Wood, a highly experienced telecommunications analyst ("Wood Dec."), there is no basis for this assertion. See Wood Dec. at ¶¶ 19-32. The fact is, CLECs use the same switching facilities and functionalities to transport and terminate ISP-bound traffic as all other traffic. These facilities and functionalities do not mysteriously become less costly because they are used to carry calls of longer duration.

Specifically, none of the factors identified by William Taylor in the declaration filed by Verizon actually results in lower ISP termination costs for CLECs. Contrary to Dr. Taylor's assertions, the fact that calls to ISPs are longer does not make CLEC termination costs cheaper unless the call set-up costs have been incorrectly allocated to usage-sensitive charges. See id. at ¶¶ 20-21. The answer to this problem is, as Sprint has suggested, to make sure that call set-up costs are recovered efficiently. See Sprint Comments at 2-3. The ILECs' assertion that the use of ISDN PRI lines lowers the incremental cost of termination because switching capacity is dedicated to PRI lines is also incorrect. This is because (as Telcordia has recognized) the switching capacity dedicated to the PRI lines is by definition usage-sensitive. See Wood Dec. at ¶¶ 23-26. If anything, the significant dedicated switching capacity needed for PRI lines likely increases the cost of termination. See id. Dr. Taylor's assertion that TELRIC studies set prices too high because they often average originating and terminating costs is irrelevant. Termination rates should simply be changed to

reflect termination costs. See id. at ¶ 27.[12] Finally, Dr. Taylor assumes that ISP-bound traffic is carried during non-peak usage periods. But this is nothing more than empty conjecture. See id. at ¶¶ 28-29.

Other ILEC arguments regarding CLEC termination costs are similarly unavailing. For example, the ILECs' tired argument that ISP collocation at CLEC switches lowers transport and termination costs is simply wrong. See, e.g., SBC Comments at 33. Collocation only lowers the fixed costs of connecting customers to the CLEC switch. These costs are not relevant to the incremental costs of transport and termination. See Wood Dec. at ¶ 48. It should be noted, of course, that the ILECs' refusal to allow ISPs to collocate at their switches, while not affecting transport and termination, has made ILECs far less efficient providers of service to ISPs. It would be bitterly ironic for the Commission to now incorrectly punish CLECs for being more efficient in this regard.

Furthermore, lest any conceivable assertion go unstated, SBC also argues that the ILEC tandem rates (which are of course relatively low) should be the basis for CLEC termination costs. See SBC Comments at 33. The fact is, however, that the switches deployed by TWTC and other CLECs perform a wide range of

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[12] In a variation on this argument, SBC asserts that the originating functions of a switch are not needed to terminate calls, thus making CLEC termination costs lower. See SBC Comments at 32. But this logic is flawed since the distinction between call origination and termination costs has no relevance to call termination costs for ISP vs. non-ISP traffic. See id. at ¶ 51.

functions not performed by ILEC tandems. See Wood Dec. at ¶ 32. The two are apples and oranges and cannot be priced similarly.

The ILECs also worry that CLECs may be busy deploying new and innovative switching technology that allows them to use some form of "termination only" capability. See, e.g., SBC Comments at 34-35; Verizon Comments at 23-25. As this technology becomes deployed, firms that are otherwise legitimate CLECs under state law should be permitted to benefit from the increased efficiency the new equipment delivers. Indeed, the ILECs themselves might consider such innovation as a means of improving the service they offer ISPs. Of course, innovations such as these should eventually be reflected in forward-looking prices for reciprocal compensation. In the meantime, innovative firms should be rewarded for lowering their cots. If, however, reciprocal compensation prices remain above cost as a result of the ILECs' recent successful appeal of the FCC's TELRIC rules, then the ILECs have only themselves to blame.[13]

Third, the ILECs argue that the costs incurred by LECs that serve ISPs are more appropriately and efficiently borne within the contractual relationship between ISPs and their subscribers. See Taylor Dec. at ¶¶ 13-23; Qwest Comments at 17. That is, the ILECs argue that ISPs should bear the costs of termination and

