

ORIGINAL

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December 11, 2000

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**FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, DC 20554**

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

Re: Ex Parte in CC Docket No. 99-68

Dear Ms. Salas:

This is to give notice that Melissa Newman, John Kure and Robert McKenna, all of Qwest, and the undersigned met with Jordan Goldstein, Legal Advisor for Commissioner Susan Ness, on December 8, 2000 to discuss reciprocal compensation. We reviewed potential growth in reciprocal compensation payments for dial up Internet access minutes given growth in Internet subscriptions and usage per household. We also discussed the merits of the Commission adopting a brief and orderly transition to a "bill and keep" inter-carrier compensation arrangement for one-way dial up Internet traffic; the level and nature of limitations that would be placed on annual reciprocal compensation payments during the transition; and the Commission's statutory authority in this area.

We reviewed excerpts from various securities analysts' reports that have addressed reciprocal compensation and the possible effects that an FCC decision to establish an orderly transition to "bill and keep" might have on the valuation of CLEC stocks. I explained that many if not most analysts that follow CLEC stocks have expressly excluded reciprocal compensation for dial up Internet traffic as a future revenue stream. They have done so because most do not believe that this particular regulatory arbitrage will last for any length of time. Making the transition to "bill and keep," therefore, should have no appreciable adverse effects on stock prices of those CLECs that are pursuing legitimate business models as opposed to simply gaming the arbitrage in question.

I noted that problems the incumbent exchange carriers have with reciprocal compensation rest largely with its application to one way dial up Internet traffic which has cost characteristics vastly different from the cost of actually terminating voice traffic over an actual local network that a facilities based CLEC might own and operate. One indication of this difference is reflected in an October 26, 2000 report on WorldCom's third quarter financial results that was prepared by Jack Grubman, a leading telecommunications securities analyst with Solomon Smith Barney. Among other things, Mr. Grubman notes

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that WorldCom recently made an adjustment to its 1999 and 2000 operating revenues by excluding a sizable amount of reciprocal compensation payments for dial up Internet access traffic. According to Mr. Grubman, WorldCom made these adjustments on the grounds that the reciprocal compensation revenues in questions had no costs associated with them and arguably should not be treated as operating revenues under GAAP.

We believe Mr. Grubman's assessment of the "no cost" nature of terminating dial up Internet traffic and WorldCom's accounting of its reciprocal compensation revenues is telling and indicative of just how egregiously unreasonable the application of reciprocal compensation to this particular traffic has become.

Finally, Mr. McKenna of Qwest discussed legal arguments favoring "bill and keep" under section 201 of the Communications Act. These arguments are set forth in the attached paper, "A Legal Roadmap for Implementing A Bill and Keep Rule for All Wireline Traffic."

Copies of the Grubman report, the Qwest paper and other materials used in the presentation to Mr. Goldstein are attached.

In accordance with Section 1.1206(b)(1) of the Commission's rules, I am filing two copies of this notice in the docket identified above. If you have any questions about this matter, please do not hesitate to call me.

