Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C.

In the Matter of	)	
	)	
Implementation of the Local Competition Provisions in the Telecommunications Act of 1996	)	CC Docket No. 96-98
	)	
Inter-Carrier Compensation for ISP-Bound Traffic	)	CC Docket No. 99-68
	)	

COMMENTS OF VERIZON COMMUNICATIONS

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Summary

The Commission correctly concluded that calls to the Internet are not local, but rather are interexchange and predominantly interstate. It should reaffirm that decision here, which is both legally correct and consistent with the decision of the Court of Appeals which required the Commission only to explain the basis of its decision.

At the same time, Verizon[1] urges the Commission to adopt a rule that puts to an end the controversy and litigation surrounding compensation arrangements for traffic to the Internet. Calls to the Internet are not local calls. These calls, therefore, are not covered by section 251(b)(5) or by the Commission's reciprocal compensation rules, and the Commission should not establish any new regime that requires the payment of inter-carrier compensation for terminating these calls.

Not only is this decision compelled by section 251 of the Act and the Commission's rules, but it is also the correct decision for public policy reasons. The payment of so-called "reciprocal" compensation for one-way calls to the Internet has undermined the Commission's goal of encouraging local service competition. In fact, it has given firms that could compete to serve local customers every incentive not to do so and to avoid those customers in favor of signing up ISPs. The Commission should take this opportunity to definitively put an end to the system that, as one independent industry analyst put it, has the "perverse effect of turning customers from assets into liabilities."

Verizon alone will be billed upwards of one billion dollars this year for compensation for Internet-bound calls, and other companies will be billed similar amounts. Unless the Commission acts quickly and decisively, these amounts will continue to increase, as Internet traffic doubles every 100 days.[2] This has drained and will continue to drain capital from the local telephone industry that would otherwise be invested in local networks to preserve high quality service and to provide new and better services. In particular, it slows the deployment of advanced telecommunications services.

These companies cannot continue to sit by and watch amounts of this magnitude leave the company without taking steps to get them back. The most logical way for them to recover the per minute charges they pay when their customers call the Internet is to impose per minute

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[1] The Verizon telephone companies ("Verizon") are the affiliated local telephone companies of Bell Atlantic Corporation (including the telephone companies formerly affiliated with GTE Corp.), d/b/a Verizon Communications. A list of these companies is attached.

[2] *Internet Freedom Act and Internet Growth and Development Act of 1999: Hearings on H.R. 1686 and H.R. 1685 Before the House Comm. on the Judiciary*, 106th Cong. (July 18, 2000) (statement of William E. Kennard, Chairman, Federal Communications Commission).

charges on those customers for such calls. But per minute Internet charges are the last thing anyone wants to see. Their only other choice would be to recover these costs from all customers, with the effect that the customer that does not use the Internet would subsidize those that do. While neither option is attractive, carriers would have no choice but to pursue them if the Commission does not quickly and decisively end the monetary outflow.

Finally, eliminating compensation on calls to the Internet will not leave CLECs without any way to recover their costs. There is no reason that they cannot recover their costs of serving ISPs the same way and to the same extent Verizon does — from those ISPs. Furthermore, the costs CLECs actually incur today to serve ISPs are far less than the compensation they have been receiving. This is true even for those CLECs that have networks similar to those of Verizon and other incumbents. But more important, CLEC networks — especially networks of CLECs that target ISPs — are different from those of traditional telephone companies, and are able to serve ISPs at much lower costs.

I. THE REMAND ISSUES

The Court of Appeals remanded "[b]ecause the Commission has not supplied a real explanation for its decision to treat end-to-end analysis as controlling."[3] This order does not require the Commission to reconsider its decision that calls to the Internet are not local — it merely requires the Commission to better explain that decision.

A. The Act and the Commission's Rules Do Not Require Compensation on Calls to the Internet.

Section 251(b)(5) of the Act obligates local exchange carriers "to establish reciprocal compensation arrangements for the transport and termination of telecommunications." The

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[3] *Bell Atlantic Telephone Cos. v. FCC*, 206 F.3d 1, 8 (D.C. Cir. 2000).

Commission "conclude[d] that section 251(b)(5) reciprocal compensation obligations should apply only to traffic that originates and terminates within a local area"[4] — and that those obligations "do not apply to the transport or termination of interstate or intrastate interexchange traffic"[5] — and carefully implemented this requirement in Subpart H of Part 51 of its regulations. These Rules require local exchange carriers to "establish reciprocal compensation arrangements for transport and termination of *local telecommunications traffic* with any requesting telecommunications carrier."[6] They further define "local telecommunications traffic" as "traffic . . . that originates and terminates within a local service area."[7] Under these rules, therefore, compensation is due only for calls that both originate and terminate in the same local service area. These rules and these definitions have not been challenged and are the starting point for analysis.

Under these rules, a call is local if it both originates and terminates in the same local service area. Only if it is local is reciprocal compensation payable. If a call is not local — if it originates in one local service area and terminates in another — then it is not local, it is interexchange. According to the Commision, "[w]e find that the reciprocal compensation provisions of section 251(b)(5) for transport and termination of traffic do not apply to the transport or termination of interstate or intrastate interexchange traffic."[8] Instead, "[t]raffic

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[4] *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 FCC Rcd 15499 ¶ 1034 (1996) ("*Local Competition Order*").

[5] *Id.*

[6] 47 C.F.R. § 51.703(a) (emphasis added).

[7] 47 C.F.R. § 51.701(b)(1).

