BEFORE THE

FEDERAL COMMUNICATIONS COMMISSION

WASHINGTON, D.C. 20554

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

REPLY DECLARATION OF WILLIAM E. TAYLOR

I. INTRODUCTION AND SUMMARY

1. I am Senior Vice President of National Economic Research Associates, Inc. (NERA), head of its telecommunications economics practice and head of its Cambridge office. I filed a Declaration in this Docket on July 21, 2000 which listed my credentials. I have been asked by Verizon Communications ("Verizon") to reply to economic issues raised by AT&T and its consultants ETI.[1] I reach four main conclusions.

2. First, AT&T assumes that the LEC serving the end user who originates the Internet-bound call is causally responsible for the cost of the call and should be obliged to compensate any other

[1] *In the Matter of Implementation of the Local Competition Provision in the Telecommunications Act of 1996 and Inter-Carrier Compensation for ISP-Bound Traffic*, CC Docket Nos. 96-98 and 99-68, July 21, 2000, Comments of AT&T Corp., ("AT&T Comments") and Declaration of Lee L. Selwyn and Patricia Kravtin ("ETI Declaration").

LECs involved in the provision of the call. While that arrangement exists and is economically efficient for local exchange calls, it is not used and is not efficient for long distance calls. In my initial Declaration, I showed that the economic argument that meet-point billing in an access charge regime was the efficient form of intercarrier compensation for long distance calls applied equally to Internet-bound calls.[2]

3. Second, AT&T repeats the tired fallacy that because local and Internet-bound calls use the same network elements, they cause the same costs. Internet-bound calls use network elements differently from local calls, and the resulting costs per minute are different. Under the rate structure proposed by AT&T—application of the local interconnection rate—CLECs serving ISPs would over-recover their costs and would face the inappropriate incentives to shed residential customers and generate sham Internet-bound traffic that I described in my initial Declaration.[3]

4. Third, AT&T and ETI appear confused as to whose costs should be measured under the Commission's Rules if a cost-based reciprocal compensation mechanism were (improperly, in my view) implemented. Unless and until a CLEC produces its own cost study consistent with 47 CFR [§51.711(b)], the relevant costs are those that the ILEC will actually incur on a forward-looking basis to carry the traffic. Under the existing regulations, alleged differences between CLEC and ILEC networks such as the ratios of switching to transport investment or the relative realization of scale economies have no bearing on the relevant costs for setting a reciprocal compensation rate—which are the forward-looking costs the ILEC incurs to carry Internet-bound traffic. And because those per-minute costs differ from the per-minute costs of carrying ordinary local traffic, economic efficiency would be enhanced by deaveraging costs and rates for Internet-bound traffic.

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[2] *In the Matter of Implementation of the Local Competition Provision in the Telecommunications Act of 1996 and Inter-Carrier Compensation for ISP-Bound Traffic*, CC Docket Nos. 96-98 and 99-68, July 21, 2000, *Declaration of William E. Taylor*, July 21, 2000, ("*Taylor Declaration*"), Section III.

[3] *Ibid.*, Section V.

5. Finally, many CLECs route calls to ISPs using equipment and serving arrangements that are very different from those used by ILECs in the public switched network. Some of these arrangements are designed specifically for handling ISP traffic and are very efficient and cost-effective for that purpose. If the Commission were to adopt any intercarrier compensation mechanism in which the CLEC was allowed to recover from the ILEC its cost of routing calls to an ISP, that mechanism should be based on the CLEC's true costs rather than using the ILEC's costs as a surrogate.

II. MEET-POINT BILLING IS AN EFFICIENT INTERCARRIER COMPENSATION MECHANISM FOR INTERNET-BOUND TRAFFIC.

6. AT&T asserts that the Commission has recognized that

> both settled law and sound economics and policy dictate that a local exchange carrier…that delivers a voice of data call originated by a customer of another LEC is entitled to cost-based compensation from the originating carrier. [AT&T Comments at 1].