Sincerely,

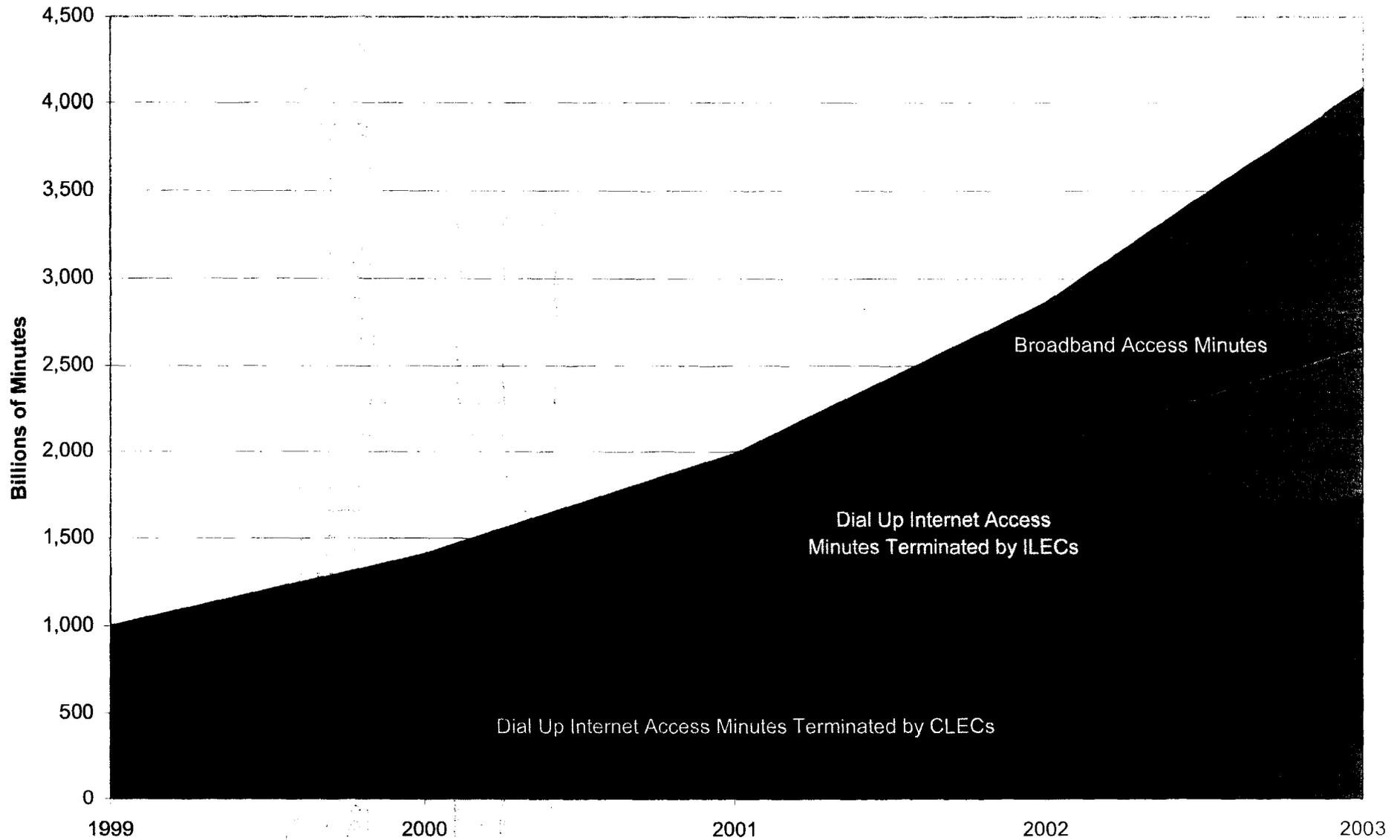


Robert T. Blau
Vice President
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Attachments

cc: Jordan Goldstein

Even With the Deployment of Broadband Services, Dial Up Internet Access Minutes Terminated by CLECs Are Expected To Grow By Nearly 50% Per Year



Potential Cost of Reciprocal Compensation for Terminating Internet Traffic

Residential Internet Usage Forecasts	1999	2000	2001	2002	2003	Avg. Ann. Growth
Total US Households (000s)	103,900	105,000	106,400	107,700	109,000	1.25%
U.S Online Households (000s)	43,600	47,300	51,400	56,900	62,500	9.73%
% Penetration	42%	45%	48%	53%	57%	
Avg Minutes of Access Per On-Line HH Per Day	63	82	106	138	179	30.00%
Avg Minutes of Access Per On-Line HH Per Year	22,888	29,754	38,681	50,285	65,370	
Total Internet Access Minutes -- Residential	997,916,800,000	1,407,383,120,000	1,988,189,008,000	2,861,212,858,400	4,085,651,050,000	42.65%
% Broadband (xDSL, Cable modems, wireless)	4%	12%	20%	29%	36%	
% Dial Up	96%	88%	80%	71%	64%	
Dial Up Access Minutes	958,000,128,000	1,238,497,145,600	1,590,551,206,400	2,031,461,129,464	2,614,816,672,000	28.29%
% of Dial Up Internet Access Minutes That CLECs Terminate	40.0%	50.0%	57.0%	66.7%	66.7%	
Dial Up Internet Access Minutes Terminated by CLECs	383,200,051,200	619,248,572,800	906,614,187,648	1,354,306,065,335	1,744,082,720,224	41.22%