[8] *Local Competition Order* ¶ 1034.

originating or terminating outside of the applicable local area would be subject to interstate and intrastate access charges."[9]

After a thorough analysis, the Commission concluded in its *Declaratory Ruling* "that the communications at issue here do not terminate at the ISP's local server, as CLECs and ISPs contend, but continue to the ultimate destination or destinations, specifically at a Internet website that is often located in another state."[10] Because these calls terminate at locations on the Internet, not at the location or in the equipment of the ISP, they cannot be "local telecommunications traffic." The *Declaratory Ruling* rightly concluded, "the reciprocal compensation requirements of section 251(b)(5) of the Act and Section 51, Subpart H (Reciprocal Compensation for Transport and Termination of Local Telecommunications Traffic) of the Commission's rules do not govern inter-carrier compensation for this [Internet-bound] traffic."[11]

B. The Questions Raised by the Court Do Not Require a Contrary Result.

The concerns raised in the Court's opinion do not require the Commission to change its mind about the nature of calls to the Internet or to come to a conclusion that is different from the one it reached in its *Declaratory Ruling*.

In general, the Court questioned whether the end-to-end analysis that the Commission has used for jurisdictional purposes is applicable here.[12] The simple answer is that it is — the

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[9] *Local Competition Order* ¶ 1035.

[10] *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 14 FCC Rcd 3689 ¶ 12 (1999) (footnote omitted) ("*Declaratory Ruling*").

This analysis is supported by the accompanying declaration of Charles L. Jackson, dated July 20, 2000, (Attachment 1).

[11] *Declaratory Ruling* ¶ 26 n.87.

[12] 206 F.3d at 7.

analysis that determines whether a call is "interstate" — where the call originates and terminates — is used to determine whether it is "local" under the Commission's rules. Furthermore, the Commission's end-to-end analysis has not been used only to resolve jurisdictional questions, but has been the basis of substantive decisions as well.[13]

1. Calls to the Internet do not "terminate" within the local serving area.

Internet-bound telecommunications do not terminate in the same local service area in which they originate — they do not terminate at the ISP, and the ISP is not the called party. The ISP, after performing verification and protocol conversion functions, sends the call along to other locations in different local serving areas. Calls to the Internet simply transit the ISP location on their way to their ultimate destination.

This processing by the ISP does not transform the call into local telecommunications traffic. As the attached declaration of Dr. Charles L. Jackson demonstrates, the network arrangements used to deliver calls to the Internet are similar to other arrangements used in the telecommunications industry. In each case, some form of call processing is done in the local service area in which the call originates. That fact, however, does not mean that the call terminates in that local service area. For example, calls placed with a calling card are verified in one location and delivered to the called party in another.[14] Similarly, long distance calls in non-equal access areas are dialed with a local telephone number, "answered" and processed in the originating calling area before being sent on to their destination.[15] In each case, the call

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[13] *E.g.*, *Teleconnect Co. v. Bell Tel. Co. of Pa.*, 6 FCC Rcd 5202, 5206 (1991), *recon.*, 10 FCC Rcd 1626 (1995) (using end-to-end analysis to identify the point at which an interstate communication terminated for purposes of the substantive application of the Commission's rules).

[14] Declaration of Charles L. Jackson ¶¶ 9-10, dated July 20, 2000.

[15] *Id.* n.1.

"terminates" elsewhere, at the location that the caller was trying to reach, not at the intermediate point where the call-processing functions are performed.

The Commission's rejection of the two-call argument was plainly correct. As the Commission has long held, a call to an enhanced service provider, like an ISP, is a single continuous communication from the originating end user to a terminating point in another exchange.[16]

2. The fact that the calls are delivered to ISPs rather than to carriers is not legally significant.

The Court of Appeals questioned the Commission's decision because Internet-bound calls are handed off to ISPs, not to "telecommunications carriers,"[17] and because those calls involve both telecommunications and information services.[18] These facts do not change the nature of the telecommunications involved or the jurisdiction of the call or in any way undermine the Commission's analysis.

In an Internet-bound call, there is a continuous communication between the caller and the distant location on the Internet — not one communication to the ISP and a separate, non-

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[16] E.g., *MTS and WATS Market Structure*, 97 F.C.C.2d 682, 711 ¶ 78 (1983) ("the user obtains local exchange services or facilities which are used, in part or in whole, for the purpose of completing interstate calls which transit its location and, commonly, another location in the exchange area"); *Amendments of Part 69 of the Commission's Rules Relating to Enhanced Service Providers*, 2 FCC Rcd 4305, 4306, ¶ 7 (1987) (ESPs "use the local network to provide interstate services"); *Amendments of Part 69 of the Commission's Rules Relating to Enhanced Service Providers*, 3 FCC Rcd 2631, 2631, ¶ 2 (1988) (ESPs are providers of interstate service and exchange access users); *Access Charge Reform*, 12 FCC Rcd 15982, 16131-32, ¶ 341 (1997) (ISPs "may use incumbent LEC facilities to originate and terminate interstate calls"); *GTE Tel. Operating Cos.; GTOC Tariff No. 1; GTOC Transmittal No. 1148*, 13 FCC Rcd 22466, 22476, ¶ 19 (1998) (Internet-bound calls "do not terminate at the ISP[] . . . but continue to the ultimate destination or destinations, very often at a distant Internet website accessed by the end user").

[17] 206 F.3d at 7.

[18] 206 F.3d at 7.

telecommunications service from the ISP to the Internet. This conclusion is compelled by a string of Commission decisions. In 1983, the Commission considered the jurisdiction of and compensation arrangements for calls to non-carriers that provided enhanced services. At that time, the Commission concluded that calls to the location of a non-carrier enhanced service provider do not terminate there but "transit" that location to their ultimate destination for "complet[ion]."[19] The Commission has reaffirmed this conclusion repeatedly since then,'[20] and it is plainly correct.

