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October 20, 2000

EX PARTE

Magalie Roman Salas
Secretary
Federal Communications Commission
Room TW-A325
445 Twelfth Street, S.W.
Washington, D.C. 20554

EX PARTE OR LATE FILED

Re: CC Docket Nos. 96-98; 99-68

Dear Ms. Salas:

On October 4, 2000, representatives for Time Warner Telecom ("TWTC") met with several members of the staff of the Pricing Division of the Common Carrier Bureau to discuss the application of reciprocal compensation to the exchange of ISP-bound traffic. During the meeting, the staff raised the following questions: (1) do LECs (either ILECs or CLECs) incur incremental costs when they transport and terminate dial-up traffic to ISPs; (2) if the FCC were to conclude that ISP-bound traffic is subject to Sections 251(b)(5) and 252(d)(2), could the FCC also impose bill and keep on all Section 251(b)(5) traffic, even where that traffic is substantially imbalanced; (3) assuming again that ISP-bound traffic is subject to Sections 251(b)(5) and 252(d)(2), what rate structure should apply to all traffic subject to the pricing rules of Section 252(d)(2); and (4) what costs does an originating LEC avoid when calls originating on its network are terminated by another LEC. These questions are addressed below.

1. CLECs Do Incur Costs When Transporting And Terminating Dial-Up ISP-Bound Calls.

There should be no dispute that LECs incur more than de minimis costs when transporting and terminating local traffic, including ISP-bound traffic. The Commission concluded in the Local Competition Order that "carriers incur costs in terminating traffic that are not de minimis."[1] The

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[1] Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers, First Report and Order, 11 FCC Rcd 15499, ¶ 1112 (1996) ("Local Competition Order"). The Commission reiterated this conclusion in an NPRM in this proceeding. See Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Inter-Carrier Compensation for ISP-Bound Traffic, Notice of Proposed Rulemaking, 14 FCC Rcd

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Commission may not now abandon this holding absent a reasonable basis for doing so. See Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 57 (1983). Yet no such reasonable basis exists on the record in this proceeding or anywhere else for that matter. Indeed, even those studies that have advocated bill and keep have recognized that transport and termination functions cause carriers to incur more than de minimis costs.[2] Furthermore, a conclusion that transport and termination imposes only de minimis incremental costs on carriers would contradict the state regulatory commission decisions on the subject as well as the FCC's own decision to adopt per minute charges for unbundled switching and shared transport.[3] There is simply no basis for asserting that every one of these generally consistent conclusions has suddenly been revealed as incorrect.

Furthermore, the ILECs themselves have long claimed that the cost of transporting and terminating voice traffic is more than de minimis. As Don Wood, a telecommunications analyst with extensive experience in analyzing telecommunications carriers' costs, explained in a Declaration filed with TWTC's reply comments in this proceeding, there is no basis for concluding that transporting and terminating ISP-bound traffic imposes fewer costs on CLECs than LECs incur when transporting and terminating voice traffic.[4] First, it is both true and irrelevant that ISP-bound calls are generally longer than most other calls. To the extent that rate structures are designed to accurately reflect the manner in which costs are incurred (e.g., through separate call set-up charges), call duration should not

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3689, ¶ 29 (1999) ("We acknowledge that, no matter what the payment arrangement, LECs incur a cost when delivering traffic to an ISP that originates on another LEC's network.").

2 See Gerald W. Brock, "Incremental Cost Of Local Usage," March 16, 1995, filed in CC Docket No. 95-185 (describing studies of local usage costs and concluding that 0.2 cents per minute is the average per minute cost of local traffic termination).

