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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

November 29, 2000

Ms. Magalie Roman Salas
Federal Communications Commission
445 12th Street, SW, Room TW-A325
Washington, DC 20554

Re: Ex Parte in CC Docket Nos. 99-68

Dear Ms. Salas:

This is to give notice that today I sent the attached written ex parte to Dorothy Attwood, Chief of the Common Carrier Bureau. In accordance with Section 1.1206(b)(1), I am filing two copies of this notice in the docket identified above.

If you or your staff has any questions about any of the data referenced above, please do not hesitate to call me.

Sincerely,

Robert T. Blau

Robert T. Blau
Vice President
Executive and Federal Regulatory Affairs

Attachment

cc: Dorothy Attwood

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November 29, 2000

Ms. Dorothy Attwood
Chief
Common Carrier Bureau
Federal Communications Commission
445 12th Street, SW, 5th Floor
Washington, D.C. 20554

Re: Ex Parte Presentation, CC Docket 99-68
Inter-Carrier Compensation for ISP-Bound Traffic

Dear Ms. Attwood:

Several parties have argued that the Commission should allow for a transition period prior to the full implementation of a bill and keep regime of reciprocal compensation. The ILECs do not believe that any additional transition period is necessary. After all, the CLECs have been on notice for at least two years (since the Commission's xDSL tariffing order in October 1998) that reciprocal compensation for ISP-bound traffic might be eliminated. Moreover, Wall Street no longer gives any credence to CLEC reciprocal compensation revenues; it has already assumed that these revenues will disappear. As one analyst recently explained, "nearly everyone now understands that the structure of reciprocal compensation simply represents a wealth transfer from the RBOC to the CLEC and that it cannot last." Gregory P. Miller, ING Barings, "Reciprocal Compensation – The End of Another Arbitrage (part 1 of 2) (Sept. 14, 2000). Under the circumstances, it is time – indeed, long past time – for the Commission to implement a bill and keep system for Internet-bound and other imbalanced traffic.

Nevertheless, in the interest of compromise, the incumbent LECs do not oppose a reasonable (e.g. one year) transition to bill and keep. The purpose of this transition should be to ramp down reciprocal compensation payments before eliminating them altogether. The best vehicle for achieving this goal is a cap mechanism that would prevent CLECs from recovering reciprocal compensation when they disproportionately receive traffic relative to the amount they are sending back to the ILEC. Such traffic concentrations suggest carriers whose businesses focus more on the collection of reciprocal compensation than on offering competitive services. Moreover, as the ILECs have previously demonstrated, these carriers of concentrated traffic have unique opportunity to reduce their costs, thereby making a transition away from reciprocal compensation unnecessary.

State Commissions that have looked at the issue have found imbalance levels of two or three to one as the appropriate benchmark. For example the Massachusetts Commission has held that to separate-out Internet-bound traffic, a "2:1 ratio as a proxy is generous to the point of likely including some ISP-bound traffic." *WorldCom v. New England Telephone*, Massachusetts DTE 97-116-C at 28 (rel. May 19, 1999). The New York Commission has ruled that once a ratio reaches 3:1, "the inference of predominantly convergent traffic becomes stronger," which in turn implies "greater efficiency and lower costs in the termination of traffic." New York Public Service Commission Case 99-C-0529, Opinion No. 99-10 at 59 (rel. Aug. 26, 1999). Similarly, the Texas Commission has recognized that carriers with traffic imbalances of greater than 3:1 are "predominately convergent traffic." *Proceeding To Examine Reciprocal Compensation*, Public Utilities Commission of Texas, Docket No. 21982, Arbitration Award at 36 (July, 2000).

Wall Street analysis released just this week demonstrates that it would take a cap in the range of two or three to one to create the necessary ramp-down to bill and keep. According to the attached analysis, a cap of 2:1 would reduce CLEC reciprocal compensation revenues by two thirds (66%). D Ernst, Legg Mason, "FCC Expected To Set Zero Price Target for Reciprocal Compensation" (Nov. 27, 2000) ("*Legg Mason Report*"). At a 3:1 level the revenues would be roughly cut in half (52%), and at 4:1 the cut would only be 38%. *Id.* Because of the high growth in Internet minutes, higher caps would be not be sufficient to significantly reduce the flow of reciprocal compensation dollars.