On the contrary, the Commission has recognized the opposite: that there are two different mechanisms through which LECs that jointly carry a call recover their costs and that neither mechanism has been applied to Internet-bound traffic.[4] Similarly, ETI (at ¶¶15-20) assumes that the LEC that serves the end user that originates the Internet-bound call is responsible for compensating all LECs that jointly provision that call. While such an arrangement is possible, it is by no means the only intercarrier compensation mechanism, and the Commission invited comment regarding which mechanism ought to be used for Internet-bound traffic: i.e., "whether or how the access charge regime or reciprocal compensation applies when two interconnecting carriers deliver traffic to an ISP."[5] In my Declaration, I explained why cost-causality requires that the LECs that jointly provision an Internet-bound call share the revenue recovered from the

[4] See, e.g., *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996* and *Inter-Carrier Compensation for ISP-Bound Traffic*, CC Docket Nos. 96-98 and 99-68, Declaratory Ruling in CC Docket No. 96-98 and Notice of Proposed Rulemaking in CC Docket No. 99-68 ("*Reciprocal Compensation Ruling*"), released February 26, 1999 at ¶9: "The Commission has no rule governing inter-carrier compensation for ISP-bound traffic."

ISP, just as they share the revenue recovered from the IXC for access for interstate long distance calls. Briefly

- Cost-causation implies that the cost-causer—the end user acting as a customer of the ISP—should face the cost of the call in the price charged by the ISP.

- If a LEC cannot charge the ISP for the full cost of the dial-up Internet-bound call, then sharing whatever revenue is derived from the ISP results in less inefficiency and competitive distortion than requiring one LEC to shoulder the burden.

- Reciprocal compensation in these circumstances would inefficiently subsidize dial-up Internet use, creating a perverse incentive to delay investment in more efficient forms of access. In addition, incentives to compete for residential customers would be diminished, while incentives for CLECs to seek out ISP customers and to generate dial-up Internet bound traffic would be artificially and inefficiently increased.

Economic analysis clearly shows that a meet-point billing sharing of the revenues obtained from the ISP dominates reciprocal compensation as an intercarrier compensation mechanism. In addition, consistency would be served by using the interstate long distance intercarrier compensation mechanism for interstate Internet-bound traffic since all LEC interstate services would then make use of the same intercarrier compensation paradigm.

7. AT&T and ETI assume that if a LEC subscriber originates a call, the LEC is responsible for the costs of carrying it to its destination. While true for local exchange calls, that assumption is factually false for interstate carrier access calls. When an AT&T long distance customer places an interstate long distance call, and two LECs jointly provision the originating end of the call, those LECs share the revenue that one LEC obtains from the IXC. In its *Reciprocal Compensation Ruling*, the Commission explicitly recognized that it had made no decision as to whether the local exchange or interstate paradigms should be applied to Internet-bound traffic,[6]

(...continued)

[5] *Reciprocal Compensation Ruling*" at ¶9.

[6] *Ibid*. at ¶9.

and AT&T's and ETI's comments offer no help on this issue.[7] They simply assume that the local exchange paradigm applies without acknowledging the possibility that a different mechanism existed or could be applied.

8. Thus, ETI's argument (at [¶¶17-20) that recovery of ILEC origination costs is irrelevant is incorrect: under the long distance paradigm, all the costs that both LECs incur in jointly supplying carrier access service are relevant in determining how the carrier access revenues should be divided. There is no pretence that the costs of originating interstate carrier access service are implicitly recovered in local tariffs from local exchange customers; similarly, for interstate Internet-bound traffic, there should also be no presumption that the costs of originating dial-up Internet traffic are covered by local exchange revenues. The quantitative importance of this conclusion is shown graphically in ETI's Figure 2, where years of 2 and 3 percent annual growth in local usage give way radically in 1996 to double-digit growth as Internet dial-up traffic expands. While Internet usage has also increased the demand for second lines (as ETI notes at ¶20), where those residential access lines are priced below cost, the sale of additional lines is a net loss for the ILEC, not a gain.[8] Even when those lines recover their own long run incremental costs, the line charges cannot be expected to fund subsidy payments to CLECs with ISP customers.

III. INTERNET-BOUND CALLS COST LESS PER-MINUTE THAN AVERAGE LOCAL EXCHANGE CALLS.

9. AT&T asserts that "the relevant costs of delivering ISP-bound traffic are the same as the costs for delivering any other local traffic."[9] AT&T's flawed justification is that:

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[7] This choice of paradigm has no bearing on the ESP exemption which exempts ISPs from carrier access charges. That exemption says nothing about whether a CLEC that delivers a call to an ISP customer gets compensated for its portion of that call from the originating ILEC or from its ISP customer.

[8] In the short run, additional sales of second lines increases revenue at little additional (short run) cost, assuming loop facilities are in place. In the economically relevant long run, loop costs matter, and where residential access lines are priced below long run cost, ILECs lose money from the sale of second lines.

[9] AT&T Comments at 17.