3 See, e.g., Proceeding to Examine Reciprocal Compensation, Dkt. No. 21982, 2000 WL 1424921 (Tex. P.U.C. July 14, 2000) (recognizing that the "current volumes of traffic between carriers do not support adoption of the bill-and-keep method"); Reexamine Reciprocal Compensation, Case 99-C-0529, 1999 WL 1020550 (N.Y.P.S.C. Aug. 26, 1999) (rejecting bill-and-keep as not cost-based); ICG Telecom Group, Inc., Case No. 99-1153-TP-ARB, 1999 WL 1489378 (Ohio P.U.C. Dec. 15, 1999) (stating that "there is no question ICG incurs costs when it delivers ISP-bound traffic that has originated from an Ameritech customer" and rejecting a reciprocal compensation rate of zero); On the Commission's Own Motion, to Consider the Total Service Long Run Incremental Costs for All Access, Toll, and Local Exchange Services Provided by Ameritech, Case No. U-11831 (Mich. P.S.C. Nov. 16, 1999) (adopting cost studies that enumerate transport and termination costs above de minimis levels); Petition of Electric Lightwave, Inc. for Arbitration of Interconnection Rates, Terms and Conditions with GTE Northwest Inc., Order No. 99-218 (Or. P.U.C. March 17, 1999) (permitting symmetrical compensation to allow carriers to recoup costs incurred to terminate traffic to ISPs); ITC--DeltaCom Communications, Inc. v. BellSouth Telecomms., Inc., Dkt. P-55, Sub 1197, 2000 WL 1089559 (N.C.U.C. July 12, 2000) (enforcing reciprocal compensation between interconnecting parties for calls that terminate to ISP customers). Regardless of whether the FCC's pricing rules are ultimately upheld as permissible under the Communications Act, the Commission has unquestionably determined that, as a matter of economics, prices above de minimis levels are appropriate for unbundled switching and shared transport. This fact is reflected in sections 51.505-51.515 (establishing pricing rules for unbundled network elements, including switching and shared transport, and establishing interim proxy prices), some provisions of which have been vacated.

4 See Declaration of Don J. Wood, filed with TWTC Reply Comments (corrected version), Aug. 7, 2000, CC Docket Nos. 96-98, 99-68 ("Wood Dec.").

distinguish voice and ISP-bound calls. Wood Dec. ¶¶ 20-21. Second, when a CLEC performs the terminating switching function for delivery of traffic to an ISP that subscribes to ISDN PRI services, it most assuredly incurs traffic sensitive, incremental costs that may be higher than the traffic sensitive, incremental costs that would be incurred if ISDN PRI services were not used. Id. ¶¶ 22-26. Third, to the extent that states have incorrectly included originating switching functions in termination rates, the answer is again to correct the rate structure rather than conclude that termination is costless. Id. ¶ 27. Fourth, the Internet dial-up "busy hour" is in the evening and weekends, and it is likely that this is also the busy hour for CLEC switches that serve ISPs. Id. ¶ 28. In sum, CLECs incur either the same level of costs or a higher level of costs when they transport and terminate ISP-bound calls as LECs incur when they perform these functions for voice calls.

Undaunted by this evidence, the ILECs continue to concoct arguments in support of their position that transport and termination of ISP-bound traffic is essentially costless for CLECs. The most recent iteration of the argument is that, when CLEC switches are not utilized at full capacity, CLECs incur no incremental costs when transporting and terminating traffic. This may in fact accurately characterize the manner in which CLECs incur costs. Busy hour demand (or, more precisely, projections of busy hour demand) drive the investment decision to place a given amount of switching capacity into place. But, as explained in section 3 below, as a practical matter costs associated with the traffic sensitive portions of the switch investment cannot be recovered based on busy hour minutes of use. The telecommunications industry instead uses rate structures based on total minutes. The observation that a CLEC incurs de minimis incremental costs when terminating traffic while the CLEC switch is not at full utilization is therefore irrelevant. If the Commission were to retain an averaged per minute termination charge for all minutes of traffic, but then rule that CLECs cannot charge during off-peak periods, CLECs would not be able to recover their costs. The resulting rate structure would amount to a peak-load pricing scheme (again, a practical impossibility) under which the peak hour price (which in fact would still be the average per minute price) is set below the CLEC's costs. The ILEC argument regarding CLEC costs at times when CLEC switches are not fully utilized therefore leads to absurd and unsustainable results.[5]

But even assuming that peak-load pricing could be adopted as a practical matter, the ILECs would in most cases still be forced to compensate CLECs for transport and termination of ISP-bound traffic. For a CLEC that is terminating large volumes of traffic to an ISP, the ISP-bound traffic will likely drive the busy hour of that CLEC switch. Taken to its logical conclusion, therefore, the ILEC argument illustrates why the existing averaged per minute charges for terminating switching leaves them in essentially the same position in which they would find themselves under a peak-load pricing regime. See discussion infra section 3.