Moreover, a transition cap of two to one would not impact the many CLECs that offer a variety of competitive services. As Legg Mason explained, "[c]ompetitive carriers that serve enterprises versus Internet Service Providers or other specialized in-bound call centers would benefit from the bill & keep system." *Legg Mason Report*. None of the CLECs covered by Legg Mason for financial review would be adversely impacted by a 2:1 cap, and others including Net2000, Teligent, Winstar, XO Communications would benefit from reduced costs. *Id.*

In developing a reasonable plan that truly transitions to bill and keep, the Commission should be guided by some fundamental principles. The undersigned would suggest the following.

- The purpose of the transition period is to ramp down reciprocal compensation payments towards zero over a relatively brief period of time. Hence, reciprocal compensation payments should be reduced at the outset of the transition and then move to zero thereafter.

- State decisions that have already started the transition to a bill and keep environment should be respected and not undermined by the transition period.

- The transition mechanisms should not enable further gaming of the rules by parties wishing to maximize reciprocal compensation payments for internet traffic.

In particular, the Commission should make clear that carriers may not use the period intended to transition *away* from reciprocal compensation to *increase* their reciprocal compensation revenues. In those states where reciprocal compensation has already been eliminated, there is no need for a transition to bill and keep. Similarly, where states have established reciprocal compensation limitations that are more stringent than the Commission's transition rules, the local state rules should govern. The intent of these requirements is to avoid the incongruous policy of imposing a federal transition to bill and keep that actually allows a carrier to increase its reciprocal compensation claims in a given state.

Similarly, carriers whose traffic imbalances increase after the date of the Commission's order should not be allowed to increase their reciprocal compensation billings. In addition to its generic caps, individual carrier's traffic imbalance should be capped at the level of their imbalance levels in the year prior to the order. This will prevent carriers from either trading ISP customers to increase reciprocal compensation for carriers with "room under the cap" or contracting with "below the cap" CLECs to port ISP telephone numbers so the traffic can be routed through another CLEC before being passed off to the ISP.

Finally, while there is no expectation that the Commission would abridge contracts that are still within their agreed term and have no change of law provision that would allow new FCC rules to govern, the Commission should impose its rules in place of new contracts or expired or expiring contracts with "evergreen" clauses. This means that the Commission should not allow CLECs to opt into other carriers existing contracts under section 252(i) of the Act. Even if that provision applied to reciprocal compensation payments, which it does not, section 51.809(c) of the Commission's rules requires ILECs to allow adoption of interconnection provisions for a "reasonable period of time after the approved agreement is available for public inspection." It would not be reasonable to allow that period to extend beyond the date of a Commission order announcing a transition to bill and keep.

Sincerely,

Robert T Blau

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cc: *Jane Jackson*
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Adam Chaneub
Rodney McDonald
Rebecca Beynon
Kyle Dixon
Anna Gomez
Jordan Goldstein
Deena Shetler

Attachment

<u>**ATTACHMENT A**</u>

Biller Keeps All; FCC Expected to Set Zero Price Target for Reciprocal Comp

09:34am EST 27-Nov-00 Legg Mason (Daniel Ernst (202) 778-4346) COVD CPTL NASC

* Next month, the FCC is expected to adopt rules that would eliminate all inter-carrier payments for local interconnection within two years. The rules are likely to be adopted in two stages whereby for two years interconnection fees are capped, after which time the fees would be eliminated all together. The rules, if enacted, could eliminate $1.4 billion in CLEC and IXC revenue in 2001 and could also save non-ILEC wireless carriers $1 billion in 2001.

* Bill and Keep. After two years of controversy and litigation, the FCC is expected to rule on the issue of reciprocal compensation in December. While it is possible the FCC could release the order at its next open meeting on December 7, we believe that it is more likely the order will be released under circulation later in the month. While the most often cited controversy deals with calls placed to Internet Service Providers (ISPs), the FCC is expected to adopt rules that impact all calls other than long-distance voice traffic. The payment scheme, which effectively sets interconnection rates at $0.00, is referred to as "bill and keep" since carriers keep all the local revenue generated by their customers.