More generally the Commission has always held that facts such as these were irrelevant to determining the end-points of communications:

> Among the variety of users of access service are facilities-based carriers, resellers (who use facilities provided by others), sharers, privately owned systems, *enhanced service providers*, and other private line and WATS customers, large and small, who 'leak' traffic into the exchange. *In each case the user obtains local exchange services or facilities which are used, in part or in whole, for the purpose of completing interstate calls which transit its location and, commonly, another location in the exchange area*.[21]

The Commission has consistently applied its end-to-end jurisdictional analysis to circumstances involving information-service providers.[22] And that analysis has been affirmed by the courts. The D.C. Circuit affirmed the Commission's assertion of jurisdiction over

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[19] *MTS and WATS Market Structure*, 97 F.C.C.2d 682, 711 ¶ 78 (1983).

[20] E.g., *Amendments of Part 69 of the Commission's Rules Relating to Enhanced Service Providers*, 2 FCC Rcd 4305, 4306, ¶ 7 (1987); *Amendments of Part 69 of the Commission's Rules Relating to Enhanced Service Providers*, 3 FCC Rcd 2631, 2631, ¶ 2 (1988); *Access Charge Reform*, 12 FCC Rcd 15982, 16131-32, ¶ 341 (1997); *GTE Tel. Operating Cos.; GTOC Tariff No. 1; GTOC Transmittal No. 1148*, 13 FCC Rcd 22466, 22476, ¶ 19 (1998).

[21] *MTS and WATS Market Structure*, 97 F.C.C.2d 682, 711 ¶ 78 (1983) (emphasis added).

[22] The Commission cited many of these decisions in its original ruling. *See Declaratory Ruling* ¶¶ 10-12 (1999).

telecommunications involving both carriers and non-carriers (in that case a cable television operator) in words that could have been written to describe the Internet:

> The stream of communication is essentially uninterrupted and properly indivisible. To categorize [the local telephone company's] activities as intrastate would disregard the character of the television industry, and serve merely to prevent the national regulation that is not only appropriate but essential to the efficient use of radio facilities. . . .
>
> . . . Any other determination would tend to fragment the regulation of a communications activity which cannot be regulated on any realistic basis except by a central authority; fifty states and myriad local authorities cannot effectively deal with bits and pieces of what is really a unified system of communication.[23]

The Commission has consistently found that the fact that calls are not handed off to carriers and that information services are involved is irrelevant to these questions and it should reaffirm that conclusion here.

3. Internet-bound calls are not "telephone exchange service."

The Commission has correctly determined that Internet-bound traffic is not "telephone exchange service" under the Act. In the *Advanced Services Remand Order*, the Commission held that "[t]he primary distinction between [telephone exchange service and exchange access] is that, while telephone exchange services permit communication 'within a telephone exchange' or 'within a connected system of telephone exchanges within the same exchange area,' exchange access refers to access to telephone exchange services or facilities for the purpose of originating or terminating communications that travel outside an exchange."[24] Because "typically ISP-bound traffic does not originate and terminate within an exchange," such traffic "does not constitute

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[23] *General Tel. Co. of Cal. v. FCC*, 413 F.2d 390, 400-01 (D.C. Cir. 1969), *cert. denied*, 396 U.S. 888 (1969).

[24] *Advanced Services Remand Order*, 15 FCC Rcd 385 at 391, ¶ 15 (footnote omitted).

telephone exchange service within the meaning of the Act."[25] Of course, if delivering calls to an ISP is "exchange access,"[26] then the call itself must be interexchange and not subject to reciprocal compensation, as the Commission correctly concluded.

Moreover, classification as "telephone exchange service" or "exchange access" is not directly relevant to this issue. The operative term under the Commission's rules is "local telecommunications traffic," which is determined by where the telecommunications "originates" and "terminates." To the extent it could be relevant, however, the Commission's conclusion that ISPs, as ESPs, use exchange access[27] forecloses the application of reciprocal compensation to Internet-bound calls.

II. THE RULEMAKING ISSUES

The Commission should rule that a local exchange carrier does not have to pay compensation for the termination of its customer's calls to the Internet.[28] If reciprocal compensation billings reflect a traffic imbalance of greater than two to one in an exchange area, there is a presumption that Internet-bound calls are involved. Any carrier wishing to bill for calls in excess of this amount should be required to certify that it is not billing for any Internet-bound calls.

A rule of this sort is necessary to decisively bring to an end the current regime in which billions of dollars in compensation have been paid for traffic that is not local. This regime has had

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[25] 15 FCC Rcd at 391-92, ¶ 16.

[26] In *Amendments of Part 69 of the Commission's Rules Relating to Enhanced Service Providers*, 3 FCC Rcd 2631, 2631, ¶ 2 (1988), the Commission found that ESPs are exchange access users.

[27] *Id*.

[28] Such a rule would not preclude Verizon from charging for the transport of Internet-bound calls delivered to its tandems. It would also not constrain the Commission from

negative effects, not just on Verizon and the other companies that have had to make these payments, but on the marketplace more generally.

A. Payment of compensation distorts markets and investments.

The reciprocal compensation system contemplated in the Act was based on the assumption that two local networks would be exchanging local calls and that the call flows would be roughly equal in each direction. It was not designed to permit one carrier to sit back, to only receive calls originated by another carrier and to receive the monthly checks for providing no local service. But the one-way nature of Internet calling has made that scenario possible — indeed, has made it commonplace. Instead of 1:1 traffic ratios with other carriers, Verizon overall is sending more than 21 times as much traffic as it is receiving, and that ratio is several times higher for some carriers. This imbalance has been rapidly increasing. This scenario is now so commonplace that Verizon expects to be billed almost one billion dollars for compensation for Internet-bound calls this year.

The payment of compensation for Internet-bound calls has numerous harmful societal consequences.