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[13] The Commission also need not give any credence to SBC's attempted reliance on a Texas PUC study for the proposition that CLEC ISP-bound traffic termination costs are lower than the costs SBC incurs to terminate all traffic. See SBC Comments at 35. The Texas Commission itself has disavowed that study as a basis for differentiating ISP-bound traffic from voice traffic. See Wood Dec. at ¶ 53.

should then pass those costs along to their ISP subscribers in the form of higher subscription charges. To begin with, this argument cannot be squared with the end user status of ISPs. As explained above, that regulatory treatment of ISPs mandates that the costs of termination be recovered by the terminating LEC from the originating LEC. Otherwise, the terminating LEC would subsidize the originating LEC (a result the ILECs obviously desire). In any event, as Don Wood explains, the ILECs are wrong even as to cost causation. See Wood Dec. at ¶¶ 7-18.

Fourth, there is no basis for the ILECs' absurd assertion that efficient, forward-looking reciprocal compensation rates discourage residential competition. See, e.g., Verizon Comments at 11-14; SBC Comments at 40. If efficient reciprocal compensation rates are set, CLECs will not have the incentive to keep reciprocal compensation revenues high by not serving potential ISP dial-up subscribers.

But even in the presence the above-cost reciprocal compensation rates that the ILECs convinced the states to adopt, it cannot be said that reciprocal compensation has prevented residential competition from developing. As Verizon admits, reciprocal compensation is a small part of CLEC revenue, likely comprising only 6% this year of average CLEC revenue. Verizon Comments at 21. Furthermore, many of the major CLECs do not even have significant reciprocal compensation revenue. See Credit Suisse First Boston, "Telecommunications Services: CLECs" (June 14, 2000) (listing Winstar, Teligent, RCN, NEXTLINK and McLeodUSA

as having no reciprocal compensation revenues). They therefore would have no reason to avoid serving residential customers.

In fact, the central reason competition has not developed extensively for residential competition is that the margins for serving business customers are higher. As the Commission has recognized,

> The observation that competitive entry will occur in some places, and for some services, more rapidly than others is a corollary to the rule that firms in competitive markets seek to maximize their profits. To maximize profits, firms naturally seek out those customers and services on which they can generate the most profits. Therefore, some customers are naturally more desirable than others at any given point in time. As competitors attempt to gain the patronage of the customers offering the greatest profit opportunities, they offer lower-priced or more desirable services. These actions have the effect of reducing over time the profitability of serving those particular customers and, as this occurs, the relative profitability of serving other customers or offering other services increases. Therefore, competitors begin seeking to service these other customers, and entry occurs in new places, or for new services.

Access Charge Order, ¶ 266, n.349 (citations omitted). The Commission never expected residential competition to develop quickly. Unfortunately, this process has been slowed further than anticipated because the ILECs have so successfully resisted providing potential residential service entrants with the inputs, such as UNEs and collocation, that they need to compete. Indeed, in many states, ILECs have convinced regulators to set unbundled loop rates above the ILEC's tariffed residential local service price.

But notwithstanding all of the obstacles, residential competition is in fact developing. Carriers are investing

heavily in deploying the networks needed to offer residential customers competitive services. For example, AT&T has made enormous investments to compete in the residential market, including its acquisitions of TCI and MediaOne. AT&T is already serving over 555,000 residential lines nationwide using UNE-P, local resale, cable telephony, fixed wireless and its own facilities to multi-dwelling units.[14] Both WorldCom and Sprint are actively pursuing residential customers in New York and Texas.[15] In addition, WorldCom and Sprint have purchased several MMDS systems, investing over $1 billion collectively, to provide local residential service using fixed wireless technology.[16] Residential customers are also being targeted by new entrants,

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14 Letter from Stephen Garavito, General Attorney, AT&T, to To-Quyen Truong, Associate Chief, FCC Cable Services Bureau, dated May 24, 2000; see also Applications for Consent to the Transfer of Control of Licenses and Section 214 Authorizations from MediaOne Group, Inc., Transferor, to AT&T Corp., Transferee, Memorandum Opinion and Order, 15 FCC Rcd 9816, ¶ 133 (2000) (In addition to the 555,000 AT&T residential customers, at the time of the AT&T-MediaOne merger, MediaOne had approximately 100,000 local telephone service customers of its own.).

