

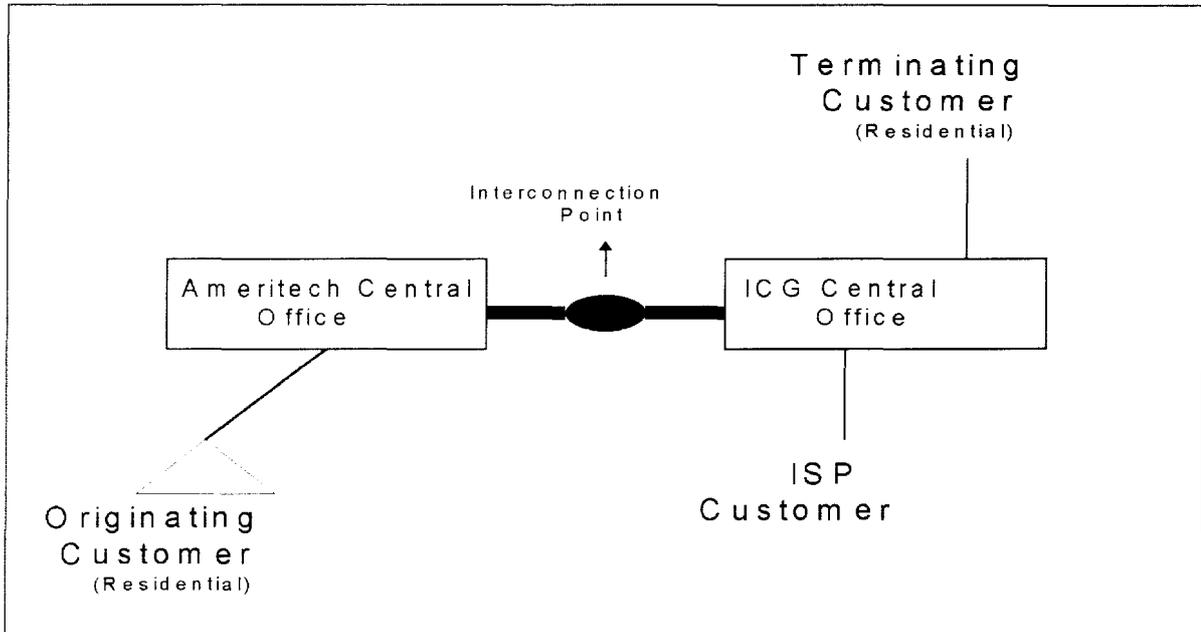
. . . customer group wherein the rates they pay for access to the network must include costs associated not only with calls they make, but also calls they receive. At a minimum, this will disrupt the ISP marketplace and is likely to send many ISPs back to Ameritech where Ameritech's more mature customer base can be used to offset the costs of terminating the ISPs traffic without raising ISP local rates.

The fact that each of these disruptions happens to benefit Ameritech should not be lost on the Commission when it considers Ameritech's rationale for refusing to pay reciprocal compensation for ISP bound traffic.

**Q. PLEASE EXPLAIN IN GREATER DETAIL YOUR CONTENTION THAT CALLS DIRECTED TO ISPS ARE FUNCTIONALLY IDENTICAL TO LOCAL VOICE CALLS FOR WHICH AMERITECH HAS AGREED TO PAY TERMINATION CHARGES.**

A. A ten minute call originated on the Ameritech network and directed to the ICG network travels exactly the same path, requires the use of exactly the same facilities, and generates exactly the same level of cost regardless of whether that call is dialed to an ICG local residential customer or to an ISP provider. The simplistic diagram below (Diagram 1) details one scenario by which such a call might travel.

Diagram 1



As you can see from the diagram, regardless of whether the originating customer dials either the ICG residential customer or the ICG ISP customer, the call travels from the originating customer's premises to the Ameritech central office switch, which then routes the call to the Ameritech/ICG interconnection point and ultimately to the ICG switch. From the ICG switch the call is then transported to either the residential customer or the ISP customer depending upon the number dialed by the Ameritech caller. Both calls use the same path and exactly the same equipment to reach their destinations. Most importantly, the costs to deliver the calls made to the residential customer and the ISP customer are identical. As such, the rates associated with recovering those costs should be identical. To single out the ISP call and suggest that \$0 compensation should be paid for purposes of carrying that particular call and some other, non-zero rate should be applied to all other calls ignores the simple economic reality that both

calls generate costs that must be recovered by the reciprocal compensation rate paid for their carriage.

