regulation, and public policy. My Statement of Qualifications appears as Attachment 1 to this affidavit and is made a part hereof. I have testified before numerous state regulatory agencies and submitted reports and affidavits before this Commission on numerous occasions dating back to the mid-1970s. I have previously submitted a joint declaration (with Patricia D. Kravtin) in this proceeding, filed July 20, 2000, on behalf of AT&T.

2. This Affidavit is being submitted on behalf of AT&T. AT&T has asked me to address the economic issues relevant to reciprocal compensation and the questions raised by the D.C. Circuit's remand of the reciprocal compensation issue to the Commission, *see Bell Atlantic v. FCC,* 206 F3d 1 (D.C. Cir. 2000), with particular reference to the arguments put forth by Dr. William Taylor of NERA on behalf of Verizon.[1] In this regard, I note that some other ILEC commenters make arguments generally similar to those raised by Dr. Taylor.

Because ISP-bound calls have been determined by the FCC to be sent-paid calls, "local" for purposes of the end user making the call and the ISP receiving it over their respective telephone services obtained from their respective LECs, reciprocal compensation is the only settlement mechanism for compensating terminating LECs for their work in completing such calls.

3. When two LECs collaborate to provide a service, the end-user has a direct business relationship with, and pays, the carrier that originates the call and, although the end-user is also being served by the second carrier that terminates the call, he or she generally has no

1. Declaration of William E. Taylor ("Taylor Declaration"), attached to Comments of Verizon Communications, July 21, 2000 ("Verizon Comments").

direct business relationship with, and no convenient mechanism by which to pay, that second carrier. Under these circumstances, the carrier that gets paid by the end-user (the originating LEC in this case) has to compensate the one that does not (the terminating LEC). Otherwise, the collaboration to provide the service becomes an *exploitation* of the LEC that does not get paid. ILEC refusals to pay CLECs compensation for ISP-bound calls are an example of this exploitation.

4. The basic economic logic of reciprocal compensation for ISP-bound calls is straightforward and sound. Local calls are "sent-paid," which means that the LEC serving the originating end user gets paid by the end user to carry the call from its point of origin all the way to its destination. When two carriers collaborate to provide a local call, an interchange of traffic takes place at a predetermined "point of interconnection" ("POI"). At the POI, the carrier that originated the call hands it off to the carrier that serves the called party.

5. Under reciprocal compensation, the originating carrier collects the entire charge for the call from the originator of the call, and remits to the interconnecting carrier that portion of the total revenue that represents the terminating carrier's share of the work involved in handling the total call. It bears emphasis that these payments are distinctly not *costs* to the originating carrier in an economic sense. Instead, these payments represent remittances of funds collected by the originating carrier, in effect, on behalf of the terminating carrier. To the extent that the originating carrier *could have* provided the same call termination service — and ILECs clearly *could have* taken steps to retain and expand their business of serving ISPs,

as discussed below — its hand-off of that traffic to a CLEC competitor and its remittance of reciprocal compensation payments to that CLEC constitute *competitive losses* to the ILEC. As I shall explain, this distinction is important in understanding how the reciprocal compensation mechanism should operate to produce economically efficient outcomes.

6. Consider the following example. I purchase an airline ticket for a trip from Boston to San Francisco. The flights I select are an American Airlines flight from Boston to Chicago, connecting to a United Airlines flight from Chicago to San Francisco. The ticket for the entire trip is issued by American Airlines and I pay the entire fare for the trip to American Airlines. However, because a portion of the trip will be on United, American is required to remit a portion of the total fare to United for its portion of my trip. In this context, American is acting as a sales agent for United, is collecting all of the revenue, and is remitting to United that portion to which United is entitled for its share of my trip. This remittance is in no normal sense a "cost" to American Airlines; it is a payment to United for monies collected by American on United's behalf.

7. This raises an important, but confusing and misleading, point in Dr. Taylor's presentation, which is, who is whose "customer" under various scenarios (e.g., an end user making a long distance call, an end user calling a local bank served by another LEC, and an end user calling an ISP served by another LEC). One way of looking at the question of who is whose "customer" is to look simply at who pays who for what. From this perspective, when an end user makes a long distance call, the end user is the "customer" of the IXC (to

whom it pays all per-minute charges associated with the call). From this perspective, although the end user actually makes use of the originating LEC's switching and transmission facilities (and the switching and transmission facilities of the terminating LEC as well), the end user is neither the originating nor terminating LEC's customer for purposes of this call. On this level (trivial from an economic perspective), who is whose "customer" is simply a matter of regulatory fiat. In this regard, while I am not a lawyer, I note that Section 201(a) of the Act expressly states that the FCC generally can decide who pays whom in cases where multiple carriers collaborate to provide an interstate service — referred to in the statute as a "through route." This illustrates why this "who pays who" perspective is not helpful in sorting out the economics of the situation.