**ILEC Reciprocal Compensation Liability Scenarios --
With a Constant Recip Comp Rate of \$.004/Min.
Scenario 1: Cap That Produces Contant Recip Comp Payments**

	12:1	8:1	4:1
<i>Cap on Terminating to Originating Minutes</i>			
<i>Dial-Minutes that Qualify for Recip Comp Payments</i>	619,248,572,800	604,409,458,432	601,913,806,816
<i>Total Recip Comp Payments</i>	\$2,476,994,291	\$2,417,637,834	\$2,407,655,227
Scenario 2			
<i>Cap on Terminating to Originating Minutes</i>		8:1	4:1
<i>Dial-Minutes that Qualify for Recip Comp Payments</i>	619,248,572,800	302,204,729,216	300,956,903,408
<i>Total Recip Comp Payments</i>	\$2,476,994,291	\$1,208,818,917	\$1,203,827,614
Scenario 3			
<i>Cap on Terminating to Originating Minutes</i>		5:1	3:1
<i>Dial-Minutes that Qualify for Recip Comp Payments</i>	619,248,572,800	251,837,274,347	225,717,677,556
<i>Total Recip Comp Payments</i>	\$2,476,994,291	\$1,007,349,097	\$902,870,710
Scenario 4			
<i>Cap on Terminating to Originating Minutes</i>		4:1	2:1
<i>Dial-Minutes that Qualify for Recip Comp Payments</i>	619,248,572,800	201,469,819,477	150,478,451,704
<i>Total Recip Comp Payments</i>	\$2,476,994,291	\$805,879,278	\$601,913,807
Scenario 5			
<i>Cap on Terminating to Originating Minutes</i>		3:1	Bill & Keep
<i>Dial-Minutes that Qualify for Recip Comp Payments</i>	619,248,572,800	151,102,364,608	0
<i>Total Recip Comp Payments</i>	\$2,476,994,291	\$604,409,458	\$0

Sources:

Total US Households (000s)
U.S Online Households (000s)
Avg Minutes of Access Per On-Line HH Per Year
% Broadband (xDSL, Cable modems, wireless)
% of Dial Up Internet Access Minutes That CLECs Terminate

Sanford Bernstein & Co and McKinsey & Co., *Broadband!*, Jan. 2000
Sanford Bernstein & Co and McKinsey & Co., *Broadband!*, Jan. 2000
Nielsen 9/14/00 Press Release; Cahners 3/28/00 Press Release; Thomas Weisel Partners, *Media Metrix's July Internet Usage Trends*, 8/23/00
Dean Witter Morgan Stanley, *The Broadband Report Reaping What You Sow: ROI in the Broadband Market*, May 2000
ALTS Press Release

For Comparable Forecasts See Also:

U.S Online Households (000s)
% Broadband (xDSL, Cable modems, wireless)

Dean Witter Morgan Stanley, *The Broadband Report Reaping What You Sow: ROI in the Broadband Market*, May 2000
Hoak Breedlove Wesneski & Co., *The Last Race for the First Mile*, 8/2/00

WORLDCOM INC/GA//

Filing Type:	10-Q
Filing Date:	Nov 14 2000
Ticker:	WCOM
CIK	723527
State:	MS
Country:	USA
Date Printed:	Dec 5 2000