**Q. WOULD THERE BE NEGATIVE ECONOMIC RESULTS FROM ALLOWING AMERITECH TO PAY \$0 FOR CALLS DIRECTED TO ISPS WHILE PAYING A NON-ZERO RATE FOR ALL OTHER CALLS?**

A. Of course. Given the option of receiving an amount greater than zero for carrying a non-ISP call and \$0 for carrying an ISP call, any reasonable carrier would fill its switch with non-ISP calls to the extent possible. Likewise, any carrier that currently served a larger proportion of ISP customers would be a less profitable network than a network that served a smaller proportion of ISP customers. In effect, allowing Ameritech to skirt its obligation to pay for the use of an interconnecting carrier's network for purposes of carrying its local customers' calls to ISP customers will skew the supply substitutability of ISP services versus other local services, thereby making other local exchange services more attractive production alternatives. This . . . .

BEFORE THE  
Federal Communications Commission  
WASHINGTON, D.C.

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

**DECLARATION OF WILLIAM PAGE MONTGOMERY**

**INTRODUCTION**

1. My name is William Page Montgomery. I am the principal of Montgomery Consulting in Laguna Beach, California, which I founded in 1993 after 16 years with the consulting firm of Economics and Technology, Inc.
2. I have been involved in telecommunications public policy and regulatory matters since 1974. I have provided consulting services in over 100 common carrier matters before the Federal Communications Commission (FCC). I have also participated in several hundred state-level telecommunications proceedings, and have submitted expert testimony before 30 state regulatory commissions. I have had considerable experience in the development of regulatory mechanisms designed to create improved efficiency incentives for monopoly local telephone companies; as well as policies and practices to increase competition in the telecommunications industry. I have been involved in extensive analysis of rates, costs and cost accounting systems. I have degrees in law and economics from Duke University and Butler University respectively.

3. In the last five years, I have been actively involved in local exchange competition proceedings and interconnection arbitrations in a number of state jurisdictions and the FCC, including CC Docket No. 96-98 and its investigations of reciprocal compensation in CC Docket No. 99-68. I have testified in Arizona, Colorado, Connecticut, Illinois, Indiana, Iowa, Kentucky, Maryland, Massachusetts, Michigan, New Mexico, Ohio, Oregon, Pennsylvania, Texas, Utah, Washington and Wisconsin. I have testified on reciprocal compensation issues involving Internet Service Providers (ISPs) in nine states, including the specific proceedings I discuss below, and each state has approved compensation for ISP-bound calls.
4. ICG Telecom Group, Inc. (ICG) asked me to review and comment on two submissions by incumbent local exchange carriers (ILECs) in response to the Commission's June 23, 2000 Public Notice (FCC 00-227). I have previously analyzed the factual assertions in the two submissions in state regulatory proceedings. One document is the Direct Testimony of Barbara A. Smith of Southwestern Bell Telephone Company ("SWBT"), submitted as Attachment B to the Comments of SBC Corporation, Inc ("SBC Cost Attachment"). The other document is the Declaration of William E. Taylor, attached to the Comments of Verizon Communications ("Verizon Cost Attachment").

**COMMON CHARACTERISTICS OF THE SBC AND VERIZON DOCUMENTS**

5. Both of these cost attachments have several things in common. Both documents make allegedly factual assertions concerning the cost incurred by competitive local exchange carriers (CLECs) to terminate high volume, long duration ISP-bound traffic. Both documents try to raise issues which appear to be quite peripheral to the specific, albeit complicated, jurisdictional issues addressed in the Public Notice. Thus, both the Verizon and SBC Cost Attachments seem to try to point the Commission away from the Public Notice issues towards somewhat superfluous policy issues, that might better be investigated after the specific jurisdictional issues in this remand proceeding have been settled. Both documents thus raise issues and assertions that could best be tested in full evidentiary hearings.
6. The analyses in both the SBC and Verizon Cost Attachments try to base assertions about the lower costs that CLECs allegedly confront for ISP-bound traffic based on the ILECs' existing costs for terminating local traffic. SBC and Verizon then simply removed various cost components that are supposedly avoided by CLECs who transport and terminate this type of traffic. Both attachments make these fairly complex factual assertions without detailing the inputs, assumptions and calculations behind their analyses. Both Cost Attachments thus highlight the value of full evidentiary processes, with written discovery, oral depositions, open evidentiary hearings and detailed review by regulatory staffs experienced in detailed cost analysis.
7. Such an evidentiary review has been completed in the case of the SBC Cost Attachment. A number of the points made in the Verizon Cost Attachment have been disputed in other proceedings. It should be no surprise, then, that the majority of state regulators who have

reviewed such complex cost assertions in detail have determined to continue the reciprocal compensation regime for ISP-bound traffic (apart from the jurisdictional issues remanded to this Commission). Indeed, the few contrary state opinions on reciprocal compensation for ISP-bound calls are in jurisdictions that either have not (yet) engaged in full scale reviews of the costs of terminating ISP-bound calls,<sup>1</sup> or are based on facts about a specific situation involving a single carrier.<sup>2</sup>

8. The Texas Public Utility Commission has declined to rely on the cost analysis in the SBC Cost Attachment, the Smith testimony.<sup>3</sup> Ms. Smith sponsored SWBT's Internet Bound Traffic (IBT) study. The Texas Commission found that:

All parties agree that the SWBT IBT cost study should not be used to set reciprocal compensation rates. The Commission concludes that the SWBT IBT cost study is not a TELRIC study and also cannot be used to justify differentiating ISP-bound traffic and voice traffic for costing purposes.<sup>4</sup>

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<sup>1</sup> See *MCI WorldCom v. Bell Atlantic -- Massachusetts*, Massachusetts Department of Telecommunications and Energy, Docket No. 97-116-C, Order, May 1999, discussed at page 23 of the Verizon Cost Attachment. This remand proceeding is not the place to debate the merit or lack thereof of specific state decisions, whether those decisions are minority rulings against reciprocal compensation for ISP-bound calls – as is this case – or the much larger majority of decisions that have ruled the other way.

<sup>2</sup> See *BellSouth Telecommunications Inc v. US LEC*, North Carolina Utilities Commission, Docket No P-561, SUB 10, March 31, 2000, discussed at page 26 of the Verizon Cost Attachment.

<sup>3</sup> Public Utility Commission Of Texas, Proceeding To Examine Reciprocal Compensation Pursuant to Section 252 Of The Federal Telecommunications Act Of 1996, Docket No. 21982, *Arbitration Award*, July 14, 2000 (“Texas July Arbitration Order”).

<sup>4</sup> Texas Arbitration Order, p. 47; emphasis added. With the concurrence of the vast majority of the CLEC parties to the Texas arbitration proceeding as well as SWBT, the Texas PUC decided to convert the existing reciprocal compensation rate into a two-part or “bifurcated” rate so as to separate the costs of call set-up from the cost of the duration of the call. The bifurcation allows (footnote continued on next page)

The Texas outcome demonstrates, I think, that the FCC should continue to accord significant weight to state regulatory commissions who can adjudicate factual issues such as those raised in the Verizon and SBC Cost Attachments, although this observation is not directly germane to the issues covered by the Public Notice (as are neither the Verizon or SBC Cost Attachments in the first instance).

**SBC AND VERIZON ASSUME THAT ISP TERMINATING SWITCHES ARE “STRIPPED DOWN” EQUIPMENT**

9. Both the SBC Cost Attachment and the Verizon Cost Attachment are very deficient in their methods and assumptions. Both Cost Attachments produce alleged rates for terminating ISP-bound traffic that are about 55% to 65% (independent of call duration effects) below the respective state tariffed rates used as a starting point. In both instances, these additional reductions are accomplished by “stripping away” otherwise legitimate switching related costs that the two Attachments claim are not involved in terminating ISP-bound traffic. Neither Cost Attachment constructs an affirmative serving arrangement for ISP-bound traffic. Neither study tries to develop serving arrangements that SBC or Verizon might claim were “optimized” to terminate ISP-bound traffic. By simply stripping off various cost components, both Attachments present results that have been cobbled together simply so that the ILECs can try to assert that CLECs realize

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calls with shorter holding times and calls with longer durations, like ISP-bound calls, to be priced on a non discriminatory basis. The bifurcation involved a significant reduction in the reciprocal compensation price for terminating ISP-bound calls. For a 30 minute call the price reduction in Texas was about the same as the change in the “cost adjusted for holding time” shown in the Verizon Cost Attachment, p. 31, Table 1

extraordinarily lower costs in terminating ISP-bound traffic.<sup>5</sup>

10. The study in the SBC Cost Attachment, for example, strips away end office switching costs associated with vertical features like Call Waiting and the costs to connect remote switching modules to the primary circuit switch through investment in umbilical trunks.<sup>6</sup> The Verizon Cost Attachment accomplishes the same type of “stripped down” reconfiguration of a local switch ostensibly by eliminating all costs associated with line-side traffic handling, expressed in centum call seconds or CCS.<sup>7</sup> Thus, both the SBC and Verizon Cost Attachments create switch configurations that are entirely hypothetical in nature.
11. It is far from clear that service providers can even buy switches from vendors without the capability of providing vertical features, or without the capacity to modify line concentration ratios over time as busy hour CCS traffic changes.<sup>8</sup> It might be more

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<sup>5</sup> As I discuss below, the assertion that switching costs for ISP-bound calls are much lower than costs for other local traffic is at odds with these claims that these ILECs and most other ILECs have made to the Commission over many years in an attempt to apply interstate switched access charges to call terminations to ISPs.

<sup>6</sup> These features of the SWBT/SBC are not found in the actual FCC submission, but were instead revealed through discovery in the Texas Arbitration Case, in SWBT responses to requests for information (RFIs) propounded by the Texas CLEC Coalition (numbers 1-14 and 2-2) – illustrating again that a forum which provides for full evidentiary review of cost studies is necessary for proper analysis.