8. From an economic perspective, what matters in assessing who is the ultimate "customer" in a multi-party transaction are familiar principles of cost causation. An end user making a call causes the costs associated with that call and, ultimately (except in situations where a subsidy has purposely been built into the system) should pay those costs. As a result, from an economic perspective, the end user making a call that involves multiple carriers is the customer of all of the carriers involved in getting the call to its intended destination. Now, for various practical or other reasons, the customer may not write separate checks to each of the entities involved. To the contrary, the more common practice is for the customer to pay only one of the carriers, who then becomes responsible, directly or indirectly, for passing money on to the other carriers who are jointly involved in carrying the call to its ultimate destination.

9. Dr. Taylor ignores this simple rule for determining customer relationships cost causation — and instead tries to concoct a rationale under which the end user *is* the originating LEC's customer when the customer calls a local bank (irrespective of whether another LEC is involved), but where the end user is *not* the customer of the originating LEC when the call is a long distance call or a call to an ISP. However, Dr. Taylor offers no principled basis for his conclusions, which are, in fact, nonsensical. As noted above, in economic terms, in all of the affected cases, the end user is the customer of all the carriers involved, since the end user is originating a call that involves all of their services. And, as noted above, this perspective helps focus upon the *competitive significance* of multi-LEC calls where the LECs are, at least in principle, competing for the same customers.

10. To see that this is so, consider the airline trip described above, from Boston to San Francisco, via Chicago. On that trip, I am a customer of both American and United. Since American also happens to serve the Chicago-to-San Francisco route, my decision to travel on United for that flight segment constitutes a competitive loss to American, which could have had my business had I selected American instead of United for that flight segment. My reasons for selecting United for that second flight segment may have been the movie being shown, the flight time, the food, or perhaps the non-availability of a seat on an American flight at the time that I needed to make the connection. Whatever the reason for my decision, American did not get my business and United did.

11. The relationship of this analogy to the handling of local calls by several different LECs is clear and straightforward. I am the originator of a local call and I pay the entire charge for the local call. Where two carriers are involved, I am the customer of both carriers (in economic terms), just as I am the customer of both airlines. I pay the originating LEC the entire charge for the call; the originating LEC then hands-off the call to the terminating LEC and remits a portion of my payment to the terminating LEC.[2] To the extent that the originating LEC could have furnished the entire call end-to-end, the fact that a portion is provided by a competing LEC constitutes a competitive loss to the originating LEC, just as my election to fly United for the second segment of my trip to San Francisco constitutes a competitive loss to American Airlines.

---

2. ILECs might argue that my airline analogy is off-point in that the payments that ILECs receive from their end-user (call originating) customers may be less than the reciprocal compensation payments they are required to make to interconnecting CLECs. If this is actually the case, and it is far from clear that it is, at least on average, the fundamental problem lies in the ILECs' own local rate structures, not with the reciprocal compensation requirement. ILECs that charge flat monthly rates for local usage are nevertheless being compensated for that usage, except that it is on a fixed monthly amount rather than on a per-minute or per-call amount. Second, the same situation likely exists in the airline industry as well — for example, in the event of a cancelled flight where the original airline is forced to rebook passengers on another carrier, the payment to that carrier for these seats may well exceed the total fare that the passengers being involuntarily rerouted had actually paid for their ticket. Airlines also pay "denied boarding compensation" for overbooked flights where the amounts involved may also exceed the original price of the ticket. Finally, interexchange carriers are sometimes required to pay switched access charges (typically where the LEC is not a BOC) that may also exceed the per-minute rate for the entire end-to-end toll call that the IXC receives. What is relevant is the *average* per-minute revenue received by the LEC and the *average* per-minute cost of handling local calls, including reciprocal compensation remittances where required.