1. Payment of compensation discourages residential local competition and investment.

Internet compensation pays carriers not to compete, in particular for residence and small business customers. Because it is available only when a customer's line is served by another carrier, Internet compensation actually pays carriers *not* to invest in their own competing facilities and *not* to provide their own competing service to residence or small business customers.

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adopting a different inter-carrier compensation scheme for voice telephony over the Internet.

Payment of compensation is bad for competition, the very competition that the Commission's implementation of the 1996 Act has been intent on encouraging. It's hard work going out into the marketplace to compete for the business of hundreds or thousands of individual telephone customers. It's relatively easy to try to sell to one or two ISPs — and especially when you can offer them special deals based on your getting these compensation payments.[29] As a result, some competitors have decided it is better to serve a few ISPs and reap these windfall profits than to invest and to compete to serve consumers.

And that's not the worst part — actually serving residential customers would *reduce* their revenues. Because it is available only when a customer's line is served by another carrier, Internet compensation actually pays carriers *not* to invest in their own competing facilities and *not* to provide their own competing service to residence or small business customers. As a Wall Street analyst observed, it has the "perverse effect of turning customers from assets into liabilities,"[30] a conclusion that is confirmed by the economic analysis in the accompanying declaration of Dr. William E. Taylor (Attachment 2).

An example, based on typical industry-wide numbers, makes this clear: Carrier A has a residential customer, an average Internet user, who uses her second line for one hour each day to reach her ISP,[31] which uses a CLEC. At a typical reciprocal compensation rate of ½ cent per

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[29] *See* Sasha Samberg-Champion, *ISP-CLEC Coalition Sought on Compensation Legislation*, Communications Daily, May 25, 2000.

[30] S. Cleland, The Precursor Group/Legg Mason Research Technology Team, *Reciprocal Compensation for Internet Traffic — Gravy Train Running Out of Track*, June 24, 1998.

[31] The Organization for Economic Co-Operation and Development estimated U.S. usage at this level in 1999. Sam Paltridge, OECD Working Party on Telecommunications and Information Services Policies, *Local Access Pricing and E-Commerce* at 21 (April 12, 2000). As newer Internet applications like Internet radio programs become more popular, holding times and

minute, Carrier A pays the CLEC $9 per month for its customer's Internet use. Carrier A also has customers who are heavy Internet users, on line three, four, five hours each day listening to music and chatting with friends. Compensation payments for these customers would cost Carrier A up to $45 per month each.

This compensation system gives ISPs artificial incentives to get their customers to stay on line more. For example, if a ISP got its customers to be logged on full time, Carrier A's liability would be $216 per month.

The typical basic monthly charge for a second line is $15, a rate that does not cover the real costs of providing the service. And because this is a line that's connected to the computer, the customer typically will not be using it to make long distance calls and will not be buying value-added features on it. Whether the reciprocal compensation payment is $9 or $45 or $216 or somewhere in between, it is clear that providing this service is a losing proposition for Carrier A.

But these numbers also show why the CLEC will never try to sign up this residential customer. If this customer moves to the CLEC, the CLEC will gain the $15 monthly service fee from the customer, but it will lose the $9 it gets in compensation *and* will incur, say, $13 in real costs to serve the customer — a loss of $7 per month and $16 per month worse off than it was before. To make matters worse for the CLEC, if the customer then changes ISPs (or the ISP switches to another CLEC), the first CLEC actually has to pay compensation to the second CLEC, making it $25 to $225 per month worse off for signing up the residential customer.

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daily usage will increase. *See, e.g.*, Frank Ahrens, *Off the Air and Into Your PC*, Wash. Post, July 16, 2000 at A1.

This is precisely why both the Massachusetts and Colorado public utility commissions and independent analysts found that the economics of applying reciprocal compensation to Internet-bound calls are simply too attractive to make entering the competitive fray worthwhile.

> The unqualified payment of reciprocal compensation for ISP-bound traffic . . . does not promote real competition in telecommunications. Rather, it enriches competitive local exchange carriers, Internet service providers, and Internet users at the expense of telephone customers or shareholders. This is done under the guise of what purports to be competition, but is really just an unintended arbitrage opportunity derived from regulations that were designed to promote real competition.[32]

And

> [W]e find that reciprocal compensation would introduce a series of unwanted distortions into the market. These include: (1) cross-subsidization of CLECs, ISPs, and Internet users by the ILEC's customers who do not use the Internet; (2) excessive use of the Internet; (3) excessive entry into the market by CLECs specializing in ISP traffic mainly for the purpose of receiving compensation from the ILECs; and (4) disincentives for CLECs to offer either residential service or advanced services themselves.[33]

The Commission should reject a payment system as undermining one of the fundamental goals of the 1996 Act.

2. Payment of compensation discourages investment in new services and technology.

The payment of reciprocal compensation not only deters investment in local facilities by competitors, it also deters investment by all carriers in new technologies that could be used to handle this traffic more efficiently. As the Chairman of Covad noted, it "slows down the

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[32] *Complaint of MCI WorldCom, Inc. against New England Telephone and Telegraph Company d/b/a Bell Atlantic-Massachusetts for breach of interconnection terms entered into under Sections 251 and 252 of the Telecommunications Act of 1996,* D.T.E. 97-116-C at 25-26 (Mass. D.T.E. May 19, 1999).

[33] *Petition of Sprint Communications Company, L.P. for Arbitration Pursuant to U.S. Code § 252(b) of the Telecommunications Act of 1996 To Establish an Interconnection Agreement with U S West Communications, Inc.*, Docket No. 00B-011T, Initial Commission Decision at 22 (Colo. P.U.C. May 3, 2000).

deployment of a high-speed packet-based network"[34] that most experts believe is necessary for the widespread deployment of advanced services.