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[5] It should also be noted that the ILEC argument leads to discriminatory treatment of CLECs that are just beginning to build their customer bases. ILECs, of course, already have large customer bases, as a result of their status as former protected monopolists. Their switches generally approach capacity during peak periods. But CLECs often do not have enough traffic to approach capacity even during their busy hours. A pricing regime that allowed recovery of switching costs only when a LEC's switch approaches full capacity would therefore prevent CLECs from recovering any costs during the crucial initial stages of entry. ILECs would, however, be permitted full recovery. Thus, in all events, the relevant time period for peak-load pricing should be a carrier's busy hour (the time when it carries the most traffic), not the time when the carrier's switch approaches full capacity.

2. The Commission Cannot And Should Not Impose Bill And Keep On All Traffic Subject To Section 251(b)(5), Unless Traffic Is Roughly Balanced Between LECs.

The Commission has neither the legal authority nor a policy basis for imposing bill and keep on all traffic subject to Section 251(b)(5), regardless of how imbalanced. Requiring bill and keep in cases of significant traffic imbalances would fly in the face of the language of Section 252(d)(2), which governs the pricing for Section 251(b)(5) traffic, and sound public policy.

The language of Section 252(d)(2) cannot be read to provide the Commission with the authority to mandate bill and keep in cases of significant traffic imbalances. Section 252(d)(2) requires that reciprocal compensation rates allow for the recovery of the "costs associated with the transport and termination on each carrier's network facilities of calls that originate on the network facilities of the other carrier." 47 U.S.C. § 252(d)(2)(A)(i). Such costs shall be determined "on the basis of a reasonable approximation of the additional costs of terminating such calls." Id. § 252(d)(2)(A)(ii). The statute goes on to allow "arrangements that afford the mutual recovery of costs through the offsetting of reciprocal obligations, including arrangements that waive mutual recovery (such as bill-and-keep arrangements)." Id. § 252(d)(2)(B)(i) (emphasis added). These provisions bestow upon all LECs the right to recover the "additional costs" of terminating local calls, and then allow such recovery to be achieved through the offsetting of reciprocal compensation obligations. Of course, arrangements for offsetting reciprocal compensation obligations such as bill and keep do not allow a LEC to recover its costs of termination where the LEC terminates significantly more traffic than it originates.[6] This is precisely what the Commission concluded in the Local Competition Order:

> Section 252(d)(2)(A)(i) provides that to be just and reasonable, reciprocal compensation must "provide for the mutual and reciprocal recovery by each carrier of costs associated with transport and termination." In general, we find that carriers incur costs in terminating traffic that are not *de minimis*, and consequently, bill-and-keep arrangements that lack any provisions for compensation do not provide for recovery of costs.

Local Competition Order ¶ 1112. The Commission explained further that, where LECs pay symmetrical rates for the transport and termination of traffic, and the balance of traffic between two LECs is roughly equal, bill and keep affords adequate cost recovery in compliance with the terms of Section 252(d)(2). Id. ¶¶ 1112-1113. But the statute simply does not permit the imposition of bill and keep where one LEC terminates significantly more traffic than the other LEC.[7]

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6 In the local competition proceeding in 1996, many CLECs did support the adoption of bill and keep. But CLECs did so based on the expectation that traffic between CLECs and ILECs would be roughly in balance. See id. ¶ 1103 (summarizing CLEC comments). Indeed, several CLECs acknowledged that bill and keep could not be defended in the presence of significant traffic imbalances. Id. Thus, as a general matter, the position taken here is consistent with the position adopted by CLECs in 1996.

7 The fact that Congress drafted Section 252(d)(2) to require that LECs be compensated for the costs of transport and termination also demonstrates that it intended to avoid any possible Fifth Amendment takings claims that may arise as a result of mandated bill and keep. See Bell Atl. Tel. Cos. v. FCC, 24 F.3d 1441, 1445-46 (D.C. Cir.

Moreover, establishing a price of zero for the exchange of traffic without regard to traffic imbalances would undermine the competitive purpose of Sections 251-252 and the 1996 Act in general. Sections 251-252 are designed to establish the preconditions for efficient competition. But bill and keep would underprice the transport and termination functions where one LEC terminates much more traffic than it originates. This would create exactly the kind of distortion that overpriced transport and termination has created since 1996. As the Commission recognized in the Local Competition Order, "as long as the cost of terminating traffic is positive [which it most certainly is], bill-and-keep arrangements are not economically efficient because they distort carriers' incentives, encouraging them to overuse competing carriers' termination facilities by seeking customers that primarily originate traffic." Local Competition Order ¶ 1112. Indeed, in advocating the adoption of bill and keep for ISP-bound traffic, it appears that the ILECs have learned nothing from the last four years. The ILECs, of course, initially convinced state commissions to set reciprocal compensation rates above cost in the hope of raising CLEC costs. Many CLECs responded by serving ISPs. Now the ILEC advocacy has swung all the way in the other direction in the hope that bill and keep will prevent even efficient CLECs from serving ISPs. But an inefficiently low price for termination will encourage overconsumption of originating services. Such inefficient incentives will only be eliminated if reciprocal compensation rates are set based on the cost of transport and termination.