12. The portrayal of reciprocal compensation payments by ILECs to CLECs as constituting a "cost" to the ILEC is simply wrong. The $1-billion "cost" that Verizon, for example, contends that it will be required to pay to CLECs as reciprocal compensation[3] constitutes a competitive loss of $1-billion in potential call termination business to Verizon, but is in no normal sense a "cost" to Verizon. It simply reflects the fact that Verizon has done a truly terrible job of competing for and retaining the business of ISPs. If the Commission were to determine that Verizon is not required to make reciprocal compensation payments to other LECs that terminate calls handed-off to them by one of the Verizon operating companies, the Commission will have in effect insulated and protected Verizon against this competitive loss, thereby undermining fundamentally the basis for competition in the local telephone service business. If Verizon and other ILECs know that the Commission will ultimately bail them out when they lose business to a rival, they will have no incentive affirmatively and aggressively to compete with anybody.

13. The FCC has established two — and only two — distinct models for the sharing of revenues among connecting carriers when more than one carrier participates in handling a given telephone call. The two models are (1) the local call model, and (2) the IXC/access charge model.

3. Verizon Comments, at 2.

14. Under the local call model, the originating carrier collects payment for the call from the originator of the call and compensates the terminating carrier either through explicit payments of reciprocal compensation or "in kind" payments under a bill-and-keep settlement arrangement. This method of compensation is appropriate because, while the originator of the call is a *customer* of the terminating LEC in economic terms, as discussed above, in practical terms the caller has no direct business relationship with the terminating LEC. Simple practical efficiency dictates that the terminating LEC receive its compensation via payments from the originating LEC, as opposed to setting up an elaborate and expensive multi-LEC clearing/billing arrangement, so that every end user could theoretically be directly billed by any LEC whose subscribers might ever be called by that end user. Reciprocal compensation indirectly, but economically properly, gets payment from the end user/customer to all of the LECs that are involved in carrying the call, at a much lower cost and a much higher customer "transparency" than any alternative arrangement could accomplish.

15. Under the IXC/access charge model, the interexchange carrier (IXC) collects the payment for the call and compensates the originating and terminating LEC through switched access charge payments made to each LEC. Here, the customer contracts with the IXC for long distance service, and the IXC remits switched access payments to the participating (originating and terminating) LECs for their work in handling the call. The reason why the IXC, in this case, collects the total revenue for the call and remits access payments to the originating and terminating LEC is purely one of convenience. The calling party is, for purposes of economic analysis, a customer of both LECs and of the IXC, and as such could,

theoretically, have made direct payments to each entity. Such an arrangement would obviously raise the transaction costs associated with long distance calling, and for that reason is not being employed.[4]

16. In principle, either type of compensation arrangement could be used for any type of call. However, with respect to calls directed to ISPs where the ISP's telephone number is within the calling party's local calling area, the FCC has determined — and on several separate occasions — that such calls are expressly *exempt* from access charge treatment and that these calls are to be billed and otherwise treated as local calls.[5] Accordingly, by this

---

4. During the early discussions of access charges in the 1980-83 time frame, proposals for such direct billing by each carrier were raised by certain parties but were rejected by the FCC. But conceptually such an arrangement could well have been adopted. When I fly from Boston to Washington, I take a taxi from my home to Logan Airport in Boston, then take another taxi from National Airport in Washington to my ultimate destination. The taxis are analogous to the LEC functions, the flight is analogous to the IXC function. There is no question but that I am a customer of both taxis and of the airline, and I make direct payments to each. Certain the airline could have "bundled" the two taxi rides into its Boston-to-Washington fare and given me vouchers for the two cab rides. That would have been directly analogous to the IXC access charge model. The point is that the payment mechanism does not in and of itself define or establish customer-to-provider relationships from an economic perspective

5. *See* In the Matter of MTS and WATS Market Structure, *Memorandum Opinion and Order*, Docket No. 78-72, 97 FCC 2d 682, 711-22 (1983) (*Access Charge Reconsideration Order*); In the Matter of Amendments of Part 69 of the Commission's Rules Relating to Enhanced Services Providers, CC Docket No. 87-215, *Order*, 3 FCC Rcd 2631 (1988) (*ESP Exemption Order*); In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, and End User Common Line Charges, CC Docket No. 96-262, 94-1 et al, *First Report and Order,* 12 FCC Rcd 15982 (1997) at ¶ 341-348.

regulatory action, the Commission has required that the local call compensation model be used for calls to ISPs where the originating LEC and the terminating LEC are not the same. While Dr. Taylor attempts to argue for some sort of access charge treatment of ISP-bound calls,[6] the matter of the ISP exemption is not at issue in this proceeding, and as such Dr. Taylor's attempts to apply the access charge model to calls that the Commission has determined are to receive local treatment are inapposite.