15 See MCI WorldCom Says Its Profit Soared 80%, N.Y. Times, April 28, 2000, at C8 ("During the quarter, MCI WorldCom said it added about 100,000 local residential customers in New York State, giving it a base of about 300,000 customers there."); Stewart Ain, Phone Companies' Competition Heats Up, N.Y. Times, July 16, 2000, § 14LI, at 3 (reporting that Sprint has begun offering residential local service in New York); Dwight Silverman, Residential Service Set By Sprint, Houston, 4 Other Cities Will Receive Offers First, Houston Chronicle, March 25, 2000, Business Section, at 1 (reporting that Sprint is providing residential local service in Texas).

16 See Federal Communications Commission, Broadband Today at 30 (Cable Services Bureau, rel. Oct. 1999).

such as Sage and McLeodUSA.[17] Perhaps the strongest force in residential competition will be cable overbuilders. Cable overbuilders, such as RCN, are building their networks to provide integrated packages of voice, video and broadband to residential customers.[18]

Fifth, the argument that reciprocal compensation diminishes the incentive of ISPs to purchase more efficient technology than ISDN lines designed to receive dial-up connections (see, e.g., Verizon Comments at 14-15) is simply a restatement of the ILECs' longstanding complaint that the end user status of ISPs distorts ISPs' incentives. The ILECs have for many years claimed that the exclusion of the ISPs from the interstate carrier access regime causes dial-up connections to be artificially underpriced, thus giving ISPs little incentive to purchase more efficient technology. This proceeding is not the place to resolve this issue, and in any event reciprocal compensation is irrelevant to its resolution. So long as reciprocal compensation is set at efficient prices, reciprocal compensation will not give ISPs any more incentive to retain dial-up connections than they already have.

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17 See Jennifer Files, Telecom Act at the Root of Four Firms, Dallas Morning News, February 6, 2000, at 1H ("80 percent of Sage's customers are residential."); Kristi Arellano, Phone Competitor Calls on Denver, McLeodUSA Wants Residential Niche, Denver Post, July 13, 2000, at C-01 (reporting that McLeodUSA is offering residential service in Denver).

18 See New Broadband Players Rush Into Cable and Telecom Markets, Communications Daily, June 9, 2000 ("Wall St. is pouring money into new breed of [broadband service providers]").

But there is no evidence that broadband deployment is being slowed by the effects of dial-up prices. CLECs, even those most dependent on reciprocal compensation, are deploying DSL and packet-switched services for which they receive no reciprocal compensation. For instance, Adelphia has invested in cable systems through which it provides residential and small businesses an alternative to dial-up Internet access with high speed one-way hybrid service or two-way cable service.[19] Focal is deploying DSL to meet its customers demands.[20] Intermedia offers a wide range of packet-switched services to its customers ranging from DSL to ATM and Frame Relay.[21]

These examples (all companies with significant reciprocal compensation revenue) demonstrate that even those that may have benefited significantly from dial-up connections to ISPs in the past recognize that they will soon become obsolete. Purchasers of Internet access increasingly demand the kind of broadband, always-on connections that dial-up cannot provide. Indeed, it

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19 See Adelphia Communications Corp. 10-K, March 30, 2000 at 5-6; Credit Suisse First Boston, "Telecommunications Services: CLECs," June 14, 2000 (stating that 15 percent of Adelphia's first quarter 2000 revenue was reciprocal compensation).

20 See Focal Communications Corp. 10-K, March 10, 2000 at 23; Credit Suisse First Boston, "Telecommunications Services: CLECs," June 14, 2000 (stating that 35 percent of Focal's first quarter 2000 revenue was reciprocal compensation).