<sup>7</sup> Verizon Cost Attachment, pp. 16-17. I say “ostensibly” because there is a serious factual question about how the Verizon Cost Attachment applied the Line CCS to tandem switching as well as end office switching costs, as I discuss below. Absent a detailed review of the workpapers supporting the study, one cannot conclude that the adjustment was implicated correctly even in a mechanical sense.

<sup>8</sup> CCS, or centum call seconds, is the measure of each one hundred (centum) seconds of traffic load offered to a switch.

costly for the switch vendors to write new software to block features, or to redesign the architecture of the switch fabric to somehow be insensitive to offered traffic loads. It is simply not rational for either vendors or service providers to try to develop switch architectures and configurations that might match the hypothetical switches posited in the Verizon and SBC Cost Attachments.

12. Even if these hypothetical switches were available in the equipment marketplace, however, the assumptions behind the Verizon and SBC Cost Attachments are not competitively neutral. The ILECs' assumptions about "stripped down" switches seem to imply that CLECs should not be compensated for the costs of general purpose equipment; CLECs should be confined to purchasing special, stripped down equipment rather than general purpose switches. The assumptions also imply that the revenue flows that CLECs need in order to grow should be limited, so as to box in CLECs from expanding their customer bases and networks. The effects of the ILECs' trying to exclude legitimate cost components from CLECs' serving arrangements for ISP-bound traffic ultimately have serious anti-competitive impacts.

**VERIZON'S ASSERTIONS ABOUT THE COST DRIVERS FOR ISP CALLS ARE INCORRECT**

13. The Verizon Cost Attachment tries to draw a link between the costs of ISP-bound calls and four possible characteristics of such calls that Verizon claims affect cost causation: Call duration, the use of dedicated capacity, call direction and load distribution.<sup>9</sup> In fact, however, none of these characteristics demonstrate that termination costs of ISP-bound calls are significantly lower than terminations of the equivalent seven-digit local voice

calls.

14. Call duration. Verizon claims that ISP bound calls are less expensive to terminate because these costs often have longer durations than other calls. The longer duration means that call set up costs, which are different than the costs of handling a call through its duration, are collected over a longer time period – until the call is disconnected. If the call terminating cost is expressed by means of a single-part rate in which set up and duration costs have been averaged, continued recovery of the set up over a longer duration results in an excessive price for the long duration call. However, this characteristic has nothing per se to do with ISP-bound calls. The same phenomenon applies to all longer duration calls, irrespective of where they originate or terminate. Telephone companies with single-part local measured service retail tariffs, usage based extended calling prices and one-part “local-toll” rates will over-recover the costs of longer duration calls made by talkative teenagers, for example.
15. If this type of rate structure distortion exists, the appropriate, and non-discriminatory remedy is to apply a two-part rate that separates the call set up costs from the duration costs. A number of states already have two-part rates in effect for reciprocal compensation; as noted, the Texas Commission just approved this rate structure change – without changing the reciprocal compensation costs it had approved previously.<sup>10</sup>

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<sup>9</sup> Verizon Cost Attachment p. 4 and following.

<sup>10</sup> See Texas Arbitration Order, p. 48. Compare: Public Utility Commission of Texas Petition of MFS Communications Company, Inc. for Arbitration of Pricing of Unbundled Loops Agreement Between MFS. and Southwestern Bell Telephone Company, Docket No. 16189, *et al*, Arbitration Award (Dec. 19, 1997), Attachment A. (“Second Texas Mega-Arbitration Award”).

Therefore, when Verizon claims that ISP-bound call costs should be differentiated based on call duration it is merely noting a possible change in rate structure, which can be effected without discriminating between ISP-bound calls and other local calls.

16. The Verizon Cost Attachment first claims that longer-duration calls to ISPs are always less expensive for CLECs to handle, but later notes that the Commission established different default compensation rates for paging calls.<sup>11</sup> In fact, Verizon's assertions are inconsistent, because the Commission determined that shorter duration paging calls were less expensive than other local calls.

A paging network's "configuration is distinctly different from either LEC wireline networks,..." and "most calls terminated by paging companies are brief (averaging 15 seconds) in duration and contain no voice message, but only an alpha-numeric message of a few characters."<sup>12</sup>

Thus, Verizon would have one believe that shorter-duration paging calls cost less and so do longer-duration ISP-bound calls.

17. Dedicated capacity. The Verizon Cost Attachment claims that CLECs incur no line CCS costs if the CLECs provision non blocking primary rate interface (PRI) connections for ISP-bound calls. "Since the circuit is dedicated to the ISP line, the use of the facility does not impose congestion costs on other users, and no rationing or call blocking is imposed

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<sup>11</sup> Verizon Cost Attachment, p. 27.

<sup>12</sup> Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, First Report and Order, August 19, 1996, paragraph 1092.

on the network as a result of the ISP line being in use.”<sup>13</sup> This rationale confuses dedicated, non-switched facilities costs, like private lines, with the high volume ISP-bound traffic, which – unlike private lines – is routed through switches and consumes switch resources at the busy period. At the switch, this traffic does impose potential call blocking on other traffic.