17. All that notwithstanding, Dr. Taylor's portrayal of the customer-to-LEC relationship[7] requires a response. Dr. Taylor posits a theory in which the originator of a local phone call is a customer of the originating LEC *except where the destination of the call is an ISP*. In that case, Dr. Taylor opines, the caller is the ISP's customer *and not the LEC's customer*.[8] Dr. Taylor apparently reaches this conclusion on the basis that the ISP, and not the end user who calls the ISP, is the *cost causer* with respect to the entire call. On this basis, he then contends, the ISP, and not the calling party, should pay the terminating LEC for its work in completing the call, and should then recover those terminating call costs from its ISP customers.

---

6. Taylor Declaration at ¶ 5.

7. Taylor Declaration at ¶s 13-23.

8. *Id.* at 10.

18. Incredibly, Dr. Taylor's analysis would have the effect of creating a distinction between ISPs and other businesses that deal with customers over the telephone and/or that deliver their services over the telephone. When considering an ordinary local telephone call to a destination other than an ISP, Dr. Taylor accepts that the calling party is the LEC's customer.[9] Thus Dr. Taylor would agree that when calling a pizza place, the caller is a customer of the LEC. He would presumably agree that the same thing is true where the caller contacts his or her bank for telephone banking services.[10] In all of these cases, he argues, the calling party is the cost causer and is thus appropriately responsible for payment for the call. According to Taylor, it is only where there is an ISP involved at the terminating end of the call that the call recipient (the ISP), and not the call originator, is responsible for the costs of the call, because the ISP is "acting as the customer of the ISP."[11]

19. It would seem that Dr. Taylor does not believe that users of the Internet are acting on their own free will; he seems to believe that they are somehow being compelled to call the ISP in a way that differs from the case where the same individuals call their bank or to order a pizza. This nonsensical theory has no basis in any sort of reality. Any business that places an ad in a newspaper or, for that matter, in the yellow pages in which it lists its phone number could, under Dr. Taylor's theory, be viewed as responsible for the costs of calls that

9. Taylor Declaration, at ¶ 16.

10. By telephone banking, I mean banking transactions conducted via a Touch-Tone based menu system, not via a dial-up connection to a modem.

11. Taylor Declaration, at ¶ 19.

they receive, since the purpose of the ad is to induce potential customers to call. While it is certainly true that a caller to an ISP is a customer of the ISP, in economic terms the caller is *also* a customer of the LEC from which the call was originated and of the LEC on which the call is terminated, as discussed above. There is no mutual exclusivity here. The ISP is no different in this respect than any other firm that does business over the telephone and/or that delivers its service via the telephone. In calling the ISP, the caller is engaging the services of one or more LECs to provide a connection to the ISP, and is also engaging the services of the ISP to reach the Internet.

20. The artificial nature of Dr. Taylor's distinction between locally-rated calls placed to an ISP versus a non-ISP called party is further buttressed by the fact that it is in all cases that end-user who decides both when, how often, and for how long to contact the ISP that he or she has selected, and that the choice of ISP is itself a decision that is made by the end-user as an exercise of his or her own free will. As I have discussed, the customer is paying for the end-to-end call to the ISP whether it involves one or two LECs. The customer is separately paying the ISP for the Internet service that the ISP furnishes.

21. Dr. Taylor's distinction appears to rest on the notion that in the case of both the ISP and the IXC, the end user is trying to "get" somewhere else, whereas when the end user calls

the bank, he has "gotten" where he wants to go.[12] However, this is sophistry, not economics. When my flight lands at National Airport, I still need to take a taxi or the Metro to "get" to where I want to go. The airline has no involvement in that decision or in the actual ground transportation service that I engage; in each instance I am a customer of the taxi or the DC Metro, not of the airline, once I get off the plane. The effect of Dr. Taylor's presentation is to conflate certain regulatory choices on the payments process — choices that were made on grounds other than economics — with the economic implications of those choices.