Wholesale and consumer revenues for the three and nine month periods ended September 30, 2000 decreased 3.6% and 0.1%, respectively, over the same periods in the prior year. The wholesale market continues to be extremely price competitive as declines in minute rates outpaced increases in traffic resulting in revenue decreases of 11.5% and 10.4%, respectively, for the three and nine months ended September 30, 2000, versus the same periods in the prior year. The wholesale market decreases were partially offset by increases of 0.3% and 5.3%, respectively, in consumer revenues as the Company's partner marketing programs helped to drive Dial-1 product gains. Consumer revenue growth was impacted by declines in 1-800-COLLECT, which has been pressured by increasing wireless substitution, and 10-10-321, which the Company no longer actively markets. The Company expects to see continued pricing pressure in both the wholesale and consumer businesses, which will affect both revenue growth and gross margins.

Alternative channels and small business revenues for the three and nine months ended September 30, 2000 increased 18.2% and 20.9%, respectively, over the prior year periods. Alternative channels and small business includes sales agents and affiliates, wholesale alternative channels, small business, prepaid calling card and paging revenues. These increases are primarily attributable to internal growth for wholesale alternative channel voice revenues. The Company expects that pricing pressures in the wholesale and small business markets will continue to negatively affect revenue growth in this area and the Company cannot predict whether or not this level of growth can be sustained in the foreseeable future.

Internet-dial revenue growth for the three and nine months ended September 30, 2000 was 4.7% and 14.6%, respectively, over the same periods in the prior year. The Company's dial access network has grown 76% to over 2.5 million modems as of September 30, 2000, compared with the same period in the prior year. Additionally, Internet connect hours increased 49% to 1.6 billion hours for the three months ended September 30, 2000 versus the third quarter of 1999. These network usage increases were offset by pricing pressure on dial-up Internet traffic as a result of contract repricings in 2000.

Other revenues which, prior to April 1999, primarily consisted of the operations of SHL, were zero for the three and nine month periods ended September 30, 2000 and zero and \$523 million, respectively, for the prior year periods. In April 1999, the Company completed the sale of SHL to EDS for \$1.6 billion.

Line costs. Line costs as a percentage of revenues for the third quarter of 2000 were 38.5% as compared to 39.9% reported for the same period of the prior year. On a year-to-date basis, line costs as a percentage of revenues decreased to 38.6% as compared to 41.7% reported for the same period of the prior year. The overall improvements are a result of annual access reform reductions, more data and dedicated Internet traffic over Company-owned facilities, and improved interconnection terms in Europe. These improvements were somewhat offset by 2000 contract repricings in the dial Internet business, continued competitive pricing

WorldCom, Inc. (WCOM)#

WCOM: 3Q Impacted by Negative Trends But Mix Still Superior to Peer Group

1M (Buy, Medium Risk)
Mkt Cap: \$73,780.5 mil.

October 26, 2000

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SUMMARY

- ▶ WCOM reported 3Q eps of \$0.47 (cash eps of \$0.57) both \$0.01 above our est. rev growth of 10.7% (old way-see text) below our 11.9% est and 11-12% str range. Reclass. of certain items put rev growth at 11.7%
- ▶ Data/IP/Intl 94% of incr. comml rev growth and over 100% of total incr rev growth. WCOM's superior mix of assets leads to rev mix which allows double-digit topline growth even in tough ind environment (comml rev growth was 18.7%)
- ▶ Nov 1 analyst mtg likely to detail focused strategy on serving corp enterprises with global on-net data/IP svcs where WCOM is in best pos to be a dominant player. Also, details of restr will materialize and company guidance on eps and rev will be set as floor off which results accelerate
- ▶ Stock dirt cheap Once new guid set and restr details know we believe shares begin long phase of material outperformance **Reit Buy**

United States

FUNDAMENTALS

P/E (12/00E).....	11.3x
P/E (12/01E).....	10.5x
TEV/EBITDA (12/00E)	6.6x
TEV/EBITDA (12/01E)	5.7x
Book Value/Share (12/00E).....	\$18.55
Price/Book Value	1.4x
Dividend/Yield (12/00E)...	\$0.00/0.0%
Revenue (12/00E)	\$41,283.0 mil.
Proj. Long-Term EPS Growth	20%
ROE (12/00E)	10.0%
Long-Term Debt to Capital(a).....	25.7%
WCOM is in the S&P 500® Index.	