21 See Intermedia Communications Inc. 10-K, March 20, 2000 at 2-3; Credit Suisse First Boston, "Telecommunications Services: CLECs," June 14, 2000 (stating that 12 percent of Intermedia's first quarter 2000 revenue was reciprocal compensation).

seems inevitable that such broadband connections will eventually replace dial-up access altogether.

Sixth, while there have undoubtedly been some fringe firms that have entered solely to arbitrage high reciprocal compensation rates, it is striking that the ILECs can offer little evidence of anomalous behavior. Indeed, several of the CLEC practices labeled as "scams" by the ILECs seem in fact to be simply more efficient means of providing service. For example, Verizon points to Brooks Fiber's use of remote NXXs in Maine as an impermissible waste of numbering resources, since Brooks Fiber obtained NXXs solely to provide ISP customers with local numbers in particular rate centers. Verizon Comments at 18-19. However, while Maine prohibited the use of remote NXXs, California has approved them.[22]

In any event, to the extent there are in fact firms that game the reciprocal compensation process, by for example serving only ISPs and not deploying any switches or other facilities, the answer is not the elimination of reciprocal compensation for ISP-bound traffic. Rather, as the Commission stated in the Declaratory Ruling, "issues regarding whether an entity is properly certified as a LEC if it serves only or predominantly

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[22] Order Instituting Rulemaking on the Commission's Own Motion Into Competition for Local Exchange Service; Order Instituting Investigation on the Commission's Own Motion Into Competition for Local Exchange Service, Decision No. 99-09-029, Rulemaking No. 95-04-043 (Filed April 26, 1995), Investigation No. 95-04-044 (Filed April 26, 1995), 1999 Cal. PUC LEXIS 649, at *24 (Cal. PUC Sept. 2, 1999) ("California Remote NXX Order").

ISPs are matters of state jurisdiction." Declaratory Ruling, ¶ 24. In particular, the Commission concluded that the states are more than capable of "assessing whether and to what extent . . . anomalous practices are inconsistent with the statutory scheme (e.g., definition of a carrier) and thereby outside the scope of any determination regarding inter-carrier compensation." Id. n.78. There is no reason to abandon this approach at this time.

Seventh, SBC argues that reciprocal compensation for ISP-bound traffic causes irrational pricing, since it supposedly causes ILECs to pay too much for terminating service, CLECs to receive too much for terminating service, and ISPs to pay too little for local service. See SBC Comments at 44-46. But these consequences follow only where reciprocal compensation is set above-cost. Of course, to the extent that these problems existed in the past, they were caused by inefficiently high reciprocal compensation rates. There is no reason to think that this should continue in the future.[23]

Eighth, SBC's assertion that applying reciprocal compensation to ISP-bound traffic prevents ILECs from serving ISPs, even when they are more efficient, is also implausible. See SBC Comments at 46. This argument is apparently based on SBC's baseless conviction that forward-looking reciprocal

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[23] SBC's statement that "[e]ven as states reduce reciprocal compensation rates" the problem will continue because of the "phenomenal growth of the Internet" makes no sense. SBC Comments at 44. If reciprocal compensation rates are set based on cost, call volumes it will have no effect.

compensation rates grossly overcompensate CLECs. This then causes CLECs to have an unfair advantage in serving ISPs. Of course, as explained, this is simply not the case.

But it is worth further emphasizing that ILECs have lost ISP customers as much because of bad service as anything else, and this is the reason they will likely continue to lose ISP customers even after reciprocal compensation rates are set at efficient levels. The ILECs have consistently neglected their ISP customers, discriminated against them in favor of their own affiliated ISP businesses and generally denied them the logical advantages that CLECs offer, such as collocation near serving switches. The ILECs must recognize that the game of blaming regulation will be over once reciprocal compensation rates are efficient: there is nothing left for them but the hard work of winning customers served by other carriers.

Ninth, Verizon's assertion that applying efficient reciprocal compensation rates to the exchange of ISP-bound traffic will lead to either high local rates or per minute rates for data lines is clearly wrong. See Verizon Comments at 21-22. If reciprocal compensation is set at efficient levels, there will be no change in ILEC costs associated with ISP-bound traffic.