22. The Commission, in any event, need not reach Dr. Taylor's theories on customer relationships or cost causality because the Commission has previously determined that ISP-bound calls are to be treated as local calls. As such, the only settlement model that is applicable is reciprocal compensation. In order for the Commission to give any consideration to Dr. Taylor's position, it would first have to rescind the ISP access charge exemption.

---

12. Even this contrived distinction fails when the actual "facts on the ground" are considered. When I place a local call to my bank for telephone banking service, the call may be answered locally but the data bases with which I will interact may be located out-of-state. This situation is identical for relevant purposes to Dr. Taylor's view of ISP activity, yet he applies an entirely different standard to the cases of bank access vs. Internet access.

ILECs contend that if they are required to pay reciprocal compensation, the rate should be based upon the CLECs' costs, and not the ILECs' costs.

23. While the ILECs' overarching position is that they should not be required to pay any reciprocal compensation for ISP-bound local calls, they go on to argue that, in the event that they are nevertheless required to compensate CLECs for their work in terminating ISP-bound traffic, the appropriate reciprocal compensation *rate* should be based upon the CLECs' costs rather than upon the ILECs' costs.

24. Dr. Taylor argues that ISP-bound calls are cheaper to complete than typical local calls, and that this lower cost should be reflected in a lower price to CLECs. He offers no factual support for this contention, and in any event his argument in this regard is partly wrong, and partly overstated.

25. Dr. Taylor and his ILEC clients advance this curious position because they believe that CLECs, having adopted a variety of network architecture and facilities practices that are designed specifically to accommodate large volumes of highly-concentrated inbound traffic, can now terminate such calls at a cost that is below the *price* that the ILECs have established as *their* reciprocal compensation rate.

26. There are several problems with Dr. Taylor's claims. First, and most obvious, he has not actually submitted any specific evidence to support them. Under the structure set up by the 1996 Act, these sorts of claims should be addressed in the first instance in inter-carrier

negotiations and, if those negotiations fail, in arbitrations. Nothing that has been submitted here supports any particular finding of any particular and categorical lower cost for delivering ISP-bound calls.

27. Second, as long as ISP-bound calls are treated for economic purposes as local calls — which is the effect of the ESP Exemption — that suggests that studies of the ILEC's cost of terminating local calls might need to be updated to reflect the most recent available data (presumably including, e.g., a somewhat longer average holding time than past studies have shown). It does not support creating a separate class of calls, with separately identified cost characteristics, based upon who the end users might choose to call.

28. Third, while there may be a number of ways to approach local call termination costs that go beyond a mere per-minute average — including, e.g., a rate structure consisting of both a call set-up charge and a subsequent per-minute charge, or a heavier reliance upon flat-rated capacity charges, as opposed to any sort of usage-sensitive charges — whatever rate structure is established should apply uniformly to all call termination rates. To use a specific example, Dr. Taylor notes that when CLECs deliver calls to ISPs, that function does not make use of switch functionalities associated with originating usage. But that is equally true when an ILEC terminates a call to a law firm or government agency — switch functionalities associated with originating service should not properly be included in *any* call termination costs. I note in this regard that when the New York Public Service Commission addressed the question of compensation for ISP-bound calls in the summer of 1999, Bell Atlantic (now

Verizon, nee NYNEX) proposed to lower its call termination rates by more than 30% across the board in order to remove these costs from the rates they originally submitted and argued for in 1996 and 1997.

29. This illustrates a broader point about requiring compensation for ISP-bound calls in the same manner as compensation for any other local calls. What the ILECs have learned from the battles over compensation for ISP-bound calls is that they should be careful what they wish for, because they might get it. ILECs had objected to bill-and-keep arrangements, then insisted upon high reciprocal compensation rates, because they thought that they would be net receivers of calls. Repeated and nearly uniform state rulings requiring compensation for ISP-bound calls have forced the ILECs to rethink those assumptions, leading to lower *reciprocal* compensation rates for all local calls, not just those bound for ISPs. The market, therefore, has effectively pressured ILECs to bring down the prices *that they will charge CLECs* for calls to the ILEC's customers. As these rates are forced down by the market-like economic pressure imposed by reciprocal compensation, the economics of serving customers who make calls, as opposed to receive them, become more favorable. In other words, when ILECs know that they have to pay CLECs to deliver ISP-bound calls, and they know that they cannot isolate the rate applicable to such calls from the rate they receive for local calls they terminate, they have strong incentives to lower the general call termination rate, which enhances the prospects for broad-based competition for the local exchange business of all classes of customers.