First, this situation drains hundreds of millions of dollars from the local telephone industry that would otherwise be invested in local networks to provide new and better services. Moreover, although Internet-bound traffic could be handled more efficiently by moving it off the circuit-switched network, and onto more efficient packet-switched technologies, there is no incentive to deploy these technologies if they won't be used. But the fundamental problem is that, as long as Internet service providers (or their carrier affiliates) can get paid reciprocal compensation if they stay on the circuit-switched network, they have little incentive to move to new packet-switched technologies, no matter how reasonably priced. And so long as no one is willing to use these new technologies, there is little incentive for originating carriers to deploy them in the first place.

Not only are CLEC-ISPs not embracing the new technology, they are providing incentives to their customers to stay with older, dial-up access. RCN, for example, offers "Free Long Distance for the Entire Summer" to their dial-up Internet customers,[35] a promotion it can fund with Internet compensation revenues from those customers' local exchange carriers. No such inducement is offered to its cable modem[36] or DSL[37] customers.

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[34] Charles McMinn, *xDSL and Section 706*, Presentation at the Economic Strategy Institute Forum on Section 706, (Sept, 16, 1998) <http://www.econstrat.org/ECONSTRAT/mcminn.htm>.

[35] RCN ISP Summer Promotion (visited July 21, 2000) <https://swww.rcn.com/signup/signup.htm>.

[36] RCN Cable Modems (visited July 21, 2000) <http://www.rcn.com/cable_modems/index.html>.

[37] RCN Commercial Internet (visited July 21, 2000) <http://www.rcn.com/commercial/internet/index.html>.

3. Payment of compensation could lead to per-minute Internet charges or general local rate increases.

Local telephone companies are faced with multi-billion dollar annual outflows of cash. They have two ways to respond. The most logical is to pass on their compensation costs to the customers that cause them — those who use the Internet. If a carrier pays ½ cent per minute because its customer calls the Internet, then that carrier would bill that ½-cent-per-minute to that customer. The other alternative would be for the carrier to recover these costs from all its local customers, which would result in consumers who do not use the Internet subsidizing those who do.[38] And this is not just speculation — one local telephone company in California is already seeking to impose just such a charge,[39] and more will inevitably be on the way if the Commission does not act promptly to make it clear that compensation is not required.

4. Payment of compensation encourages bad behavior.

When the system permits people to make money by doing nothing, lots of people will do nothing. When it permits people to make even more money through inefficient, socially wasteful behavior, some people will engage in such activities.

Sham CLECs. Internet service providers and others have set up shop as supposed "carriers" for the sole purpose of getting paid reciprocal compensation and provide no competitive local services. This is demonstrated by the fact that while Verizon sends millions of

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[38] One state regulator testified that his commission rejected compensation for Internet calls, in part, because "I would have to provide a mechanism for the incumbent LECs who are originating most of this traffic to recover that cost. When that happens, I may be forced to consider higher rates for my constituents, the ratepayers of Louisiana, and that is something I don't want to see." *Reciprocal Compensation Requirements: Hearings on H.R. 4445 Before the Subcomm. on Telecommunications Trade & Consumer Protection*, 106 Cong. (June 22, 2000) (Statement of Jay A. Blossman, Jr., Commissioner, La. Public Service Commission).

minutes to these "carriers," they send no traffic at all to Verizon. In the most extreme case, Verizon delivered almost 5,000,000 minutes of local traffic to one provider in 1999 and received not a single minute in return. Twelve other providers were in that same position last year, albeit on a smaller scale.

The transformation of ISPs into CLECs just to cash in on reciprocal compensation has spawned a cottage industry. Recently reported in the press was an ISP industry meeting in which one "[c]onference session showed ISPs how to make that transition to CLEC status to ensure they reaped benefits" of reciprocal compensation payment.[40]

Kick-backs and horse barns. The North Carolina Utilities Commission recently found one CLEC guilty of "improperly invoicing BellSouth for millions of dollars of reciprocal compensation."[41] The commission found that US LEC had agreed to pay kick-backs to two companies amounting to 40% of all reciprocal compensation BellSouth paid US LEC if they originated connections on BellSouth's network and terminated them to US LEC telephone numbers.[42] These two companies "established networks to generate reciprocal compensation for US LEC and commissions for themselves."[43] To do this, one of these companies (Metacomm) offered free service and even "paid sales agents more than $400,000 ($25,000 per customer) to persuade customers to sign up for free access to [its] network." One of Metacomm's customers

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[39] *Petition by Pac-West Telecomm, Inc. for Arbitration of an Interconnection Agreement with Roseville Telephone Company,* Testimony of Greg R. Gierczak, Roseville Telephone Co., Proceeding No. A. 00-05-021 (Cal. P.U.C. filed May 12, 2000).

[40] Sasha Samberg-Champion, *ISP-CLEC Coalition Sought on Compensation Legislation*, Communications Daily, May 25, 2000.

[41] *BellSouth Telecommunications, Inc. v. US LEC of North Carolina Inc.*, Order Denying Reciprocal Compensation, Docket No. P-561, Sub 10 (N.C. U.C. March 31, 2000).

[42] *Id.*, Finding of Fact 3.

[43] *Id.*, Finding of Fact 4.

was Charlie Horse Farm, a firm that was in the business of boarding horses and which "never accessed or attempted to access Metacomm's network." "Metacomm nevertheless originated connections from a router [— and four PRIs so that it could establish 92 connections at one time —] located at the horse barn to a terminating router for approximately one year, and US LEC has billed BellSouth reciprocal compensation for all of the minutes of use attributable to the connections established by the router at the horse barn."