In any event, this is the wrong proceeding to address bill and keep for the exchange of any traffic. The Commission has indicated that it intends to issue a Notice of Inquiry to address comprehensively the issue of inter-carrier compensation, including apparently whether bill and keep should be applied to all forms of inter-carrier telecommunications traffic. Without taking any position on the merits of a broad application of bill and keep to inter-carrier compensation, TWTC urges the Commission not to pre-judge the outcome of a broader proceeding by selectively applying bill and keep only to local traffic at this time. If, after full notice and public comment, the Commission believes that bill and keep is appropriate and legally permissible for inter-carrier compensation, it should implement it simultaneously and uniformly across all forms of inter-carrier traffic. In no event should the Commission adopt bill and keep for only one form of traffic.

3. There Is No Basis For Adopting Capacity-Based Or Peak-Load Pricing For Reciprocal Compensation.

The existing average per minute charges used to recover the variable costs of transporting and terminating Section 251(b)(5) traffic, although imperfect, do not need to be fundamentally changed to address their imperfections. To be sure, there may well be rate structure changes that can and should be made to make the current regime more efficient. For example, as mentioned, it may make sense to require that call set-up costs be recovered in the form of flat per call charges, rather than through per minute charges. Indeed, the states are making this change to reciprocal compensation prices.[8] But there is no basis for requiring recovery of usage-sensitive costs through capacity-based charges or for

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1994) (the FCC may not construe the Communications Act in a way that gives rise to takings claims unless the language of the Act includes a "clear warrant" for such a construction or unless the agency's ability to implement the statutory provision would be rendered a nullity absent a construction that would create takings claims).

[8] See, e.g., Proceeding to Examine Reciprocal Compensation, Dkt. No. 21982, 2000 WL 1424921, at *25 (Tex. P.U.C. July 14, 2000) (establishing a separate per call charge for end office call set-up).

adopting any form of peak-load pricing in this proceeding. Any new rate structure will increase the level of uncertainty in the market, a cost the Commission must seriously consider when weighing the costs and benefits of regulation. In addition, capacity-based and peak-load pricing both suffer from distinct and serious problems that counsel against their adoption at this time.

A capacity-based rate structure (e.g., per DS1 circuit equivalent of usage) offers few benefits and potentially significant costs. Such a structure would have little effect on the price paid for transport and termination because, as under current charges, the total forward-looking incremental cost of transport and termination would still be recovered. The only difference is that the total cost would be divided on a circuit-by-circuit basis (or some other capacity measure), rather than on a per minute basis. Moreover, it is hard to see why the pricing signals under a capacity-based rate structure would be any more accurate than under a per minute rate structure. Even where ISPs subscribe to ISDN PRI service, which gives the subscriber priority treatment in the allocation of switching capacity, the switching capacity used for this service is unquestionably shared, and its use for termination unquestionably causes CLECs to incur incremental, traffic-sensitive costs. See Wood Dec. ¶ 24. Per minute charges would appear to capture such costs just as accurately, or more so, than capacity-based charges. Thus, it does not appear that mandating capacity-based charges would increase efficiency in any way, or produce any other identifiable benefit. Instead, it would probably do some harm, since implementing such a proposal would require state commissions and carriers to incur the substantial cost of developing capacity-based charges.