30. The Commission, therefore, should be extremely skeptical of any proposal that would create some special, low rate for ISP-bound calls as a class. To the contrary, the Commission should require any local call termination regime — whether minute-based, call set-up-based, capacity-based, or time-of-day-based — to apply to all traffic classified as local to the originating caller, and let the chips fall where they may as to whether compensation for calls to ISPs as a class is higher or lower than average.

31. I cannot offer an opinion as to the veracity of the ILECs' factual claims as to the relative magnitudes of CLEC and ILEC call termination costs; clearly, the ILECs have advanced no factual support for such contentions. However, if in fact CLECs have been able to adopt various efficiency measures that work to reduce their costs below those of the ILECs, that by itself in no way justifies reducing the reciprocal compensation rate to equal the allegedly lower CLEC cost levels.

32. If CLEC costs are lower than the costs that ILECs currently incur in terminating local calls, there is no obvious reason why ILECs themselves could not adopt precisely the same efficiency measures that the CLECs have implemented so as to bring their own costs down to these lower levels. Indeed, inasmuch as ILECs — particularly BOCs — by virtue of their large volume purchases of equipment and transmission facilities, are able to acquire the same types of equipment that CLECs have purchased *at an even lower cost than those confronted by CLECs*, *efficient* ILEC terminating call costs should actually be *considerably*

lower than even the most efficient CLEC.[13] That they are not — that is, that the ILECs have failed to adopt the very same network modifications that CLECs have employed — is a management decision entirely within the control of the ILECs, and is certainly not something for which they should now be rewarded.

33. In competitive markets, prices will ultimately tend to decrease as firms increase their overall productivity and adopt efficiency measures that lower their costs. In the instant situation, however, the ILECs have elected *not* to pursue the same cost-reducing techniques that they allege CLECs have adopted, and are asking the Commission to *protect them* against the competitive market losses that would (otherwise) inevitably follow.

---

13. Testimony offered by SBC in the 1998 Connecticut DPUC proceeding to consider the Joint Application of SBC and SNET for approval of their merger indicated that following the merger SNET's costs of equipment purchases would decrease substantially due to the increased purchasing power of SBC relative to that of a stand-alone SNET. Specifically, SBC indicated it has "learned from the SBC/Pacific Telesis merger that scope and scale, especially in the purchasing area, are tangible and significant." *Joint Application of SBC Communications, Inc. And Southern New England Telecommunications Corporation for Approval of a Change of Control*, Connecticut Department of Public Utility Control (DPUC) Docket No. 98-02-20, SBC Response to MCI-4, Exhibit A, "Introduction and Opening Comments of Don Kiernan", January 5, 1998, SBCSNET004573. SBC's Chief Financial Officer also stated that "we know that SNET pays over 20 percent more for purchases of switching and transport equipment than we do at SBC." *Id.* SBC also indicated that the savings experienced in contract negotiations to date for the combined SBC/Pacific Telesis "tend to support the consultants' estimates" during the SBC/PTG merger discussions of procurement savings (expense and capital) in the 7%-10% range. *Id.*, SBC Response to OCC-12.

34. Although ILECs attempt to impute illegitimacy to CLECs that have elected to specialize in serving customers with high inward calling requirements, the admission by Verizon and others that specialized network architectures and equipment have enabled CLECs to offer inward services at lower cost undermines this portrayal at its most fundamental level.[14] Nothing in the *Telecommunications Act of 1996* or any subsequent FCC rulemaking requires that CLECs be mere clones of ILECs, albeit smaller in overall size. Indeed, market specialization is expressly encouraged by provisions in Sections 251 and 252 that permit CLECs to utilize ILEC facilities in combination with their own to create the specific mix of services that each elects to offer in the market.

35. No economic or regulatory policy of which I am aware supports the notion that a new competitor should be barred from seeking the business of customers that receive more calls than they make, or vice versa. To the contrary, the purpose of the 1996 Act is to enable and foster competition in all telecommunications markets. It follows as a policy matter that new competitors should be free to seek whatever customers they can serve efficiently.