18. Verizon confuses “non traffic sensitive” as it may be used in a pricing sense (i.e., since the dedicated line is not shared, its costs are not allocated) with the traffic engineering effects associated with different levels of busy hour offered traffic loads. If a voice configuration with a line concentration of perhaps 6:1 imposes traffic sensitive costs on the switch, a lower concentration ratio of 2:1 or even 1:1 does not change the burden on switch to “non-traffic” sensitive costs.<sup>14</sup>
19. In addition, the Verizon Cost Attachment seems to have misapplied its removal of all line CCS costs from the standard switch cost models because the adjustment also lowers the estimated tandem switching unit costs shown on Table 1 by over 50%. But tandem switching is engineered according to the total traffic offered via incoming and outgoing trunks and thus line CCS volumes are irrelevant. The Verizon adjustment should not

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<sup>13</sup> Verizon Cost Attachment, p. 17. The Line CCS adjustment reduces Verizon’s estimated switching costs by about 60% compared to the rates adopted in the six Bell Atlantic states used in the Verizon analysis.

<sup>14</sup> The “traffic sensitive” versus “non traffic sensitive” distinction for arcane regulatory purposes like jurisdictional separations was acceptable, albeit imprecise, in its time because local carrier switches served only voice calls that had stable, long standing characteristics like a fixed 6:1 or 4:1 line concentration ratio. Since all calling exhibited these stable patterns, the costs of local exchange line concentration could be arbitrarily labeled “non traffic sensitive.” Even under jurisdictional separations, however, interexchange message circuit costs were treated as traffic sensitive and separated on the basis of conversation-minutes. 47 CFR 36.126(e)(3)(i). (footnote continued on next page)

affect tandem costs so drastically, if at all. Without a thorough review of the calculations supporting the Verizon adjustment, however, the source of this apparent anomaly cannot be analyzed.

20. Traffic load distribution. The Verizon Cost Attachment makes another error similar to its misinterpretation of the engineering cost effect of high volume ISP-bound traffic offered over dedicated facilities. Verizon claims that Internet traffic is less costly to serve because it is likely to have a flatter peak load, so that “the fraction of usage falling in the busy hour is smaller for Internet-bound and voice traffic...”<sup>15</sup> This assertion is wrong on its face because it is not the percentage (or fraction) of busy hour traffic that drives switching costs but rather the absolute load measured in CCS. Nevertheless, Verizon’s current assertion contradicts what its Bell Atlantic unit told the Commission:

The growth of the Internet has, however, dramatically changed the overall usage patterns in many offices, throwing out the window many of the traditional statistics on telephone company facility needs. In particular, standard telephone lines serviced by “typical” central offices are each in use about 5 minutes during the busy hour. By contrast, recent measurements in offices that service [i.e., terminate calls to] large ISPs show that the lines to those ISPs are in use more than 45 minutes in the busy hour.<sup>16</sup>

Although the SBC and Verizon cost attachments now claim that ISP-bound calls are less expensive to serve, three years ago these companies, as well as most other ILECs, insisted that handling ISP traffic was so expensive that local rates could not cover the costs and that

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<sup>15</sup> Verizon Cost Attachment, pp. 17-18.

<sup>16</sup> Usage of the Public Switched Network by Information Service and Internet Access Providers, CC Docket No. 96-263, Joint Comments of Bell Atlantic and NYNEX, March 24, 1997 (“Bell Atlantic ISP Comments”), p. 5.  
(footnote continued on next page)

usage-sensitive access charges should apply. Previously, a July 10, 1996 letter from NYNEX's Director, Federal Regulatory Matters to the Chief, Competitive Pricing Division made similar assertions.<sup>17</sup>

It is important to note that dial-up connections for this [ISP-bound] traffic require dedicated links through the switch and the network for the duration of the call...[T]his incremental demand is already beginning to impact the quality of voice telephone service...

Bell Atlantic's traffic studies demonstrated new peak load costs, because "the CCS or occupancy data indicate that this traffic is incremental to normal voice traffic, not complimentary. Occupancy levels in excess of 20 CCS per hour are realized in most cases by 10:00 AM, and this load is sustained throughout the day..."

21. Similarly, in 1997, SBC's subsidiary, SWBT, suggested that ISP-bound traffic should be subject to end office switching charges of 0.637 cents<sup>18</sup> -- much higher than reciprocal compensation rates for ISP-bound traffic in the current generation of interconnection agreements. SWBT claimed that terminating costs for ISP-bound traffic were higher:

Today, when Internet traffic is handled via the circuit-switched network, the traffic originating from clusters of subscribers is funneled to a few high traffic points in the network. This "funneling/concentration effect" raises the average traffic volumes beyond the normal switched access parameters. .... The traffic from these clusters of users creates a real traffic overload on the line side equipment of a given switch.