Tenth, SBC's alarmist argument that application of reciprocal compensation could undermine the U.S. positions taken before the ITU is easily dismissed. See SBC Comments at 47-48. The U.S. has opposed that proposal because it may be adopted without adequate debate and because, as currently drafted, it is

so vague and opaque as to be unenforceable.[24] It has also been suggested that this proposal could be used to impose the above-cost international settlement rates on the international exchange of Internet traffic. Id. Opposing such above-cost rates is hardly inconsistent with seeking to establish cost-based rates domestically.

Eleventh, woven throughout the arguments discussed above is the ILEC refrain that local rates do not cover the cost of serving ISP subscribers. This assertion is probably wrong and is in any event irrelevant. The ILECs have never offered credible evidence to support the supposed ISP revenue shortfall. Indeed, their massive revenues from second line sales (which produce close to 100% incremental profit, since the ILECs have generally recovered the costs of unused second lines long ago) combined with revenues from other overpriced services in all likelihood make the ILECs more than whole. It is therefore no surprise that the Commission was forced to conclude in the Access Charge Order, "[w]e are . . . not convinced that the nonassessment of access charges results in incumbent ISPs imposing uncompensated costs on incumbent LECs." Access Charge Order, ¶ 346.

But again, reciprocal compensation is irrelevant to this debate. The ILECs complain that they pay per-minute reciprocal compensation charges but generally charge ISP customers flat monthly rates. However, so long as efficient rates are set, the

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[24] See "ITU Study Group Settlement Rate System For Internet," Communications Daily (Apr. 24, 2000).

ILECs will only pay CLECs to cover the costs ILECs avoid when CLECs terminate ISP-bound traffic. That is, where efficient reciprocal compensation rates have been implemented, the ILECs incur the same per-minute ISP dial-up costs regardless of whether the traffic terminates on ILEC networks or on CLEC networks. Even if the Commission were to eliminate reciprocal compensation for ISP-bound traffic, the CLECs would stop serving the ISPs, the ISPs would return to the ILEC network, and the ILECs would still experience the same purported shortfall that exists today. In short, the Commission's admonition in the Access Charge Order, applies as much to this proceeding as it does to the access charge context: "To the extent that some intrastate rate structures fail to compensate incumbent LECs adequately for providing service to customers with high volumes of incoming calls, incumbent LECs may address their concerns to state regulators." Access Charge Order, ¶ 346.

It should also be emphasized that the ILECs' claim that the exploding growth of the Internet will only exacerbate problems caused by reciprocal compensation is again misleading. Internet use is indeed growing. But if efficient reciprocal compensation rates are implemented, reciprocal compensation will have no effect on ILEC costs associated with such increased usage. Furthermore, it should be noted that a very significant percentage of Internet traffic is carried over dedicated lines, especially to and from businesses. Also, while there is significant dial-up usage, dial-up will eventually be replaced as a means of accessing the Internet by broadband connections.

For all of these reasons, the policy arguments raised by the ILECs cannot support the elimination of reciprocal compensation for ISP-bound traffic. Such a policy would not, as SBC asserts, lead to efficient outcomes. It would simply lead to the elimination of competition in the provision of local service to ISPs. The ILECs would keep their current low ISDN PRI rates in place, since they can recover the cost of terminating ISP traffic from ISP subscribers. If CLECs were denied the right to collect reciprocal compensation, they could only serve ISPs profitably by charging the ISPs for transport and termination. This would price the CLECs out of the market. Moreover, if a CLEC were to win an ISP, the ISP would end up subsidizing the ILEC because it would be paying for transport and termination costs that the ILEC would avoid.

Nor is there any merit in SBC's proposal that the Commission establish a cap of 2:1 above which traffic is presumed to be Internet and non-compensable. SBC Comments at 54. Such a cap would obviously arbitrarily limit the extent to which ISPs have competitive alternatives. It is based on the same flawed premise as the elimination of reciprocal compensation: that forward-looking reciprocal compensation prices create inefficient incentives.