36. Reciprocal compensation works to create a market for the function of terminating calls. In the absence of CLECs serving firms that receive calls, the sole supplier will be the ILEC just as, in fact, ILECs had previously monopolized the business of providing ISPs with connections to the PSTN prior to the 1996 Act. In that situation, the amount of resources that

---

14. See, e.g., Verizon Comments at 23-25.

society will expend overall on terminating calls will be the amount of resources that it takes for the ILEC to perform that function. If a CLEC is unable to perform that function as efficiently as the ILEC, then it will tend to avoid customers who receive calls, and properly so; if it is less efficient than the ILEC, then society wastes resources by having that CLEC perform that function. On the other hand, if a CLEC can perform that function *more efficiently* than the ILEC, then it will seek out customers who are net receivers of calls, including firms such as pizza delivery services, travel agencies, credit card verification firms, and ISPs. The more efficiently the CLECs perform this function when compared to the ILECs, the more money they will make by winning over customers who receive calls, and the more society is served by CLECs actually taking over this function.

37. For that reason, the FCC has expressly required that reciprocal compensation rates be, in fact, symmetric as between the ILEC and the CLEC – and that they be based upon the ILEC's forward-looking costs — unless the CLEC can demonstrate that its forward-looking costs are actually *greater* than the ILEC's costs. Specifically, 47 CFR § 51.711 of the FCC's rules provides that:

> A state commission may establish asymmetrical rates for transport and termination of local telecommunications traffic only if the carrier other than the incumbent LEC (or the smaller of two incumbent LECs) proves to the state commission on the basis of a cost study using the forward-looking economic cost based pricing methodology described in Secs. 51.505 and 51.511, that the forward-looking costs for a network efficiently configured and operated by the carrier other than the incumbent LEC (or the smaller of two incumbent LECs), *exceed the costs incurred by the incumbent LEC* (or

> the larger incumbent LEC), and, consequently, that such that a higher rate is justified.

Emphasis supplied.

The requirement that ILECs compensate CLECs for terminating ISP-bound calls will not diminish CLEC interest in the residential exchange service market.

38. Dr. Taylor argues that payment of intercarrier compensation for ISP-bound calls — particularly at a rate that exceeds the CLEC's costs of terminating those calls by some measure — distorts CLECs' competitive incentives, somehow converting end user customers from (potential) assets to (potential) liabilities. This is simply not true. In fact, as I have previously noted,[15] CLEC participation in call termination has forced ILECs to reduce their own call termination charges, enabling CLECs to retain a greater portion of their total revenue from *outward* calling services, such as basic residential and basic business exchange service.

39. Dr. Taylor's presentation in this regard completely ignores the strong efficiency-enhancing effects of symmetrical ILEC-focused reciprocal compensation rates. Instead, looking at the CLECs' recent success at competing for the business of firms that receive calls, he asserts that payment of compensation for ISP-bound calls converts "normal" residence end user customers from potential assets to be competed for to potential liabilities to be avoided. This claim is somewhere between misleading and false. To the extent that there is any

---

15. Para. 29, *supra.*

incentive to avoid customers that make more calls than they receive, that arises from factors that have nothing to do with the fact that it is ISPs, as opposed to other types of businesses, that are receiving an increasing amount of traffic from end users.

40. Dr. Taylor seems to be saying that if ILECs are required to pay reciprocal compensation to CLECs in excess of the CLECs' actual costs, then CLECs will simply focus all of their attention on handling ISP-bound traffic and ignore the residence market altogether. For this contention to be valid, the potential amount of capital that CLECs are prepared to invest *in all local exchange market segments* would necessarily have to be fixed. In effect, Dr. Taylor is contending that the profitable inward calling business would divert capital and entry away from what he contends is the less-profitable residential service business.

41. Dr. Taylor's analysis fails as a result of two key flaws in his reasoning. First, the amount of capital potentially available for investment in local exchange markets is by no means fixed; capital will enter the CLEC business in any segment that is profitable. If the residential market is profitable as an absolute matter (even if less profitable than the inbound call termination business), capital will still enter and the market will be served. On the other hand, the ILECs themselves have raised enormous barriers to entering the residential market segment because these ILECs have often set their UNE rates in excess of their retail rates or, if less, sufficiently close to their retail rates such that no competitor would confront sufficient margin to make its entry sustainable. That, of course, also has nothing whatever to do with conditions extant in the reciprocal compensation area. If the ILECs have successfully worked

to discourage entry in the residential segment by manipulating their wholesale and retail price levels and the differential between them, then entry will not occur there whether or not the inbound call termination segment is profitable.