Numbering schemes. The Maine Public Utilities Commission found that one CLEC, Brooks Fiber, had obtained 54 NXX codes — 540,000 telephone numbers — throughout the state to allow it to serve ISPs from its single facility in Portland. The Maine Commission found that "Brooks has no local switching facilities or loops deployed in any of the locations outside its Portland area exchange to which the 54 non-Portland codes are nominally assigned" and that "had no local exchange customers in those locations and all of its local exchange service customers were located in the Portland area exchange."[44] Brooks was using these telephone numbers to provide a service that the Maine commission found to be much like 800 service, it allowed end users to call a distant location on a toll-free basis.[45] In fact, the commission found "800 or some equivalent service would provide the same or better toll-free access to ISP customers."[46]

At least as important, the Brooks arrangement wasted hundreds of thousands of telephone numbers. The commission found, "Brooks proposes to use numbers at the rate of 550,000 for ten

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[44] *Investigation into the Use of Central Office Codes (NXXs) by New England Fiber Communications LLC d/b/a Brooks Fiber*, Order Requiring Reclamation of NXX Codes and Special ISP Rates by ILECs, Docket No. 98-758, Order No. 4 at 4 (Me. P.U.C. June 30, 2000).

[45] *Id.* at 11.

customers (equivalent to a 'fill' rate of under two one thousandths of one percent)."[47] Therefore, "It would take only two or three more Brooks-like arrangements, each with one ISP customer, to completely exhaust Maine's numbering resources."[48] At a time when the Commission and the states are expending great efforts to conserve telephone number resources and the industry is embarking on costly number pooling initiatives, the Commission should not adopt a reciprocal compensation policy that encourages activities like those of Brooks.

Interstate access scams. In a proceeding before the New Hampshire Public Utilities Commission, CLECs claimed a right to reciprocal compensation payments for delivering calls to ISPs that are physically located not just in a different local calling area, but even in a different state, from the Verizon customers placing the call.[49] Under this "virtual local call" theory, a call to an ISP is local if the ISP has a telephone number with an NXX code assigned to the caller's local calling area, even if the ISP is not actually in that area, or even in that state.[50]

These examples are just the tip of the iceberg — practices that, in some cases, were uncovered by accident and that have been made the subject of regulatory proceedings. There is much more out there. Moreover, the fact that regulators have been able to stop some of this bad

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[46] *Id.* at 12. The way Brooks used the NXXs assigned to it prevented Verizon from recognizing or billing the call as a toll call by making the call appear to be local even when Verizon carried it to a distant location, while the CLEC billed reciprocal compensation for the call — all on a call that did not terminate to any customer in the originating local calling area.

[47] *Id.* at 17.

[48] *Id.* at 16-17.

[49] *NEVD of New Hampshire, LLC, Petition for Declaratory Judgment that Internet Traffic be Treated as Local Traffic Subject to Reciprocal Compensation*, Docket DT 99-085 (N.H. P.U.C. filed July 4, 1999).

[50] *NEVD of New Hampshire, LLC, Petition for Declaratory Judgment that Internet Traffic be Treated as Local Traffic Subject to Reciprocal Compensation*, Docket DT 99-085, MCI Brief at 7-9 (N.H. P.U.C. dated May 26, 2000).

behavior does not mean that it is not a problem or that there is no need to fix the real cause of the problem — the system that causes inefficient, socially wasteful behavior. For every case of bad behavior that has come to light and been dealt with, there are dozens more that have not been located and that continue. Moreover, even where the regulators have acted, the process has taken many months, if not many years, and has needlessly consumed both carrier and public resources.

B. Elimination of compensation won't have bad side effects.

Elimination of compensation payments for Internet calls will right these wrongs. It will not have the negative effects its proponents claim.

1. Loss of compensation won't hamper CLEC growth.

Some have said that the loss of compensation for Internet-bound calls will stifle the growth of competitive alternatives. Professional analysts disagree. As Eric Strumingher, Managing Director of Research at Paine Webber recently testified:

> Some are concerned that ending the payment of reciprocal compensation for Internet traffic will thwart investment in telecommunications. In my opinion, this is the wrong conclusion.

Furthermore,

> Informed investors realize that the sustainability of revenues generated from [reciprocal compensation] is subject to great uncertainty given the ambiguity/inconsistency of the current regulations. It has been clear for years to knowledgeable entrepreneurs and investors that reciprocal compensation for Internet service is a source of revenue that could very well go away.[51]

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[51] *Reciprocal Compensation Requirements: Hearings on H.R. 4445 Before the Subcomm. on Telecommunications Trade & Consumer Protection*, 106 Cong. (June 22, 2000) (Testimony of Eric Strumingher, Managing Director, Research, Paine Webber).

Another analyst reports that reciprocal compensation accounts for only 8 percent of CLEC revenues, which is expected to decline to 6 percent by year's end.[52] Its loss — or its diminution by eliminating compensation for Internet-bound calls — will not cause these carriers to go out of business.

Nor is this a new perspective on the CLECs' reliance on reciprocal compensation payments. As early as August 1998, Wall Street had concluded, "By and large, the CLECs have relatively minimal exposure to reciprocal compensation. * * * As such, for the majority of the CLECs, we believe that investors should not lose any sleep over the issue."[53]

The fact is that most compensation is not going to small carriers trying to break into the local exchange service marketplace. Rather, in 1999, almost half the traffic in the old Bell Atlantic states went to the two largest long distance carriers, which do not need artificial infusions of capital to enable them to get into the market. Another 40 percent was routed to eight CLECs , some of which sent Verizon no traffic at all and others that had traffic imbalances of greater than 40 to one — imbalances that reached 11,269:1 and 8369:1 in the most extreme cases — suggesting that they are not providing any real local service, but are in business solely to collect compensation payments.