> LECs use the same facilities in the same manner—and thus incur the same costs—delivering traffic to their dial-up ISP customers as they do delivering voice and data traffic to their other customers.[10]

While ETI is a bit more circumspect, asserting that "the ILECs should bear the burden of demonstrating the existence of any significant cost differences,"[11] it nevertheless concludes that there is "no relevant technical difference in the manner by which these two types of traffic (i.e., 'ordinary' and Internet-bound) are terminated," and that "ILECs have failed to demonstrate that call duration, or any other factor, makes delivering ISP-bound calls significantly less costly than other calls."[12]

10. AT&T and ETI embrace the fallacy that if the same facilities are used, the same costs are incurred, with no distinction for characteristics of that use. As described at length in my Declaration, the costs for transporting and switching traffic are not determined by <u>what</u> network elements are used—they are determined by <u>how</u> the network elements are used. Specifically,

- the longer holding time of Internet-bound traffic unequivocally results in a lower cost per-minute because call setup costs are averaged over more minutes, and
- the ISPs' requirement of a one-to-one trunk concentration ratio dedicates more switch capacity to individual customers and thus lowers the traffic sensitive costs of switching ISP-bound traffic.

Verizon's cost studies show that these two characteristics of Internet-bound traffic result in per-minute costs that are about **74%** lower than the cost for ordinary local exchange traffic which underlies the reciprocal compensation rate that AT&T proposes to apply to Internet-bound traffic.

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[10] AT&T Comments at 1.

[11] ETI Comments at 9.

[12] ETI Comments at 9 and 14.

11. Fundamentally, since it can be shown that it costs less to transport and switch Internet-bound traffic than to transport and switch ordinary local traffic,[13] economic efficiency requires that if intercarrier compensation prices are to be charged for internet traffic, (which they should not be), separate prices for such lower-cost traffic must be established. The Commission recognized this principle when it noted that the costs of transporting and switching traffic during peak and off-peak hours may be different, and that states should evaluate the benefits and costs of different pricing schemes where the costs are different.[14] Similarly, in the same Order, the FCC required that loop costs be deaveraged to reflect anticipated differences in costs.[15] If AT&T's principle—that using the same elements in the same manner results in the same costs—were used in calculating local exchange costs, there would be no distinction permitted between peak and off-peak usage or between high-cost rural and low-cost urban loops. Although the manner in which residential customers in rural areas use their local exchange service is the same as customers in urban areas, rural loops entail higher cost (per loop), and, in competitive markets, rural customers would be charged a higher price per loop than urban customers.

12. ETI asserts that differences in call duration and time-of-day traffic distributions do not result in lower costs to transport and switch Internet-bound traffic.[16] First, ETI appears to accept the proposition (at least in principle) that, "to the extent that fixed call set-up costs exist, the total cost per minute (including both call set up and incremental per minute costs) will necessarily fall as duration increases."[17] However, ETI asserts that this fact is irrelevant and outweighed quantitatively by other cost characteristics specific to the networks that CLECs build.

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[13] In my Declaration (Section IV), I outlined four characteristics of Internet-bound traffic which explain why the per-minute cost an efficient carrier incurs to switch and transport that traffic is lower than its cost to switch and transport ordinary local exchange traffic: longer call duration which spreads the fixed costs of call setup over more minutes, one-to-one trunk concentration that effectively dedicates switch capacity to individual customers, lack of switching features and functions on the terminating end of a call, and the relatively smaller concentration of Internet-bound traffic during the system busy hour.

[14] *In the Matter of Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98, First Report and Order ("*Interconnection Order*"), released August 19, 1996, at ¶ 1064.

[15] *Interconnection Order*, ¶ 764.

[16] ETI Comments at 14 and 16.

[17] *Ibid.*, at 15.

13. As an empirical matter, Verizon's cost studies show that adjusting for longer holding times—holding everything else constant—does in fact result in significantly lower per-minute costs, compared to the per-minute costs of shorter-duration local exchange traffic. In my Declaration, I presented a Table which showed that adjusting for the longer holding times of Internet traffic reduced tandem and end office transport and termination per-minute costs by **52%** and **28%**, respectively. Thus, ETI's speculations (in ¶28-33) regarding the relative proportion of call setup costs are irrelevant; in Verizon's forward-looking cost studies, setup costs are sufficiently large that spreading them over 28 minutes results in a significantly lower per-minute average cost than spreading them over 3 minutes. Conversely, charging a per-minute reciprocal compensation rate based on the average cost of a 3 minute call results in a nine-fold over-recovery of the setup cost which is actually significant in the Verizon cost studies.