Nor should the Commission require that reciprocal compensation rates be based on peak-load demand. To convey fully optimal pricing signals, peak-load pricing must vary by a number of factors, such as time of day, day of the week, and location. Implementation of such a detailed pricing structure is impractical. For different reasons, so-called "simple" peak-load pricing (which typically establishes two prices -- one for peak and one for off-peak), while perhaps easier to implement, is also undesirable because it fails to send optimal pricing signals. Given these problems, it is not surprising that the Commission has repeatedly refused to require peak-load pricing for network elements. For the same reasons, peak-load pricing is not suited to ISP-bound traffic and should be rejected.[9]

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[9] The following analysis draws extensively from a discussion of peak-load pricing contained within a paper by Drs. Steven R. Brenner and Bridger M. Mitchell, entitled "Economic Issues in the Choice of Compensation Arrangements for Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers," that was attached as an exhibit to the Comments of the Cellular Telecommunications Industry Association filed in Interconnection Between Local Exchange Carriers and CMRS Providers, CC Dkt. No. 95-185 (filed March 4, 1996) ("CMRS Paper"). Within the context of interconnection compensation arrangements between LEC-CMRS providers, Drs. Brenner and Mitchell examined the advantages and disadvantages of adopting usage sensitive prices versus bill and keep, but were unable to definitively conclude that one arrangement was clearly superior. See id. at 49. Nonetheless, even if they had concluded that bill and keep was superior to usage sensitive pricing for LEC-CMRS interconnection (which they did not), it should be noted that at least two facts distinguish LEC-CLEC interconnection. First, unlike LEC-CMRS interconnection, in which each provider faces different fixed and variable costs for terminating traffic, interconnecting wireline carriers face similar costs. Second, with costs being roughly the same, the only other factor to consider is the balance in the amount of traffic delivered to each provider during its busy or "peak" hour. Because CLEC peak hours for terminating ISP-bound traffic coincide with CLEC peak hours generally, the substantial imbalances between LEC-CLEC termination of

True peak-load pricing, while theoretically optimal, cannot be implemented as a practical matter at this time. Patterns of telephone usage vary by a number of factors, including by time (e.g., from hour to hour, by day of the week, and time of the year), by location (e.g., from business to residential areas), and by type of service (e.g., voice, data). See CMRS Paper at 33-34 & n.34. Yet, setting theoretically optimal prices at this level of detail (i.e., from hour to hour, by serving wire center, and by type of service) is not feasible. Id. at 33. Not only is it "difficult and costly to collect the detailed demand information necessary to calculate such prices, [but] demand may [also] be constantly shifting and [thus] require frequent changes in peak pricing periods." Id. Additional issues arise from a billing perspective because "it is costly to collect charges based on such prices" and "consumers likely would find it difficult to deal with such complicated pricing structures (assuming they were reflected in retail pricing)." Id. at 33-34. Further, "[v]arying prices would be unlikely to have the desired effect on consumer calling, even if implemented, because consumers are unlikely to understand and know the varying prices of calling at various times." Id. at 34.

Simple peak-load pricing suffers from different, but equally fatal, problems. As noted, simple peak-load pricing studies typically assume a uniform, higher demand "peak" period and a uniform, lower demand "off-peak" period, making it optimal to set only two price levels. Id. at 33. Setting only two (or even three) prices, however, does not send fully optimal price signals. Id. at 33-34. Specifically, because there are generally only two pricing periods, simple "[p]eak period prices may be right 'on average' over the period, but will be too low for some traffic, too high for most of the rest of the traffic, and just right only by accident." Id. at 35. As a result, the benefits of simple peak-load pricing (which are minimal when compared to uniform, per minute pricing) are likely outweighed by the increased costs of implementing such a compensation arrangement.

Based on similar concerns, the Commission has considered and rejected peak-load pricing for unbundled network elements, including local switching and tandem-switched and common transport. See Access Charge Reform, Fifth Report and Order, 14 FCC Rcd 14221, ¶ 211 (1999) (finding no reason to revisit its conclusion that peak-load pricing was inappropriate for local switching); Access Charge Reform, First Report and Order, 12 FCC Rcd 15982, ¶¶ 148, 194 (1997) ("Access Charge First Report and Order") (rejecting peak-load pricing for local switching, tandem-switched and common transport); Local Competition Order ¶¶ 755-757.[10] The Commission has described in detail the practical problems associated with peak-load pricing:

> For example, different parts of a given provider's network may experience peak traffic volumes at different times (e.g., business districts may experience their peak period between 10:00 and 11:00 a.m., while suburban areas may have their peak periods between 7:00 and 8:00 p.m.). Moreover, peak periods may change over time. For

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ISP-bound traffic underscore that CLECs will incur termination costs that will not be compensated under bill and keep.

[10] While the Commission has previously recognized that peak-load pricing might better reflect the costs of providing traffic-sensitive services, even in that instance, it refused to require carriers to develop peak-sensitive access charge rate structures because of the potential difficulties in doing so. See Access Charge Reform, 11 FCC Rcd 21354, ¶ 78 n.141 (1997) (citation omitted).