2. Loss of compensation won't lead to per-minute Internet charges.

As shown above, if carriers must continue to make per-minute payments to CLECs on account of their customers' Internet usage, then these carriers might, most reluctantly, be forced to recover per minute charges from those customers. Proponents of compensation for calls to the

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[52] Credit Suisse First Boston, *Telecommunications Services: CLECs* at 3, (June 14, 2000).

[53] Bear Stearns, *What Reciprocal Compensation Means to the CLECs* at 2, (August 6, 1998).

Internet claim that the loss of such compensation will lead ISPs to impose per minute charges. This is nonsense.

First, when Verizon serves ISPs, it charges for service according to its intrastate tariffs customers from those customers. The services that ISPs use are typically bought on a flat-rate, not a usage sensitive, basis. These arrangements have not driven these ISPs to impose per minute Internet access charges, and there is absolutely no reason to believe that CLECs' ISP customers would impose such charges either.

Second, the costs a CLEC incurs to serve an ISP are for dedicated equipment and a dedicated line to the ISP. These costs are not usage sensitive and are most logically recovered from the ISP on a flat-rate basis. And CLECs can charge for these services to the same extent that Verizon and other incumbents can. There would be no reason (other than CLEC greed) for these costs to be recovered through per-minute charges which might translate into per-minute ISP charges for Internet access.

C. CLECs don't need reciprocal compensation to permit them to recover their costs.

The proponents of compensation argue that at least some competing carriers incur legitimate costs in order to deliver Internet traffic that they need to recover. Even where real costs in fact exist, there is no reason why these carriers cannot recover them exactly as Verizon does — from its own retail customers. In addition, the cost of delivering ISP calls is far less than the cost of delivering ordinary voice calls, and the voice call termination rate, therefore, should not be used as a surrogate for such costs.

1. These CLECs should recover them from their own customers.

There is no reason to believe that costs must go unrecovered in the absence of reciprocal compensation or similar payments. The proponents of compensation ignore the fact that these

carriers already can recover their costs in exactly the same way and to exactly the same extent as the incumbents — through the business line or other rates they charge to ISPs. In fact, this is exactly what the CLECs do in areas where they have negotiated bill-and-keep arrangements with the incumbents.[54]

2. CLECs are deploying even cheaper arrangements to serve their ISP customers.

As shown below, because of the nature of traffic to the Internet, a CLEC's cost to deliver Internet calls is only 26 percent of Verizon's cost to deliver a local call, even assuming the CLEC uses the same equipment and serving arrangements.[55] However, CLECs have developed other arrangements that further reduce their costs. For example:

Telco hotels. These are locations where multiple ISPs can collocate their equipment with CLEC hosts,[56] driving virtually to zero the cost of terminating Internet-bound traffic. Even without formal "hotels" CLECs are collocating with ISPs to make termination almost costless.

NaviPath. NaviPath offers "revolutionary switch bypass technology" that promises to "deliver[] all modem calls directly to NaviPath's access switches and completely bypasses Local Exchange Carriers' switches." This switch receives ISP calls directly from the incumbent carrier's network, bypassing the CLEC voice switch entirely (presuming it even has one). It converts the call to IP packets and sends them to NaviPath's wide area network, which directs Web traffic

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[54] *Petition by Pac-West Telecomm, Inc. for Arbitration of an Interconnection Agreement with Roseville Telephone Company*, Testimony of Greg R. Gierczak, Roseville Telephone Co., Proceeding No. A. 00-05-021 (Cal. P.U.C. filed May 12, 2000).

[55] Declaration of William Taylor ¶ 34, dated July 20, 2000.

[56] Alan J. Wax, *Plans for 'Telco Hotel'/Phone and Internet Firms Would Rent in Garden City*, Newsday, June 9, 2000, at A65.

straight to an Internet backbone, while sending e-mail and requests for local content to the local ISP.[57]

Softswitches. Manufacturers including Lucent, Cisco, Hewlett-Packard, Sun Microsystems and Telcordia are supporting open, software-based switches that are specially designed to interconnect circuit-switched and IP networks and that are much less costly than traditional telephone company switches. A central component of the softswitch is a media gateway which is little more than an improvement on an ISP's traditional modem bank. Instead of looking like CPE, the modem bank is made to look like a piece of carrier equipment — a switch. As an article in this month's *Telecommunications* notes, use of this equipment "puts the CLECs in an advantageous position regarding rules governing intercarrier settlement, and also gives them a way to provide PRI lines to ISP customers more economically. . . ."[58]

These new switches are cheaper because they do not have to provide all the features that have to be included in equipment that is designed to provide regular local telephone service. As the *Telecommunications* article points out, the typical end office switch can support up to 3500 features or services, while "only about a dozen or so are meaningful" for the CLEC.[59]

Virtual POP/managed port services. These are arrangements, such as those described in the attached Lucent white paper, in which the CLEC provides network resources to the ISP at the ISP's premises and which "offer[] major cost benefits to the CLEC" — one application reducing the CLEC's cost of terminating to less than one-third the cost of traditional PRIs via a Class 5

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[57] See NaviPath (visited July 21, 2000) <http://www.navipath.com/technology/index.php3>.

[58] *Next-Gen Giving Voice Switches a Makeover*, Telecommunications, July 2000, at 37.

[59] *Id.*

voice switch.[60] As the white paper also notes, "Reciprocal compensation revenues can make offering virtual POP services even more attractive for CLECs, adding a significant revenue source to the CLEC's 'managed port service' revenues."[61]

3. The cost of terminating calls to ISPs is less than the cost to terminate ordinary local calls.

Some of the proponents of reciprocal compensation claim that the costs to terminate a local exchange call and the costs to deliver a call to an ISP are the same. This is not correct. As the accompanying declaration of William Taylor demonstrates, using the methodology approved by the Commission, the cost to deliver a call to an ISP is a fraction of the cost of terminating an ordinary local exchange telephone call even if the CLEC has the same type of network as Verizon, which it generally does not.