(a) Data as of most recent quarter

SHARE DATA

Price (10/26/00)	\$25.25
52-Week Range.....	\$60.96-\$21.81
Shares Outstanding(a)	2,922.0 mil.
Convertible	No

RECOMMENDATION

Current Rating	1M
Prior Rating.....	1M
Current Target Price	\$87.00
Previous Target Price.....	\$87.00

EARNINGS PER SHARE

FY ends		1Q	2Q	3Q	4Q	Full Year
12/99A	Actual	\$0.24A	\$0.30A	\$0.37A	\$0.42A	\$1.33A
12/00E	Current	\$0.54A	\$0.56A	\$0.57A	\$0.57E	\$2.24E
	Previous	\$0.54A	\$0.56A	\$0.56E	\$0.58E	\$2.24E
12/01E	Current	NA	NA	NA	NA	\$2.40E
	Previous	NA	NA	NA	NA	\$2.40E
12/02E	Current	NA	NA	NA	NA	NA
	Previous	NA	NA	NA	NA	NA

First Call Consensus EPS: 12/00E \$1.86; 12/01E \$2.20; 12/02E \$2.71

OPINION

Before talking about the results, we would like to summarize our current viewpoint about WCOM. We believe WCOM is aggressively focusing the company to achieve growth profitability. The heritage of WCOM is as a business service company and over the years with Wiltel, MFS/UUNET, and MCI, WCOM obtained key assets and scale to serve a full range of business customers on a global basis with a full suite of data/IP services. We are at a point where we believe WCOM's strategic focus has never been clearer. Namely, WCOM will optimize its asset base by becoming the preeminent provider of telecom services to corporate enterprises on a global basis. This entails investing in growth areas such as hosting, VPNs and managed services in order to leverage the world's largest commercial-facing network footprint. WCOM will build its company based on digital initiatives in an e-commerce world utilizing WCOM's array of global IP/fiber network assets. We think the period of distraction has passed. No more wireless thoughts, which are irrelevant to a business-centric, data/IP network-based carrier such as WCOM. The focus is on growing

data/IP services to corporate enterprise users on a global basis. WCOM spends \$9 billion per year on capex (year to date spending is \$7.8 billion, so \$9 billion is likely to be exceeded, which is why 2001 spending could be lower than 2000 as spending on subsea, hosting and softswitches will all occur in this year). Virtually all targeted to building network assets to support provisioning of data/IP services to corporate users in the U.S. and on an international basis. We strongly believe this marks an inflection point where WCOM becomes the WCOM of old -- focused, growing, highly profitable and a great stock.

WCOM reported 3Q results that came in below our expectations in revenues but were a penny ahead of our earnings expectations. It is important to note that WCOM is changing the way it is classifying certain revenue categories and putting them as a contra to cost. This reclassification is a change in presentation that not only adheres to GAAP accounting but more formally comports to GAAP accounting. Specifically, revenue streams such as reciprocal compensation and the PICC charges that WCOM collects with no cost associated to these charges, are being taken out of gross revenues and used as a contra to line costs. This is similar in how AT&T and Sprint reflect growth rates in revenues by taking out PICC charges. In addition, there is a small amount of equipment sales that WCOM included in its revenue streams. These equipment sales relate to selling to Bells equipment, to place in Bells' COs such that WCOM carries traffic on. These items, according to GAAP, are better reflected as contra to cost of goods. This is similar to the 3Q98 change in presentation for international revenues where WCOM's self-correspondence caused them to reflect settlement charges as a net contra to costs as opposed to being carried in revenues. The reclassification of PICC increased the reported revenue growth rate, but reciprocal compensation did not since it was flat year over year and the reclassification of equipment sales actually hurt the revenue growth rate in the new format vs. the old.