> instance, growth in Internet usage may create new peak periods in the late evening. Further, charging different prices for calls made during different parts of the day may cause some customers to shift their calling to the less expensive time periods, which could shift the peak or create new peaks. Thus, to design an efficient peak-sensitive pricing system requires detailed knowledge of both the structure of costs as well as demand.

Local Competition Order ¶ 756. As a result, the Commission "conclude[d] that the practical problems associated with peak-sensitive pricing make it inappropriate for us to require states to impose such a rate structure for unbundled local switching or other shared facilities whose costs vary with capacity." Id. ¶ 757.

Nothing in the record in this proceeding indicates that the practical difficulties of peak-load pricing are somehow lessened for LEC-CLEC exchange of local traffic. This is not to say that average per minute prices send optimal price signals. But the cost of achieving optimal pricing signals far outweighs the costs associated with the current rate structure. Given its theoretical advantages, it may make sense for the Commission to revisit peak-load pricing in the context of its planned comprehensive inter-carrier compensation proceeding. It should not, however, hold up this proceeding while it attempts to design a complex pricing scheme to account for peak-load usage.

4. An Originating LEC Does Avoid Costs When Another LEC Terminates ISP-Bound Traffic.

When calls, including ISP-bound calls, originate on one LEC's network and terminate on another LEC's network, the originating LEC avoids the forward looking cost of transport and termination. ILECs have argued that delivering ISP-bound calls to CLECs causes ILECs to incur extra costs associated with tandem switching and transport, and that this fact justifies bill and keep for ISP-bound traffic. This argument is easily rejected. CLECs and ILECs exchange all local traffic, ISP-bound included, over the same interconnection facilities. There is no basis, therefore, for treating ISP-bound calls differently because of ILEC origination costs.

More fundamentally, there is no basis for concluding that the ILECs fail to avoid costs when calls, including but not limited to calls bound for ISPs, are terminated by a CLEC. The ILEC arguments in support of such failure rely on two factual assumptions, both incorrect. First, the ILECs assume that a meaningful percentage of the calls delivered to ISPs would, if they had remained on the ILEC network, have been completed as intra-office calls. If this were true, the ILEC would not have incurred a separate cost for terminating switching, and therefore would not avoid such a cost when the function is performed by a CLEC. In reality, there has been no demonstration that such intra-office calls occur between ISP subscribers and ISPs with any frequency. Indeed, there is some indication that the ILECs themselves do not even know the percentage of traffic that originates and terminates among

end users served by the same end office.[11] Nor is there any reason to assume that an ISP's customers reside within close physical proximity to the physical location of the ISP's terminating equipment.

Second, the ILECs argue that, because a CLEC sometimes establishes its point of interconnection ("POI") at the location of the ILEC tandem, the ILEC incurs more transport costs to deliver an ISP-bound call to the CLEC than it would have incurred if the call had stayed on the ILEC network. Because transport costs have some mileage sensitivity, an increase in the required transport distance – if such an increase were required – could serve to create additional costs for that ILEC that are not avoidable when the CLEC performs the function of call termination. In support of this argument, the ILECs argue (correctly) that interoffice traffic that remains on their networks may travel over direct trunks between end offices (so-called 5-5 trunks). They then imply (incorrectly) that the mileage associated with such trunking is likely to be less than the mileage associated with carrying the call to the CLEC POI near the ILEC tandem. This argument overlooks the fact that the direct trunking facilities between ILEC end offices do not simply travel "cross country" along a straight-line path from one end office to the other, but invariably travel along existing trunking routes that pass through the locations of the ILEC tandems. As a result, the ILECs have the same or greater number of transport miles, and incur the same or greater transport mileage costs, for a call that remains on their network versus a call that is delivered to, and terminated by, a CLEC. When the underlying facts are considered, therefore, it is clear that an ILEC avoids switching and transport costs when the functions of call termination are performed for it by a CLEC. Cost-based rates for reciprocal compensation will leave the ILEC in a comparable, if not slightly improved, position than it would have faced if the call had remained on its network.