Any claim that the costs to terminate a local voice call and the costs to deliver a call to an ISP are the same is based upon the assumption that the two types of traffic use the telephone network in the same way. As discussed above, many CLECs use different, less expensive equipment, rather than costly circuit switches, to deliver calls to the Internet. Even if equipment like that in Verizon's network is used, Internet-bound calls differ from ordinary local calls in significant ways that make delivering them much less costly.

First, Internet calls are much longer than ordinary voice calls, according to independent estimations, by a factor of eight to twelve. This spreads the cost of setting up the call over more minutes, thereby lowering the per minute cost. Second, there is no dedicated path through the

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[60] Lucent Technologies, *The CLEC Business Opportunity in Managed Port Services* at 18 (January 2000) <http://www.lucent.com/ins/library/pdf/white_papers/clecbowp.pdf>.

[61] *Id.* at 11.

switch for every customer voice line, because of the relatively short duration of voice calls.[62] ISPs typically use ISDN Primary Rate Interface (PRI) ports, which have no concentration — there is a path through the switch for every line. Third, Verizon's cost to terminate a local call often involves tandem switching, a cost that CLECs do not have.

As the Taylor declaration shows, these network differences significantly affect cost. First, the longer a call is connected through the network, the lower the cost per minute because the cost to set up the call is spread over more minutes of use. Second, in a PRI unit where each line has a dedicated network path, the network paths are fixed and not traffic sensitive. Such fixed costs should be excluded from the cost recovered through usage-based intercarrier compensation. The cost of the higher grade of service provided by this dedicated network path should be borne by the CLEC's ISP customer, not by Verizon or its end user customers. This is consistent with the Commission's approach to reciprocal compensation:

> We find that, once a call has been delivered to the incumbent LEC end office serving the called party, the 'additional cost' to the LEC of terminating a call that originates on a competing carrier's network primarily consists of the traffic-sensitive component of local switching. The network elements involved with the termination of traffic include the end-office switch and local loop. The costs of local loops and line ports associated with local switches do not vary in proportion to the number of calls terminated over these facilities. We conclude that such non-traffic sensitive costs should not be considered 'additional costs' when a LEC terminates a call that originated on the network of a competing carrier.[63]

The Verizon study described in the Taylor declaration starts with Verizon's approved transport and terminations rates in six states and first adjusts them based on an average Internet call of 28 minutes, an estimate which is, if anything, on the low side. This reduces the rate by more than 28 percent. The second adjustment is to remove the Line CCS costs, which produces a

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[62] Typically, there is one path through the switch for every six end user lines.

[63] *Local Competition Order* ¶ 1057 (footnote omitted).

reduction of an additional 46 percent in the six states. When these two simple adjustments are made, it is clear that even where the CLEC is using the same equipment and has the same network architecture as Verizon, its cost to route a call to an ISP is significantly less than Verizon's cost to terminate a voice call.

4. Even CLECs recognize that their costs to deliver this traffic are lower.

In recent months, Verizon has negotiated interconnection agreements with some CLECs that recognize that they have much lower costs to terminate calls to the Internet. While Verizon believes that the compensation rates in these contracts are still significantly higher than the CLECs' real costs, they do demonstrate that regular reciprocal compensation rates are excessive.

Verizon has such agreements in one or more states with a number of CLECs. While each agreement is a little bit different, they generally have some common threads. First, the compensation rates are reciprocal for traffic delivered to the CLEC and delivered to a Verizon end office. Second, these rates are lower than those for reciprocal compensation in other agreements. Third, Verizon pays a lower rate when there is a significant traffic imbalance.

These new agreements do not solve the problem. These rates more than cover the costs that these CLECs incur to route this traffic to the ISPs. And the rapidly growing volume of Internet traffic reinforces the economic incentives that distort the market even at the lower compensation rates.

Conclusion

The Commission should reaffirm that calls to the Internet are predominantly interstate, not local, and that its reciprocal compensation rules do not apply to them. It should also establish a federal inter-carrier compensation mechanism for these calls, in which no compensation is paid for terminating Internet-bound calls, even when the caller and the ISP are in the same local calling area. Because of the history of problems in this area, a traffic imbalance of two to one or greater in an exchange area establishes a presumption that calls to the Internet are involved. Any carrier wishing to bill for calls in excess of this amount should be required to certify that it is not billing for any Internet-bound calls.

Respectfully submitted,

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The Verizon Telephone Companies

The Verizon telephone companies are the affiliated local telephone companies of Bell Atlantic Corporation (d/b/a Verizon Communications), including the telephone companies formerly affiliated with GTE Corporation. These are:

Bell Atlantic-Delaware, Inc.
Bell Atlantic-Maryland, Inc.
Bell Atlantic-New Jersey, Inc.
Bell Atlantic-Pennsylvania, Inc.
Bell Atlantic-Virginia, Inc.
Bell Atlantic-Washington, D.C., Inc.
Bell Atlantic-West Virginia, Inc.
Contel of Minnesota, Inc.
Contel of the South, Inc.
GTE Alaska Incorporated
GTE Arkansas Incorporated
GTE California Incorporated
GTE Midwest Incorporated
GTE Southwest Incorporated
The Micronesian Telecommunications Corporation
New England Telephone and Telegraph Company
New York Telephone Company
Verizon Florida Inc.
Verizon Hawaii Inc.
Verizon North Inc.
Verizon Northwest Inc.
Verizon South Inc.
Verizon West Coast Inc.