14. ETI then argues (at ¶29) that

> even if the ILEC has shown that…differences in the average fixed component of different types of calls were significant…the appropriate prescription would be to better align the rate structure for reciprocal compensation with the underlying cost structure (e.g., to establish separate, cost-based set-up and duration charges)…

I agree: all else equal, the rate structure for reciprocal compensation ought to reflect the cost structure. Unfortunately, AT&T's policy prescription[18] in this case—mandate "reciprocal compensation for ISP-bound traffic at the same cost-based rates established by state commissions for the voice and data traffic that is concededly subject to § 251(b)(5)"—has the opposite effect. Since those rates invariably recover setup and duration costs in an average per-minute price, it is essential that if the Commission were to require intercarrier compensation here, different prices be permitted for call types having radically different durations.

AT&T's artfully worded claim[19] that

[18] See AT&T Comments at 16-17.

[19] *Ibid.*, at 17.

> the relevant costs of delivering ISP-bound traffic are the same as the costs for delivering any other local traffic

is a triumph of language over economics. The per-minute costs of delivering Internet traffic are very different from the per-minute costs of delivering ordinary local exchange traffic, and because the reciprocal compensation rate structure is an average price per minute, the relevant costs are the average per-minute costs.

15. Moreover, the traffic mix (between Internet-bound and ordinary local exchange traffic) is not a simple fact of nature over which carriers have little control—which is arguably the case for different types of ordinary local exchange traffic. Carriers can, and do, choose to specialize in transporting and terminating Internet-bound traffic, so any difference in average per-minute cost between local exchange and Internet-bound traffic can be profitably exploited. Moreover, rapid growth of dial-up Internet usage means that even small differences between rates and costs per-minute can generate large differences between total costs and total revenues. And when the reciprocal compensation rate exceeds the average cost of handling the traffic, bad things happen: ILEC costs increase which ultimately will be recovered from telephone customers, competition is distorted as CLECs avoid dial-up Internet users and seek ISPs as customers, and arbitrage opportunities arise along with the incentive to generate sham Internet-bound traffic. Under these circumstances, economically rational public policy requires elimination of reciprocal compensation obligations for Internet-bound traffic. If such charges are nevertheless imposed, then, at a minimum,

- the reciprocal compensation rate structure must mirror the cost structure, e.g., permitting both per-minute and per-call prices, and
- the reciprocal compensation rate level for Internet-bound traffic must be based separately on the cost of transport and termination for that traffic.

16. ETI also takes issue with the fact that the traffic load for ISP-bound traffic is likely to be less peaked than for ordinary voice traffic. ETI suggests (without proof) that for ISP-specialized CLECs, the mere fact that they have more homogeneous customers means that their time-of-day

load distribution will be more peaked—and, therefore will require more switch resources.[20] Once again, ETI and AT&T are wrong. ILEC studies confirm that the load distribution for Internet-bound traffic is flatter than for ordinary local exchange traffic, in the sense that a smaller fraction of Internet-bound usage occurs during the busy hour for Internet-bound traffic than for local exchange traffic in general.[21] Of course, the cost of serving Internet traffic is not determined by the load distribution of Internet traffic in isolation but by the effect of carrying Internet traffic on the aggregate load distribution of the ILEC's switch. However, the fact that the Internet-bound load distribution is flatter than the aggregate local traffic load distribution does imply that the effect on ILEC costs of carrying Internet traffic is smaller (all else equal) than the effect on ILEC costs of carrying ordinary local traffic.[22]

17. At ¶37, ETI cites a number of ILEC cost filings in support of its assertion that CLEC costs to serve Internet traffic exceed those of the ILECs. In general, the cited studies support no such claim. At issue (in ETI's mind, at least) is the per-minute cost of carrying this traffic, not the total cost. Yet, the studies ETI cites address the ILECs' concern that additional demand caused by Internet dial-up access leads to additional costs—additional total costs—rather than an increase in the per-minute cost of serving local exchange and Internet dial-up demand. ILEC total traffic-sensitive costs of serving this traffic increased sharply after 1996, following the

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[20] *Ibid*., at 16.