It has also been suggested that an originating LEC does not avoid costs where another LEC terminates traffic during the originating LEC's off-peak periods. Such an argument is based on the demonstrably false premise that peak periods occur at consistent times throughout ILEC and CLEC networks. An ILEC may not avoid originating switching costs during off-peak periods for the switch serving the originating customer, because there are no incremental originating costs to avoid. It may nevertheless avoid terminating switching costs (those relevant to reciprocal compensation), however, because the switch that would have been utilized by the ILEC to terminate the call (in the absence of the CLEC doing so) may be experiencing its busy hour. There is absolutely no reason to assume that the busy hour for the ILEC originating switch is the same as the busy hour for either (1) the switch that the ILEC would use to terminate the call, or (2) the switch that the CLEC would use to terminate the call. Because different switches experience different busy hours, any attempt to develop a reciprocal compensation structure based on peak usage falls victim to the problems described in section 3 above.

Furthermore, it is worth repeating the point made numerous times by TWTC and other firms that are attempting to provide local service to ISPs: the ILECs' true complaint regarding Internet traffic has nothing to do with reciprocal compensation or CLECs. Internet traffic is certainly growing, and carrying that traffic unquestionably imposes costs on LECs. But so long as reciprocal compensation charges are based on the forward-looking cost of transport and termination, and they

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[11] See Testimony of Richard Scholl on behalf of Pacific Bell, California PUC Rulemaking 00-02-005, T.E. p. 1041 (Aug. 18, 2000) (conceding that Pacific Bell does not have this information).

increasingly are,[12] an ILEC is in precisely the same financial position if it transports and terminates ISP-bound traffic itself or pays a CLEC to perform this function. To the extent that the ILECs experience a shortfall as a result of carrying ISP-bound traffic (and, as explained below, there is no basis for concluding that they do), it is because their originating charges, paid by local subscribers, are set below cost. In any event, this is an issue that the ILECs need to bring to state regulators, not the FCC.[13] The only question for the FCC in this proceeding is how to ensure that the rate for the exchange of local traffic does not harm competition for serving ISPs. The only solution is a cost-based reciprocal compensation price.

But even if the Commission were to consider the question of whether ILECs experience a revenue shortfall as a result of underpriced originating charges, it would probably find that the ILECs do not experience a shortfall now and are unlikely to experience one in the future. To begin with, ILEC revenue from the sale of second lines used for dial-up ISP connections (revenue which is likely close to 100% profit, given that the cost of most ILEC second lines has been recovered long ago) in most cases more than compensates for the costs of originating ISP-bound traffic. To the extent this is not true, states have generally averaged local rates across large geographic areas and built subsidies into vertical feature prices such that ILECs are almost invariably made whole. In fact, since the growth of the Internet began in earnest about three years ago, the ILECs have not shown that they have experienced any net negative financial effects.[14] As to the future, dial-up connections are likely to gradually be replaced by dedicated, high-speed connections such as xDSL. The ILECs are

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12 The states are systematically lowering reciprocal compensation rates to a level that approximates forward-looking costs. See, e.g., Petition of Pacific Bell for Arbitration of an Interconnection Agreement with MFS/WorldCom Pursuant to Section 252(b) of the Telecomms. Act, 2000 WL 1022238, Order Modifying Decision 99-09-069 (Cal. P.U.C. May 18, 2000) (reducing the end office rate from $.0075 to $.002 per minute); Proceeding on Motion of the Commission to Reexamine Reciprocal Compensation, Case No. 99-C-0529, Opinion No. 99-10, 1999 WL 1020550 (N.Y.P.S.C. Aug. 26, 1999) (establishing a rebuttable presumption that, where traffic imbalances exceed 3:1, terminating LECs may not charge the tandem switching rate); Proceeding to Examine Reciprocal Compensation, Dkt. No. 21982, 2000 WL 1424921 (Tex. P.U.C. July 14, 2000) (reducing the per minute end office rate from $0.001507 to $0.0010423).