42. As long as the ILEC's rate for flat-rated local calling (together with any portable universal service subsidies and other revenues) is high enough to cover the CLEC's cost of handling the local usage that its end users, on average, generate — including calls to ISPs — then CLECs have an incentive to seek the business of residence customers as a whole by offering a flat-rated local calling plan comparable to that offered by the ILEC. And as long as the customers that the CLEC garners have the same average usage characteristics as the ILEC's customer base, the CLEC will make money on the flat-rated calling plan to (essentially) the same extent that the ILEC does.[16]

43. The discussion above reveals what Dr. Taylor is really complaining about: To the extent that ISP-bound calls are treated as local calls as far as the end user is concerned, it is

---

16. A LEC's revenues from flat-rate residence service are by no means confined to the basic dial tone rate and associated flat-rate usage elements. In fact, additional revenues from switched access, intraLATA toll, interLATA toll, and most particularly vertical features, when combined with the basic monthly dial tone line rate, will frequently convert an apparent "loss" into a substantial profit. Additionally, ILECs enjoy considerable revenues from their monopoly directory publishing business, revenues that in many jurisdictions are booked "below the line," that are not available to CLECs yet contribute dramatically to overall ILEC profitability. For example, US West's 1999 Annual Report indicates that it directory publishing segment, while responsible for only 11% of the Corporation's total revenues, represented fully 39% of its 1999 profits! *US West, Inc. 1999 Annual Report*, Notes to Consolidated Financial Statements, at F-25.

obvious that an increase in calls to ISPs — just like any other increase in calls — is not cost-free to the LEC serving the end user, whether that LEC terminates ISP-bound calls directly on its own network or hands them off to one or more CLECs for termination. (It is also important to recognize that along with the costs associated with increasing Internet traffic have come enormous revenue increases in sales of additional lines, such that no ILEC has been able to demonstrate an overall decline in profits as a result of increased Internet traffic.)

44. Note, however, that this complaint really has nothing to do, economically, with reciprocal compensation for ISP-bound calls. In a monopoly environment, the ILEC provides connectivity between the end user and the ISP, incurring both originating and terminating switching costs and inter-switch transport costs. Under the ESP Exemption, these costs are to be recovered from charges to end users, not charges to the ISP. If end user charges are fixed (e.g., under a flat-rated calling plan that an ILEC may have committed to "freeze" as part of an incentive regulation arrangement), then a change in customer calling patterns leading to more and longer calls to ISPs will increase the ILEC's costs and decrease its profit margins from its residence customers whether calls to ISPs are completed by the ILEC or are handed off to a CLEC. If the ILEC could shed some of the costs associated with such calls by virtue of CLECs serving ISPs, but with no compensation to the CLECs for their work, then the ILEC's profit margins from residence customers would increase. This would presumably make residence customers marginally more profitable to serve, and marginally more attractive to CLECs as well.

45. But the same could be said about compensation for calls to any other type of firm that receives a lot of traffic. It seems a safe assumption that most calls to pizza delivery services are from residence customers. The commercial success of firms like Domino's and Papa John's suggests that, on average, residence customers make a lot of calls to pizza delivery services. Paying compensation on those calls (where calls terminating at the pizza delivery service are provided by a CLEC) erodes the profitability of serving residence customers. Therefore, under Dr. Taylor's argument, the Commission should not only ban compensation for ISP-bound calls in the name of promoting competition for residence customers, it should also ban compensation for pizza-bound calls as well, since the obligation to pay such compensation "distorts" competition for residence customers in exactly the same way that Dr. Taylor asserts occurs by paying compensation for ISP-bound calls. Similarly, it seems a fair assumption that small business customers are major users of dial-up credit card verification services (larger retail outlets will use private lines for this function). Dr. Taylor's logic indicates that, to encourage competition for small business customers, the Commission should ban compensation for calls to credit card verification services as well. Indeed, there is no logical limit to Dr. Taylor's argument: to encourage local competition to the maximum degree possible, the Commission should simply eliminate reciprocal compensation entirely, since payment of such compensation, on his theory, necessarily "distorts" competition for any customer who makes a lot of calls to any location where reciprocal compensation applies.

46. There is, however, a much more basic problem with Dr. Taylor's economic argument than the fact that it proves too much. His argument ignores a fundamental law of economics