[21] Bell Atlantic conducted a traffic study in Delaware which showed that a particular CLEC that specializes in serving ISPs experienced a lower percentage of traffic during its busiest hour than does Bell Atlantic. (See Additional Testimony of Gary E. Sanford, Delaware PSC Docket No. 00-205, filed May 26, 2000). In addition, the load distribution of Texas CLECs was measured by SBC and similar results were obtained. (See *In re: Proceeding to Examine Reciprocal Compensation Pursuant to Section 252 of the Federal Telecommunications Act of 1996*, before the Public Utility Commission of Texas, Docket No. 21982, Direct Testimony of Barbara A. Smith on behalf of Southwestern Bell Telephone Company, Attachment 2 at 3, March 15, 2000).

[22] To see this, assume first that Internet and ordinary local exchange traffic peak during the same hour in a given switch. The fact that the Internet load distribution is flatter means (as a matter of arithmetic) that the percentage of traffic in the busy hour will fall when Internet and ordinary local traffic are combined. Alternatively, assume that Internet and ordinary local exchange traffic peaks are different in a given switch. The percentage of traffic in the aggregate busy hour must be smaller than it was under the previous assumption that the peak hours coincided. [A smaller proportion of Internet-bound minutes will occur at the aggregate peak if the peak hours are different than if they coincide]. Thus, the assumption of coincident peaks gives the maximum cost of Internet-bound traffic, and the ILEC cost studies based entirely on the characteristics of Internet-bound traffic would yield costs which were conservatively *high*.

increase in usage volumes: the numbers behind ETI's Figure 2 show that annual growth in local dial equipment minutes increased from an average of less than 3 percent in the 1980s and first half of the 1990s to about 10 percent from 1996 through 1998.[23]

18. Finally, ETI incorrectly asserts that NERA claims that CLEC costs are less than ILEC costs. This claim is inaccurate and irrelevant and reinforces the point that ETI is confused about whose costs are relevant if reciprocal compensation is mandated. Under FCC rules, it is the ILEC's costs that determine the reciprocal compensation rate, unless the CLEC can show that its efficient costs of switching and transporting Internet-bound traffic are higher than those of the ILEC. What is clear from the structure of the Verizon cost studies is that the cost to switch and transport Internet-bound traffic is lower than the cost to switch and transport ordinary voice traffic for both the ILEC and the CLEC. Therefore, when either carrier transports and switches Internet-bound traffic, a different, lower reciprocal compensation charge should apply. Otherwise, the reciprocal compensation rate will exceed the cost of switching and transporting Internet traffic, and market distortions and arbitrage will follow.

19. Regardless of unsubstantiated differences or similarities between ILEC and CLEC networks, there is no economic reason why a customer should have to pay more to use the high-cost services of an entrant. Competitive choice should unambiguously make customers better off, and regulation should surely try to emulate this feature of competitive entry. Indeed, there are reasons why the customer might expect to pay less. If the CLEC's service differs from that of the ILEC—for example, if the CLEC service is specialized to serve Internet-bound traffic—one would expect its unit costs to be lower than those of LECs configured to serve all types of traffic, and in a competitive market, the price of the service would fall towards the lower unit cost. Such specialization is, in fact, occurring, and, driven in part by reciprocal compensation revenues, the line between ISPs and CLECs is fading. According to a recent survey, about 62 percent of national ISPs plan to partner with CLECs, 46 plan to merge with CLECs and nearly 66 percent plan to lease CLEC facilities.[24] CLEC and ISP functions are converging as well: new

[23] FCC Report, *Trends in Telephone Service , January 2000*, Table 12.1.

[24] Infonetics Research, "The National ISP Opportunity 1998".

technologies such as softswitches, virtual ISP POPs, and managed port services for ISPs outsource current ISP functions to CLECs, further blurring the distinction between the CLEC and its customer. This convergence has two economic consequences.

20. First, as the distinction between the CLEC and its ISP customer fades, the ability of the CLEC/ISP to recover its costs from its customer—i.e., from the dial-up end user customer that caused the costs in the first place—is increased. On the one hand, the costs in question are lower—certainly lower than the ILEC's reciprocal compensation rate—because of the characteristics of the traffic and because of the specialization of the CLEC in serving ISP traffic. Hence, the amount the CLEC must recover to be made whole is less than what it would receive from reciprocal compensation at the rate that pertains to local exchange traffic. On the other hand, as it combines with or performs more of the functions of the ISP, the CLEC's ability to recover costs directly from the end user customer—in addition to the ISP—increases. In either event, there is no economic reason for the CLEC to depend on intercarrier compensation to recover these reduced costs.