In addition, TWTC's experience is that many kinds of customers other than ISPs receive far more traffic than they originate. For example, many of TWTC's non-ISP business customers purchase in-bound PRIs to obtain access to corporate LANs in the same local calling area. This kind of service is

purchased by law firms, hospitals, consulting companies, and many other kinds of businesses. Moreover, some companies, like large electric utilities, subscribe to regular voice lines dedicated to customer service, and again these lines exhibit high termination to origination ratios. As a result, even in the absence of ISP-bound traffic, TWTC's terminating to originating traffic ratio would likely exceed 2:1. For example, during the months of June and July of this year, TWTC's terminating to originating ratio for local traffic (excluding ISP-bound traffic) in the Ameritech and Cincinnati Bell regions was approximately 24 to 1.[25] Thus, if TWTC is representative, there is no basis for presuming that traffic in excess of a 2:1 ratio of termination to origination is ISP-bound traffic.

Moreover, the ILECs strongly imply that carriers with imbalanced terminating to originating traffic flows must be serving only or primarily ISPs. But this is untrue. For example, ISPs comprise only approximately ten percent of TWTC's customers. That number would drop to zero, however, if TWTC could not recover the costs of terminating traffic to ISPs.

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[25] This ratio covers only the old Ameritech and Cincinnati Bell regions since those were the only markets in which TWTC has been able to collect reliable data. TWTC serves Milwaukee, Columbus, Indianapolis and Cincinnati in those regions.

IV. CONCLUSION

For the reasons described herein, the Commission should rule that Section 251(b)(5) applies to the exchange of ISP-bound traffic and that the same price level and price structure should be adopted by states for all traffic subject to Section 251(b)(5).

Respectfully submitted,

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ATTORNEYS FOR TIME WARNER COMMUNICATIONS HOLDINGS INC.

August 7, 2000

EXHIBIT

DECLARATION OF DON J. WOOD

1. My name is Don J. Wood. My business address is 914 Stream Valley Trail, Alpharetta, Georgia 30022. I am a principal in the firm of Wood & Wood, an economic and financial consulting firm. I provide economic and regulatory analysis of the telecommunications and related "convergence" industries, with an emphasis on economic policy, development of competitive markets, and cost of service issues.

2. I received a BBA in Finance with distinction from Emory University and an MBA with concentrations in Finance and Microeconomics from the College of William and Mary. My telecommunications experience includes employment at both a Regional Bell Operating Company ("RBOC") and an Interexchange Carrier ("IXC"). I was employed in the local exchange industry by BellSouth Services, Inc. in its Pricing and Economics, Service Cost Division. My responsibilities included performing cost analyses of new and existing services, preparing documentation for filings with state regulatory commissions and the Federal Communications Commission ("FCC"), developing methodology and computer models for use by other analysts, and performing special assembly cost studies. I was also employed in the interexchange industry by MCI Telecommunications Corporation, as Manager of Regulatory Analysis for the Southern Division. In this capacity I was responsible for the development and implementation of regulatory policy

for operations in the southern U. S. I then served as a Manager in the Economic Analysis and Regulatory Affairs Organization, where I participated in the development of regulatory policy for national issues.

3. I have testified on telecommunications issues before the regulatory commissions of twenty-eight states, Puerto Rico, and the District of Columbia. I have also presented testimony regarding interconnection and cost of service issues in state, federal, and overseas courts, before arbitration panels, and have presented comments to the FCC. To date, I have participated in over forty arbitration proceedings in which the rates for reciprocal compensation were at issue, and in over twenty-five proceedings subsequently undertaken by state regulators to establish permanent rates for reciprocal compensation (and the underlying UNEs) to replace interim rates adopted in arbitrations.

4. I have prepared this declaration at the request of Time Warner Telecom ("TWTC") in order to respond to the declaration of William E. Taylor on behalf of Verizon Communications, as well as arguments presented by SBC Communications.

Response to Taylor Arguments

5. I am responding to three broad claims made by Dr. Taylor:

(1) An economic review of the flow of cost causation associated with a call to an ISP indicates that the ISP and its customer become the "cost causers" in a way that supports the suspension of reciprocal compensation for these calls, but only these calls.