* Expect a Lack of Clarity. While we believe that the bill & keep endpoint will be clearly articulated by the expected ruling, the timing and details of implementation will not be. At issue will be when to start implementing, the length of the interim period, the form of interim period pricing, and the scope of calls covered under the ruling (e.g. local to local, local to ISP, wireless to local). Further, given the current political uncertainty, the ruling itself could be delayed.

* Reciprocal Compensation Potentially Cut by 66% in 2001. If the FCC adopts a cap system during the interim period, reciprocal compensation revenues could be cut by 66% in 2001, from an estimated $2 billion to $685 million. Carriers with a high degree of reciprocal compensation would experience a greater impact versus a straight reduction in rates. Long-distance carriers with CLEC operations would experience the largest dollar reduction in revenues - an estimated $1 billion.

* Enterprise-Focused CLECs Could Benefit. Competitive carriers that serve enterprises versus Internet Service Providers or other specialized in-bound call centers would benefit from the bill & keep system. Currently, CLECs must pay ILECs a fee when calls made by CLEC customers terminate locally at the premise of an ILEC customer. We estimate that CLECs will pay more than $500 million in recip-comp fees during 2000, these fees would eventually be eliminated.

* Non-ILEC Cellular & PCS Providers May Save $1 Billion. Cellular and PCS providers not associated with an ILEC will pay an estimated $2.6 billion in reciprocal compensation fees to ILEC for transferring calls between wireless networks and local land-line networks. Either in conjunction with this ruling or under a separate proceeding, wireless interconnection fees would also be impacted - potentially saving non-ILEC wireless providers $1 billion in 2001 under the cap system.

* Slight Positive to Coverage Group. We believe that the companies that we currently cover have local traffic in-flow within the 2:1 cap, and therefore would not be adversely impacted by the ruling in any scenario. Further, we believe that Net 2000 (NTKK: SB/4, $2 15/32), Teligent (TGNT: B/4, $4 1/64), Winstar (WCII: SB/4, $19), and XO Communications (XOXO: SB/3. $16 15/16) are net payers of reciprocal compensation fees and could experience cost reductions that amount to nearly 2% of revenue with the full implementation of bill & keep. DSL providers, as they do not carry local voice traffic, including Covad Communications (COVD: B/4, $2 7/8) and Network Access Solutions (NASC: M/4, $1 17/32), would not be impacted by the ruling.

IMPACT SUMMARY:

Next month, the FCC is expected to adopt rules that would eliminate all intercarrier payments for local interconnection within two years. The rules are likely to be adopted in two stages whereby for two years interconnection fees are capped, after which time the fees would be eliminated all together. The rules, if enacted, could eliminate $1.4 billion in CLEC and IXC revenue in 2001 and could also save non-ILEC wireless carriers $1 billion in 2001. We note that the CLEC operations of IXCs account for 70% of the total reciprocal compensation revenue base.

Table 1. Impact on Competitive Carriers

	2001 Current Estimates			2001E With 2:1 Cap			
	Rev $mil	Recip-Comp Rev $mil	Recip Comp Pmts $mil	Recip-Comp Rev $mil	Recip Comp Pmts $mil	EBITDA Change $mil	% Change of Rev
COVD	500	-	-	-	-	-	0.0%
CPTL	367	-	-	-	-	-	0.0%
NASC	82	-	-	-	-	-	0.0%
NTKK	190	3.2	7.2	3.2	3.6	3.6	1.9%
TGNT	391	1.7	3.7	1.7	1.8	1.8	0.5%
WCII	1,040	4.4	9.8	4.4	4.9	4.9	0.5%
XOXO	1,436	16.1	35.7	16.1	17.9	17.9	1.2%
Other CLECs	9,965	726.8	51.5	235.3	25.7	(466)	-4.7%
IXC/CLECs	55,458	1,291	415.9	430.4	208.0	(653)	-1.2%
Total	69,428	2,043	523.8	691.1	261.9	(1,090)	-1.6%