The specifics of the revenue breakdown between the new and old presentation including a display of recip comp, PICC and equipment sales are included Table 1-3 below. But the punchline is that on a going-forward basis, WCOM's revenue presentation will comport more closely with GAAP definitions of revenues, i.e. billed revenue where there is a cost associated with it as opposed to billed revenue, which is essentially a pass through with not costs associated with it or revenue that simply reflects the cost associated with a piece of equipment. It is important to note that these reclassifications do not impact EBITDA, EBIT, or net income, hence EPS is unaffected.

New Way: Revenue Presentation - Business Versus Wholesale & Consumer

(in \$millions)

The New Way excludes revenue streams in Table 2

Table 1

	1Q99	2Q99	3Q99	4Q99	1Q00	2Q00	3Q00	Growth Percentages		
								1Q99 vs.	2Q99 vs.	3Q00 vs.
Voice	\$2,564	\$2,545	\$2,517	\$2,552	\$2,591	\$2,627	\$2,587	1.1%	3.2%	2.8%
Data	1,382	1,455	1,603	1,652	1,791	1,897	1,966	29.6%	30.4%	22.6%
International	1,022	1,075	1,107	1,192	1,346	1,423	1,570	31.7%	32.4%	41.8%
Internet	309	357	424	492	545	605	640	76.4%	69.5%	50.9%
Internet - dial	320	364	385	428	417	405	403	30.3%	11.3%	4.7%
Commercial Services	5,597	5,796	6,036	6,316	6,690	6,957	7,166	19.5%	20.0%	18.7%
Wholesale and consumer	2,817	2,857	2,970	3,006	2,929	2,860	2,881	4.0%	0.1%	-3.0%
Communications services	8,414	8,653	9,006	9,322	9,619	9,817	10,047	14.3%	13.5%	11.6%
Other	403	120	-10	0	0	0	0	NA	NA	NA
Total	\$8,817	\$8,773	\$8,996	\$9,322	\$9,619	\$9,817	\$10,047	9.1%	11.9%	11.7%

Table 2

	1Q99	2Q99	3Q99	4Q99	1Q00	2Q00	3Q00
Reciprocal compensation							
Voice	\$67	\$69	\$82	\$68	\$96	\$90	\$78
Internet - dial	64	64	66	66	88	74	71
International	21	32	21	35	19	23	21
	\$152	\$165	\$169	\$169	\$203	\$187	\$170
PICC							
Consumer PICC	50	45	61	67	67	66	0
Small business PICC	38	31	33	36	35	35	31
	\$88	\$76	\$94	\$103	\$102	\$101	\$31
Cobra Equipment sales	\$65	\$51	\$49	\$31	\$54	\$88	\$55

Source: SSB & Company Reports

Table 3

Old Way: Revenue Presentation - Business Versus Wholesale and Consumer

(The Old Way includes revenue streams in Table 2)

	1Q99	2Q99	3Q99	4Q99	1Q00	2Q00	3Q00	Growth Percentages		
								1Q99 vs.	2Q99 vs.	3Q99 vs.
Voice	\$2,669	\$2,645	\$2,632	\$2,656	\$2,722	\$2,752	\$2,696	2.0%	4.0%	2.4%
Data	1,382	1,455	1,603	1,652	1,791	1,897	1,966	29.6%	30.4%	22.6%
International	1,043	1,107	1,128	1,227	1,365	1,446	1,591	30.9%	30.6%	41.0%
Internet	374	408	473	523	599	693	695	60.2%	69.9%	46.9%
Internet - dial	384	428	451	494	505	479	474	31.5%	11.9%	5.1%
Commercial Services	5,852	6,043	6,287	6,552	6,982	7,267	7,422	19.3%	20.3%	18.1%
Wholesale and consumer	2,867	2,902	3,031	3,073	2,996	2,926	2,881	4.5%	0.8%	-4.9%
Communications services	8,719	8,945	9,318	9,625	9,978	10,193	10,303	14.4%	14.0%	10.6%
Other	403	120	-10	0	0	0	0	NA	NA	NA
Total	\$9,122	\$9,065	\$9,308	\$9,625	\$9,978	\$10,193	\$10,303	9.4%	12.4%	10.7%

