edge providers for being in this "fast lane," even if an individual end user decides not to use the fast lane for some or all of the edge providers on the favored list.