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<sup>17</sup> See Attachment D to Bell Atlantic's March 24, 1997 ISP Comments. Emphasis in original.

<sup>18</sup> Usage of the Public Switched Network by Information Service and Internet Access Providers, FCC Docket No. 96-263, Comments of Southwestern Bell Telephone Company, March 24, 1997 ("SWBT ISP Comments"). The actual rates SWBT advocated for this traffic were set out in SWBT's January 29, 1997 Initial Comments in FCC Docket No. 96-262, Access Charge Reform, at Appendix A and Attachment 1 thereto.

The results of this growth in traffic terminating to ISPs are busy-hour and busy-day shifts, larger magnitude and more frequent blocking in certain central offices (especially those serving ISPs) congestion in interoffice trunk groups and congestion in internal modules of SWBT's switching systems.<sup>19</sup>

On reply, SBC reiterated that “[a]s Internet traffic continues to grow on the PSTN, this traffic will have an ever increasing effect on peak-usage with corresponding cost increases,” and that even if ISPs purchased trunk side switch connections from ILECs “congestion still occurs on interoffice facilities and terminating end office switches.”<sup>20</sup> Of course, when a CLEC handles the ISP-bound traffic, the CLEC rather than the ILEC operates the terminating office, where calls to ISPs are concentrated and the possibility of switching congestion is the greatest.

22. Thus, a correct understanding of the traffic characteristics of ISP-bound calls supports a precisely opposite conclusion that Verizon's statement about the “fraction” of traffic in the busy hour. The lower concentration ratios that are required by CLEC switches that terminate high volumes ISP-bound calls require higher outlays for additional equipment including the switching fabric and more concentration modules. The added costs associated with lower concentration ratios, other modifications in the CLEC's switches to accommodate high busy hour loads and differences in network architecture are driven by the traffic characteristics of

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<sup>19</sup> SWBT ISP Comments, pp. 7, 9 emphasis added.

<sup>20</sup> Usage of the Public Switched Network by Information Service and Internet Access Providers, FCC Docket No. 96-263, Comments of Southwestern Bell Telephone Company, Pacific Bell and Nevada Bell, April 23, 1997 (“SWBT ISP Reply Comments”), citing Pacific Bell whitepaper “Surfing the ‘Second Wave’”.  
(footnote continued on next page)

the lines that terminate at ISP modem banks. These are all traffic sensitive costs in the engineering sense, and should be reflected in the inter-carrier compensation rate.

23. **Call direction.** Finally, Verizon notes that the volume of inbound calls terminating to an ISP is substantially greater than the volume of outgoing calls. Like the duration of calls discussed above, directionality per se neither serves to differentiate ISP-bound calls from other calls -- all calls have both an originating and terminating end, by definition -- nor proves in any way that ISP-bound calls experience dramatically lower costs, as Verizon alleges. Like the call duration point, Verizon is really distinguishing a rate structure issue and then claiming the difference is an affect on ISP-bound call costs. ILECs' own switching cost studies have never studied "one-way" call costs separately from other local calls although a number of reciprocal compensation rates are bifurcated into originating and terminating interoffice and inter-carrier rate elements.<sup>21</sup> In its discussion of call direction, like that of call duration, Verizon is really just dealing with a rate structure that separates originating and terminating call costs, as many retail, access charge, and reciprocal compensation tariffs do currently. Verizon provides no basis for discriminating between ISP-bound calls and other local calls.

**VERIZON'S CLAIMS ABOUT ECONOMIC EFFICIENCY ARE INCORRECT**

24. Although Verizon's attempt to depict ISP-bound call duration, direction and traffic load as

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<sup>21</sup> The ILECs' own switching cost studies have never studied "one-way" call costs separately from other local calls although a number of reciprocal compensation rates are bifurcated into originating and terminating interoffice rate elements. In addition, when discussing the possible cost differences between paging calls and other types of local traffic, *supra*, the Commission did determine that whether calls are one-way or two-way was a cost causing factor.  
(footnote continued on next page)

the drivers of lower costs for these calls is incorrect, it also draws the entirely erroneous that CLECs who find ways to reduce the costs of ISP-bound calls harm economic efficiency, or receive some sort of “subsidy.” This Commission has recognized correctly that competing service providers should have the economic incentives to seek out lower cost-serving arrangements, so that competition can benefit consumers. Efficient competition requires that a new competitor should be able to provide its services at least at the same price levied by the incumbent. If the newer provider can do better, i.e., operate more efficiently, then over time the marketplace will drive down prices to reflect this sustainable, efficient cost. In its Local Competition decision, the Commission explained this policy objective as follows:

[The cost] benchmark of forward-looking cost and existing network design most closely represents the incremental costs that incumbents actually expect to incur in making network elements available to new entrants. Moreover, this approach encourages facilities-based competition to the extent that new entrants, by designing more efficient network configurations, are able to provide the service at a lower cost than the incumbent LEC.<sup>22</sup>

25. Preliminary analysis also suggests that the recent decision of the U.S. Court of Appeals for the Eighth Circuit<sup>23</sup> does not affect this core economic policy requirement in any way. The Court agreed with the Commission that interconnection and UNE costs should be based on incumbents’ forward looking costs. It rejected costs based upon completely hypothetical equipment configurations, like those developed in the SBC and Verizon Cost Attachments.