Source: SSB & Company Reports

DISCUSSION OF 3Q RESULTS

Turning to the results, putting aside one-time charges, WCOM reported earnings from operations of \$0.47 per share, \$0.01 above our \$0.46 per share estimate and 27% above a year ago's \$0.37 per share. Cash EPS was \$0.57 per share, a 21% gain over a year ago.

Revenues were disappointing coming at 10.7% 'old-way' reported number vs. our estimate of 11.9% (we were at the high end of guidance range of 11% to 12%) as WCOM remains impacted by downward trends in voice, wholesale, certain aspects of data (such as private line) as well as dial-up Internet, which continues to see dramatic pricing declines especially on dial-up ports. Relative to our model, WCOM fell short on IP (both dedicated and dial-up) and to a lesser degree on data but outperformed in international. Of course, in 1Q and 2Q, WCOM exceeded our data and dedicated IP estimates but fell short on international. The point is that you don't run a company via a spreadsheet and one has to look at business trends over a cumulative period of time.

The good news is that WCOM does have a different class of assets and a different mix of revenues relative to its major peer group. Hence, while AT&T had negative 3% top line growth all in its communications service business, and Sprint had barely above 2% revenue growth in its LD communications business, WCOM reported overall 12% top-line growth using this new classification of revenues. To be fair, looking at WCOM revenue growth, the old way - meaning, recip comp and PICCs included in revenues, WCOM would have reported 10.7% overall revenue growth, below our estimate of 11.8%, which we know with increasing certainty was going to be aggressive in light of Sprint's results in particular. However, 10.7% is still superior to virtually any major player in the global telecom space, most of whom trade at higher multiples than WCOM.

Table 4

3Q00 Comparative Growth Rates / Revenue Composition			
	WCOM	FON	T
Consumer Y/Y Growth	0%	-6%	-11%
Business Services Y/Y Growth (including Wholesale)	14%	6%	2.5%
Data / IP / International Revenue (as % of Comm. Service Revenue)	45%	27%	18%
Domestic Voice Revenue (as % of Comm. Service Revenue)	55%	73%	82%

Source: SSB Estimates

As WCOM did last quarter, they break out their revenues between commercial services and wholesale & consumer. Fully, 94% of incremental commercial revenues and over 100% of total incremental revenue growth came from data/IP/international growth areas. Looking at revenue growth for wholesale & consumer, WCOM reported revenue declines of 3% in the quarter (it would be a negative 5% using the old revenue reporting method). We estimate that the wholesale part of this declined by about 10% and consumer, we estimate was roughly flat. In fact, WCOM dial-1 residential revenues grew 10% in the quarter offset by declines in transactional services. In each of these cases, there are separate trends occurring. Wholesale actually improved a bit from the 2Q when the decline was 13% but consumer grew 8% in the 2Q and now is basically flat.

More importantly, commercial services, which includes WCOM's commercial facing businesses, voice, data, international and Internet grew 18.7% year over year (18.1% using the old methodology). Voice grew 3% on the newly reported basis, with revenue growth not that much different on the old basis, namely 2.4%. We estimate that LD voice declined by about 3% on 7% traffic growth whereas local voice improved 17%. In terms of data and IP, overall data and IP grew about 25% on a year-over-year basis with commercial data growing 23% and IP growing 29%.