13 Access Charge First Report and Order ¶ 346 ("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.").

14 For example, SBC's market capitalization has steadily risen from $73 billion in 1997, SBC to Buy Ameritech for $71 Bln in Stock, Debt, Bloomberg News (May 11, 1998), to $178.6 billion in 1999, Statistics at a Glance -- NYSE:SBC (Oct. 18, 2000) <http://biz.yahoo.com/p/s/sbc.html>. BellSouth's market capitalization rose from $74 billion in 1998, Sector Spider Trust SEC filing, EDGARPlus (Dec. 21, 1998), to $78.4 billion in 2000, Statistics at a Glance -- NYSE:BLS (Oct. 18, 2000) <http://biz.yahoo.com/p/b/bls.html>. Verizon's market capitalization grew from $75 billion in 1998, Sector Spider Trust SEC filing, EDGARPlus (Dec. 21, 1998), to $131 billion in 2000, Statistics at a Glance -- NYSE:VZ (Oct. 18, 2000) <http://biz.yahoo.com/p/v/vz.html>. Of course, these increases in market capitalization are due in part to acquisitions and growth in lines of business other than local service (e.g., wireless). However, major acquisitions and growth in wireless services have not prevented other major telecommunications service providers, most notably AT&T, from experiencing severe market valuation discounts.

aggressively marketing such services, and they have projected vast profits from their sale.[15] Indeed, the ILECs' profit margins in the provision of these services will no doubt benefit from the fact that non-ILEC xDSL service providers (such as Northpoint and Covad) are quickly disappearing from the competitive market.[16] Thus, the revenues ILECs receive now and will receive in the near future for originating ISP-bound traffic are significant and likely compensatory. In no event can the Commission conclude based on the facts on the record in this proceeding that the ILECs experience a revenue shortfall on the originating side.

5. Conclusion

The discussion in the preceding sections makes clear that all LECs, including CLECs, incur costs that are more than de minimis when transporting and terminating traffic and that the terms of Section 252(d)(2) mandate that these costs be recovered through cost-based reciprocal compensation charges. It is also imprudent at this time to attempt to mandate that these charges be set using either a capacity-based or peak-load pricing approach. In both cases, the costs of implementing such new rate structures, not the least of which is the further uncertainty the industry would experience during the transition to a new rate structure, far outweigh any theoretical benefit they may (or may not) deliver. Furthermore, the Commission should reject the ILECs' specious claim that they do not avoid costs when CLECs perform transport and termination of calls originating on ILEC networks. The Commission should, indeed must, therefore rule that the exchange of ISP-bound traffic is subject to the existing state-set prices for reciprocal compensation. Any other result would be unlawful and would create new inefficient incentives for CLECs and ILECs alike.

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15 See US West Investor Relations <http://www.qwest.com/about/ir/index.html> (March 3, 2000) (noting that US West was the only "RBOC to reach the milestone we set [in] early 1999 by delivering our high-speed data product, Megabit, to more than 110,000 customers"); SBC Communications, Inc., 1999 Annual Report at 2-3 (2000) (announcing that SBC invested $6 billion in building broadband networks to capitalize on the Internet's growth and that its Internet strategy "is targeted to generate more than $3.5 billion in new annual revenues"); BellSouth Investor Relations 3Q00 Earnings Commentary (visited Oct. 19, 2000) <http://www.bellsouth.com/investor/3q00comentaryh.shtml> (claiming that a key aspect of the 25.3% "record growth rate" in data-related revenues was "an 81% growth in DSL customers" and projecting a total of 200,000 DSL customers by the end of 2000); Verizon Communications Sets Financial Targets (Aug. 8, 2000) <http://newscenter.verizon.com/proactive/newsroom/release.vtml?id=41688> (stating that "the acquisition of OnePoint and the combination of DSL assets with Northpoint will increase long-term growth").

Of course, such dedicated services also eliminate reciprocal compensation, because they establish dedicated connections between ISP subscribers and ISPs.

16 Verizon purchased Northpoint, merging the two companies' DSL businesses to create "a strong broadband competitor ideally positioned to unleash the Internet's full potential for delivering an unlimited array of content and applications to high-speed customers." See Verizon and Northpoint to Merge DSL Businesses to Create Leading National Broadband Company (Aug. 8, 2000) <http://newscenter.verizon.com/proactive/newsroom/release.vtml?id=41668>. SBC has agreed to invest $50 million in Covad and will begin marketing Covad's DSL service in and out of its service territory. See Covad, SBC Sign Deal for $750 Million and Settle Litigation, Communications Daily (Sept. 12, 2000) (noting that "SBC is acquiring 6% of Covad for $150 million pending regulatory approval").

Pursuant to Section 1.1206(b)(1) of the Commission's rules, 47 C.F.R. § 1.1206(b)(1), an original and one copy of this letter are being provided for inclusion in the public version of the above-referenced proceeding.

Sincerely,

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Don Wood
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cc: Tamara Preiss
Rodney McDonald
Adam Candeub