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<sup>22</sup> Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, First Report and Order, paragraph 685, emphasis added.

<sup>23</sup> *Iowa Utilities Board et al. v. FCC*, July 18 2000.  
(footnote continued on next page)

Indeed, using entirely hypothetical switch configurations to estimate the ILEC competitors' costs of reciprocal compensation for ISP-bound calls would create a double standard with respect to any costs intended to be forward looking. It would be economically and logically inconsistent to set the costs for reciprocal compensation of ISP-bound calls so as to penalize a CLEC for possibly developing a more efficient network. Penalizing a possibly more efficient network obliterates the correct test for efficient competition which demands only that the CLEC be at least as efficient as the incumbent, as the Commission recognized.

26. The premise of the Verizon and SBC Cost Attachments, however, is that the Commission overturn this principle, thereby imposing a moral hazard on CLECs: If CLECs have to pay incumbents for use of necessary interconnection and unbundled network elements, the CLECs must pay the ILECs' costs, even if the ILECs' "existing network design" is sub-optimal. But if CLECs can build more efficient serving arrangements, CLECs must charge a lower price than incumbents. The Verizon Cost Attachment even goes so far as to claim that CLECs should not be allowed to lower prices to their end users -- if the CLECs' costs are lower than the ILECs -- because this activity would indicate a "subsidy":

the CLEC could then funnel back some of the excessive compensation so received to the ISP or the Internet user through, e.g., lower monthly charges for Internet use, then the net price paid for the ISP call would be below the cost imposed on the originating ILEC. This would be equivalent to receiving a subsidy.<sup>24</sup>

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<sup>24</sup> Verizon Cost Attachment, p. 20. Verizon claims that failure to flow through all CLEC cost efficiencies would stimulate demand for Internet services inefficiently. The Commission, on the other hand, has stated that one goal of the 1996 Telecommunications Act is to "preserve the vibrant and competitive free market that presently exists for the Internet and other interactive computer services," and has found that it has a Congressional mandate to foster and preserve the dynamic market for Internet-related services. Implementation of the Local Competition Provisions (footnote continued on next page)

Thus, what most economists would see as a process by which consumer prices are bid down over time by the competitive marketplace, Verizon would prefer to have the Commission view as a market failure. The Commission point quoted above recognized that the purpose of introducing competition is to give competitors incentives to lower costs over time. The pricing standard was designed to “encourage” CLECs to design more efficient network configurations, and be able to provide the service at a lower cost than the incumbent LEC. If a CLEC could realize lower costs, competitive policy requires that the CLEC and the CLEC customers should benefit from such efficiencies. Any other pricing rule would have anti-consumer effects.

**ILECs ARE NOT “VICTIMS” OF RECIPROCAL COMPENSATION, AND THEY REMAIN  
DOMINANT SERVICE PROVIDERS**

27. Finally, in a manner that has come to typify the incumbents’ public policy advocacy in recent years, the Verizon Cost Attachment includes assertions that seem to try to depict the dominant ILECs as “victims” of the current reciprocal compensation regime for ISP-bound traffic. The Verizon Cost Attachment does this in at least two ways. Of course, like the cost assertions themselves, these issues are far removed from the issues on which the Commission sought comments in the Public Notice. The Verizon Cost Attachment suggests that ILECs are victims of the current regime because ILECs are not involved in the “cost causation” between callers to ISP modem banks and the ISPs themselves.<sup>25</sup> Second, the Verizon

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in the Telecommunications Act of 1996, CC Docket No. 96-98; Inter-Carrier Compensation for ISP-Bound Traffic. CC Docket Nos. 96-98 and 99-68, Declaratory Ruling, at paragraph 6.

<sup>25</sup> Verizon Cost Attachment, pp. 7-8.  
(footnote continued on next page)

document suggests that eliminating reciprocal compensation of ISP-bound calls would be “competitively neutral” compared to the current situation, where the ILECs’ remaining control of 95% of end users (i.e., callers to ISPs) provides incentives to ISPs to contract with CLECs for the transport and termination of ISPs’ inbound calls.<sup>26</sup> Aside from the utter irrelevance of these points to the remanded issues before the Commission, both assertions are wrong.