(2) The costs incurred by CLECs to terminate calls made to ISPs are less than the cost that would be incurred to terminate a comparable call to a non-ISP end users.

(3) The application of reciprocal compensation to calls made to ISPs creates, through various methods, harm to economic efficiency.

6. When examined in detail, each of Dr. Taylor's claims are revealed to be unsupported conceptually or factually.

Response to Claim No. 1: An economic review of the flow of cost causation associated with a call to an ISP indicates that the ISP and its customer become the "cost causers" in a way that supports the suspension of reciprocal compensation for these calls, but only these calls.

7. In paragraphs 14 through 20, Dr. Taylor describes various call scenarios intended to illustrate call causation. While I agree in principle that cost causation is relevant to the question before the Commission, and specifically that total societal welfare is maximized when cost causers are responsible for the costs they incur, I disagree with Dr. Taylor's assertion that the flow of cost causation in a local telephone call is dependent in any way on the identity of the calling or called party.

8. The application of the basic economic principles upon which Dr. Taylor and I agree seems clear enough in the current context. If a subscriber to Verizon's local exchange service picks up the phone and initiates a call to another subscriber to Verizon's service, that caller has caused Verizon to incur both originating and terminating costs. If that same subscriber initiates a call to a subscriber to a CLEC's service, that caller has caused

Verizon to ultimately incur the costs of both call origination and termination. Because of a contractual arrangement (the interconnection agreement between the two carriers), the CLEC agrees to accept responsibility for the call brought to it and to deliver it to the called party of Verizon's customer's choosing. The call has then been completed and the CLEC has then incurred the cost of call termination. At that point, it is meaningful to say that, as in the first example, the calling party has caused the costs of both call origination and termination to be incurred by some carrier. In the first intra-network example, Verizon incurred both costs; in the second inter-network example, Verizon incurred the origination cost and the CLEC incurred the termination cost. Since Verizon brought the traffic to the CLEC in order to provide a service to its customer, Verizon causes the CLEC to incur – if it is to meet is obligations pursuant to the interconnection agreement – the cost of call termination. When Verizon then compensates the CLEC, through the payment of reciprocal compensation, for completing the call, it incurs the cost of call termination caused by its subscriber and then finds itself in exactly the same position that it was in when the subscriber initiated a call that stayed on the Verizon network.

9. The same logic works in reverse. If a CLEC subscriber initiates a call to a subscriber served by Verizon, the CLEC customer – by the act of making the call -- will cause the costs of call origination and termination to be incurred by some entity. By taking the call to Verizon and expecting it to be delivered pursuant to the interconnection agreement, the CLEC causes Verizon to incur the cost of call termination. By paying Verizon the

reciprocal compensation rate, the CLEC incurs the cost of call termination caused by its customer.

10. This flow of causation is straight-forward, reciprocal, and – most importantly – *completely independent of the identity of the calling and called parties.* This last characteristic is where I disagree with Dr. Taylor. At paragraph 17 of his declaration, he argues that it is necessary to first know the identity of the calling and called parties, and any other business relationship that these entities may have, in order to determine cost causation. As I understand his argument, when a residential or business subscriber calls a residential subscriber, the flow of cost causation is as I have described it above. When a residential or business subscriber calls a business subscriber, the flow of cost causation is as I have described it above. When a residential or business subscriber calls a business subscriber with which it has a "customer-supplier" or "direct commercial" relationship, Dr. Taylor asserts that the flow of cost causation evolves because the subscriber and the called party mutually benefit from the direct commercial relationship. Because of that mutual benefit, Dr. Taylor asserts, the call becomes akin – in terms of cost-causation – to a toll call carried by an IXC.