21. Second, if the ILEC is nevertheless required to reimburse the CLEC, economic efficiency requires that the amount not exceed the CLECs' costs of handling the traffic. Otherwise, dial-up Internet access is subsidized, local exchange competition is distorted and inefficient arbitrage opportunities arise. For these reasons, where the incumbent LEC's forward-looking costs are not a good proxy for the forward-looking costs of the CLEC, the Commission has encouraged cost-based rates instead of symmetry. The Commission's rules—47 CFR §51.711(b)—<u>permit</u> high-cost CLECs to file forward-looking cost studies to justify their costs, but §51.711(c) <u>requires</u> paging and radiotelephone providers to file forward-looking cost studies because their technologies and costs differ from and are lower than those of the ILEC. In the context of paging, the FCC declined to use the ILEC's TELRIC termination costs as a proxy for those of the CLEC, recognizing that the different cost structures pertaining to paging companies and

wireline LECs raised the possibility of arbitrage, a problem that is already plaguing the wireline side of the industry:[25]

> Using incumbent LEC's costs for termination of traffic as a proxy for paging providers' costs, when the LECs' costs are likely higher than paging providers' costs, might create uneconomic incentives for paging providers to generate traffic simply in order to receive termination compensation.[26]

Instead, the Commission has required separate cost studies to justify a cost-based rate which the FCC explicitly expects would be lower than the wireline ILECs' TELRIC-based rate.[27]

22. The Commission's concern covers both rate levels and structures. In its *Reciprocal Compensation Ruling*, the FCC acknowledged that the cost characteristics of Internet-bound traffic were such that an average per-minute reciprocal compensation price would not accurately reflect the way that costs were caused:

> efficient rates for inter-carrier compensation for ISP-bound traffic are not likely to be based entirely on minute-of-use pricing structures. In particular, pure minute-of-use pricing structures are not likely to reflect accurately how costs are incurred for delivering ISP-bound traffic.[28]

Echoing this sentiment, Massachusetts regulators stated flatly that:

> The revenues generated by reciprocal compensation for … incoming traffic are most likely in excess of the cost of sending such traffic to ISPs. … Not surprisingly, ISPs view themselves as beneficiaries of this "competition" and argue fervently in favor of maintaining reciprocal compensation for ISP-bound traffic. However, the benefits gained, through this regulatory distortion, by CLECs, ISPs, and their customers do not make society as a whole better off, because they come artificially at the expense of others.[29]

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[25] See, e.g., Taylor Declaration, Section V.

[26] FCC, *In the Matter of Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98, First Report and Order ("Local Competition Order"), released August 19, 1996, ¶1093.

[27] Note that the paging case also involves one-way calling; like ISPs, paging companies do not originate traffic.

[28] *Reciprocal Compensation Ruling*, at ¶29.

[29] Massachusetts Department of Telecommunications and Energy, *Complaint of MCI WorldCom, Inc., Against New England Telephone and Telegraph Company d/b/a Bell Atlantic-Massachusetts for Breach of*

(continued...)

Thus, if intercarrier compensation for Internet-bound traffic is to be based on reciprocal compensation, differences in the level and structure of costs between Internet and ordinary local exchange traffic should be reflected in the level and structure of rates.

IV. CONCLUSION

23. Two conclusions emerge from this discussion. First, and most important, irrespective of the level and structure of the costs of transport and termination, cost-causation requires that ISP customers face directly the costs their usage imposes on the network—just as interstate long distance customers pay those costs directly to their serving IXC, which then compensates the LECs that jointly carry the call. That same mechanism preserves efficiency incentives for Internet-bound traffic: customers of the ISP pay the ISP for the services they demand, and the ISP reimburses the LECs that jointly carry the call, consistently with the ESP exemption. This mechanism—and not reciprocal compensation—applies cost-causation and minimizes the efficiency losses from subsidy and competitive distortions inherent in the ESP exemption. Second, if reciprocal compensation is (incorrectly, in my view) chosen as the mechanism for intercarrier compensation, serious problems must be addressed. Economic distortions stemming from inefficient subsidies to dial-up Internet traffic, warped incentives in local exchange competition and profit opportunity from arbitrage can be mitigated if the rate level and structure for intercarrier compensation reflects the cost characteristics of Internet-bound traffic and of the CLECs that carry it.

(...continued)

Interconnection Terms Entered Into Under Sections 251 and 252 of the Telecommunications Act of 1996, Docket No. 97-116-C, Order, May 1999.Emphasis added.