Source: Company data and Legg Mason estimates

Our analysis of reciprocal compensation reductions expected in 2001 is based upon the assumption that the FCC will adopt a 2:1 cap (terminating traffic to originating traffic) allowed for reciprocal compensation payments. Under this scenario, carriers would only be compensated for terminating calls up to the 2:1 cap - all terminations above this cap would be provided free of charge. Under a 3:1 cap, reciprocal compensation revenues to CLECs would be reduced by 52% and under a 4:1 cap, 38%. If the ruling goes into effect later than January 2001, then the potential impact would be reduced accordingly.

Table 2. Impact Analysis Under Alternative Ratio Cap

Ratio Cap	2:1	3:1	4:1
Recip-Comp Revenue Decrease	66%	52%	38%

Source: Legg Mason estimates

BACKGROUND

Interconnection. Interconnection refers to the process by which competing carriers transfer traffic from one network to the other. Without interconnection, subscribers of competitive networks would exist on an island, able to communicate among themselves but unable to communicate with any other telecommunications users. The 1996 Act requires that telecommunications carriers interconnect with every other carrier - competitors and incumbents alike.

Reciprocal Compensation. The Act specified that the rate one carrier charges another carrier be "just and reasonable" and be provided on the same terms to all carriers. Further, the Act requires incumbents to establish reciprocal compensation with competing carriers - that is, ILECs must pay CLECs when calls are terminated on the competitor's network, just as CLECs must pay ILECs when calls terminate on the incumbent network.

Bill & Keep. The payment scheme, which effectively sets interconnection rates at $0.00, is referred to as "bill and keep" since carriers keep all the local revenue generated by their customers. In a perfectly competitive market, bill & keep is the effective result since carriers would terminate as much traffic as they originate, and would therefore pay termination fees exactly equal to the termination fees they collect. Bill & keep was considered during the drafting of the 1996 Telecommunications Act, but was not adopted since incumbents believed they would have an undue burden of terminating more calls placed by competitors than the incumbents terminated on competitive networks. Bill & keep is essentially the same system that Tier-1 Internet backbone providers use to exchange traffic in their peering arrangements.

Litigation - Supreme Court Affirms FCC Jurisdiction. The FCC's original interconnection order, released in early 1997, attempted to set a national framework for interconnection principals and rates. However, contention over the compensation of calls placed to the Internet led to a July 1997 ruling by the 8th Circuit Court of Appeals that effectively stayed the FCC's rules regarding interconnection. Without the Federal guidelines represented by the FCC's order, CLECs were forced to negotiate each agreement in every state on a wide range of regulatory platforms. This period of uncertainty and contention was largely laid to rest in January 1999, when the Supreme Court overturned the 8th Circuit decision and upheld the FCC's claim of jurisdiction over the pricing and terms of interconnection. However, the Supreme Court ruling effectively left the issue of ISP traffic unresolved. Nevertheless, the High Court affirmation that the FCC does hold jurisdiction regarding interconnection will play a critical role in adoption of the FCC's expected bill & keep order. Without that jurisdiction, litigants could argue the FCC's order should not override current state laws that mandate reciprocal compensation payments.

The ISP Factor - Additional Litigation. In order to avoid paying CLECs for interconnection fees involving ISPs, incumbents have claimed that such calls are not local calls at all ? since they ultimately go the Internet ? and, therefore, are not subject to the rules of local interconnection/reciprocal compensation. In order to maintain its jurisdiction over this issue, the FCC ruled in February 1999, that such calls were "interstate" in nature, which also meant, in principle, the calls were not subject to interconnection/ reciprocal compensation. However, pending further study, the FCC left the issue to the states. To date, 26 states that have reviewed the issue have ruled that incumbents are required to compensate CLECs for calls placed to ISPs. In March 2000, the DC Circuit Court of Appeals overturned the FCC's finding that calls to ISPs are 'interstate' in nature and required the FCC to rethink its decision. As a result, CLECs with existing interconnection agreements will be entitled to compensation for calls made to ISPs until the FCC resolves the issue.