11. In the evolved case of a call to an ISP, Dr. Taylor argues that the ISP's customer is the cost causer and that the ISP should be responsible for compensating the LECs (ILEC and CLEC) for the costs they incur when carrying the call. Dr. Taylor is half right in this regard, but for the wrong reason: the ISP's customer *is* the cost causer; not because it is

the ISP's customer, but because it is Verizon's customer making a telephone call. The calling party is not buying telephone service from the ISP, it is buying that service from Verizon. The costs at issue here are those associated with the use of that telephone service. It is the cost of the service being provided by Verizon, not the ISP, that is at issue. It is simply not meaningful to assert that the ISP is responsible for the costs associated with the service that the subscriber is obtaining from Verizon, especially when the subscriber is paying Verizon, and not the ISP, to provide that service.

12. There are two simple ways to look at the problem that underscore the failures in Dr. Taylor's logic. First, Dr. Taylor argues that it is the subscriber's direct commercial relationship, or customer-supplier contract, with the ISP that is causing the cost at issue. It would follow, then, that if the subscriber failed to live up to its side of the contract and did not pay its bills to the ISP, Verizon would have cause to disconnect that subscriber's telephone service. That clearly does not and should not happen. In reality, the costs at issue are those associated with a telephone call, and the contract (and customer-supplier relationship) for telephone service is between the subscriber and Verizon. If the call is carried by more than one LEC, the interconnection agreement between the LECs that handle the call is the relevant contract. Any contract between the subscriber and an ISP, like a contract between the subscriber and any other called party, is simply irrelevant.

13. The second flaw is one of under-inclusiveness. Dr. Taylor states at paragraph 19 that when placing the call to an ISP, the subscriber is "clearly acting as the customer of the

ISP, in precisely the same sense that [it] behaved as an IXC customer" when placing a toll call. Because of the "direct commercial relationship" between the subscriber and the ISP, Dr. Taylor argues, it or its customer becomes the cost causer of the telephone call, and this shift in cost causation justifies the elimination of reciprocal compensation in favor of a meet point billing arrangement which, as a practical matter, equates to bill and keep for this traffic.

14. The obvious problem with this example is that the subscribers to Verizon's local exchange telephone service enter into "direct commercial arrangements" with numerous commercial entities (brokerage firms, flower shops, banks with on-line services, or the oft-mentioned pizza parlor). Dr. Taylor does not argue for the extension of what he refers to as the "LEC-LEC-IXC" paradigm to the subscriber's calls related to each of these other commercial arrangements, however. Verizon (and the other ILECs) are not, as I understand it, arguing that reciprocal compensation should be eliminated for all such customers, but instead are limiting the exclusion to a classification of customer that CLECs have been successful in attracting. Dr. Taylor's argument, if valid, would apply equally to pizza parlors, brokerage firms, and flower shops, and each of these entities would owe – pursuant to the Taylor theory – compensation to the LECs beyond the level of the rates for the telephone service to which they subscribe.

15. Dr. Taylor does not address this apparent over-inclusiveness in his declaration. ILEC witnesses in recent and ongoing state proceedings have done so, however. For example,

in an ongoing investigation before the California Public Utilities Commission, Pacific Bell's economic witness attempted to explain why ISPs, but none of the numerous other identically-situated entities with which the subscriber has a commercial relationship, owe compensation to the LECs.[1] In doing so, the Pacific Bell witness used the example of online banking services. His only argument was that "the bank's online services are incidental to the bank's normal operation." That may be true for some banks, but it hardly addresses the question. For a bank that decides to abandon brick and mortar operations and offer all functions online, this activity would certainly be more than "incidental" to its operations, yet the Pacific Bell witness would only place it in the category with ISPs if it placed "an icon in the corner of its on-line service that let users to the Internet." An obvious question is compelled by this line of reasoning: at what point does an activity become more than incidental to a subscriber's operations? Clearly, the services sold via telephone by the pizza takeout company or the flower shop are not "incidental" to their operations, yet the ILECs, including Verizon, are not arguing that these entities owe additional compensation to the LECs or that calls to them should be exempted from reciprocal compensation. The only distinguishing factor for ISPs is the relative success that ILECs and CLECs have had in attracting them as customers.

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1 See Direct Testimony of Robert G. Harris, California PUC Rulemaking 00-02-005, July 14, 2000, pp. 14-15.