28. The Verizon Cost Attachment attempts to develop a new-found concept of “cost causation,” in which ISPs would be treated like interexchange carriers (IXCs). The proposal suffers from many problems in addition to being impossible to implement under the current ISP exception. This new notion of “cost causation” (a) violates established definitions of cost causation; (b) confuses mere billing arrangements that have been applied to long distance traffic with true cost causation; and (c) at best, simply masks any problems that some ILECs may have with respect to existing retail service pricing.

29. In telecommunications, cost causation has always been assigned to the originating caller. The only exception is 800-type numbers, where the called party voluntarily assumes responsibility for payment. Even commercial mobile telecommunications services in the United States are moving to the “calling party pays” model, which has long applied to such services in Europe and other parts of the world. The standard notion of cost causation is reflected in the Telecommunications Act’s requirement that the cost causer’s carrier should pay compensation to another carrier if the second carrier happens to assume the cost of terminating the call. The Commission recently confirmed this same cost causation

relationship.<sup>27</sup> Verizon's attempt to analogize ISPs to interexchange carriers with respect to access charges fails, because access charge practices merely reflect the telephone monopoly "settlement" practices that had to be replaced when long distance and local operations were separated at the AT&T divestiture. It is true that local carriers send IXCs a bill for access charges and the IXCs pay it. This condition is not "cost causation," however. Many other business telephone users market their services by means of telecommunications to ILEC customers and are not subject to being treated like IXCs, even though some of these users' marketing efforts may generate incoming traffic volumes similar to those of an ISP. Basically, then the new "cost causation" test provides no set of coherent standards which regulators could actually use.

30. The attempt in the Verizon Cost Attachment to suggest that ILECs are victims of the current reciprocal compensation regime for ISP-bound calls, because of the ILECs' continued dominance over telephone customer who use the Internet, is a case of seeing a glass as 5% empty, when all others see the glass as 95% full. ILECs remain many times larger than their CLEC counterparts and serve masses of originating end users. These end users' rates are designed to recover, on average, the ILECs' costs of originating and terminating calls as well as to recover costs and often very large margins for other vertical and usage-based services. CLECs have yet to realize any of these market advantages. CLECs lack the ILECs' scale and CLECs are strictly price-takers in the marketplace. When an ILEC end user dials up an ISP served by the ILEC, the ILEC recovers costs that approximately compensate it for

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<sup>26</sup> Verizon Cost Attachment, pp. 22-23.

<sup>27</sup> TSR Wireless, LLC, et al, v. U S West Communications, Inc., et al File Nos. E-98-13, E-98-15 And E-98-16, E-98-17, E-98-18, Memorandum Opinion And Order, June 21, 2000 ( FCC 00-194).

handling the end-to-end call – both originating and terminating costs. The ILECs’ retail rate structures were set before competitive carriers might assume the terminating function for some calls, so the retail rates reflect both originating and terminating use. It may be true that these retail rate structures are not perfect, and that some high usage customers are “subsidized” by low usage customers, but this condition, besides residing in the ILECs’ retail rate structures over which no CLEC has any control, simply reflects the general effects of rate averaging. Averaged prices are by definition better for some customers and worse for others.

31. As long as the ILEC is compensated overall for its originating and terminating costs by average if imperfect rates, an ILEC obtains an economic advantage over all CLECs merely because of its traditional monopoly position. To use the percentages noted in the Verizon Cost Attachment, if, say, 95% of the users of dial-up Internet services are an ILEC’s residual monopoly customers and 5% are CLEC customers, the ILEC will be compensated much more completely for both call origination and termination costs, even for calls that a CLEC terminates. Ninety-five percent of calls to ISPs will provide the ILEC both originating and terminating compensation (albeit perhaps not perfectly), and the CLEC will receive full compensation, at best, only 5% of the time. The CLEC receives originating and terminating compensation absent reciprocal compensation, only if no other CLEC is involved.
32. A CLEC that terminates ISP-bound calls placed by customers of other CLECs would be just as disadvantaged by the elimination of reciprocal competition, as if the calls were originated by ILEC customers. If the CLEC serves relatively more ISP customers, the originating carrier is spared some of the terminating costs for its customers. If the originating carrier is an ILEC who still serves 95% of all customers, the ILEC will experience large windfall

gains, while the CLEC realizes a deficit with reciprocal compensation. This condition is inherent in the ILEC's dominant market position, unless carriers compensate each other symmetrically and reciprocally for the terminating component of the ISP call.

**CONCLUSION**

34. For all of the reasons discussed above, I recommend that the Commission give no weight whatsoever to the claims made in the SBC and Verizon Cost Attachments.

I declare under penalty of perjury that the foregoing is true and correct.

/Signed/ William Page Montgomery  
August 3, 2000

**CERTIFICATE OF SERVICE**

I do hereby certify that I have this 4<sup>th</sup> day of August 2000 served the following parties to this action with a copy of the foregoing **REPLY COMMENTS** by hand delivery or by placing a true and correct copy of the same in the United States Mail, postage prepaid, addressed to the parties listed on the attached service list.

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