Data growth was fueled by frame/ATM which continues to expand in importance to corporate users who migrate off of older private line networks. Clearly, in data, it takes more

units to get revenue which mimics declining unit cost trends. Corporate users are requiring increasing bandwidth for new applications. WCOM doubles the capacity of its network each year (as measured by VGE miles), an indication of its strong demand growth. In fact, multi-megabit circuits grew 62% year over year and local VGEs doubled, the fourth consecutive quarter of accelerating growth. In fact, we suspect local data grew close to 30% in the quarter.

It is evident that the drag on IP remains dial-up, which only grew 5% year over year after having grown 11% in the 2Q00 down from 30% growth in 1Q00. Connect hours grew 49% year over year and modems increased 76% but pricing is and will remain brutal. As far as dedicated IP is concerned (which is now 61% of IP revenues, up from 58% in 2Q00 and less than 50% a year ago), revenues grew 51% in the quarter. Dedicated tends to be very lumpy given that it is selling access, transport, VPNs, hosting, etc. to larger corporate customers. The growth rate over the last eight quarters, has ranged anywhere from 40% to 80% on a year-over-year basis and this remains, clearly, where WCOM will leverage its IP assets and its soon-to-be acquired Digex capabilities. We suspect that many of WCOM's hosting managed-services efforts are a bit on hold (though still growing triple-digit) until the ICIX/DIGX deal closes at which point, we expect WCOM will have an aggressive roll-out of tool-kits, managed services, web center-type of capabilities.

In fact, Digex today reported better-than-expected results. Digex is getting 70% of revenues from corporate customers but they clearly lack distribution which WCOM brings. Revenues per server, which is already industry-leading, continues to accelerate. Most importantly, 120 WCOM account executives are already trained on DIGEX tool kits. Bolting on Digex's capabilities to WCOM's global IP/UUNET backbone and millions of square feet of data center space, all being leveraged by WCOM's salesforce, we believe will position WCOM to dominate the totality of the corporate enterprise space for IP-driven services.

The international area grew 42% to \$1.57 billion on a year-over-year basis, representing a nice pickup from 32% growth in 2Q. This includes Embratel, which WCOM owns a majority of and has consolidated in its results. In particular, Embratel, as can be seen in its public filings, is doing quite well as it is gaining traction especially with data products in Brazil. Embratel represented \$932 million in 3Q while Europe/Asia was \$637 million. Specifically, Europe grew 25% year over year, Asia's growth doubled and Embratel grew 41% vs. a year ago. WCOM continues to expand its global reach such that it is getting revenues from six countries where they did no business a year ago, which obviously represents huge opportunities for new revenue growth. WCOM added 2,000 new on-net buildings outside the U.S., bringing its buildings on-net to 15,000 on top of the 50,000 on-net buildings in the U.S. UUNET now has 2,500 POPs worldwide and WCOM has 20 facilities-based local network cities outside the U.S.

If one wants to compare WCOM's results to AT&T's business services, which includes wholesale, the WCOM commercial services plus wholesale, grew by our estimation roughly 14%, obviously well above the 2.5% growth rate of AT&T.

As far as profitability is concerned, WCOM remains quite good at leveraging its cost structure. Gross margins were 61.5% in the quarter, up from 60% last year. WCOM is moving more traffic on-net, carrying higher bit-rate data services and has declining access costs but it also has to deal with increasing off-net dial-up IP, which hurts gross margin. Operating margins were 25.4% vs. 24.4% a year ago. EBITDA margins were 37.8% up from 36.4% a year ago. If one looked at the old way of classifying recip comp and PICC revenues (meaning putting them in revenues and not using them as a contra to costs), margins are 100 basis points lower but the progression is the same, in other words, EBITDA and operating margins in either event improved 100 basis points on a year over year basis. In fact, the absolute dollar amount of EBITDA or operating income does not change no matter which classification one looks at. In either case, EBITDA and operating income grew 16% on a

year over year basis on revenue growth of 12% or 10.7%, depending on which format one looks at.

INDUSTRY TRANSFORMING BUT WCOM WELL-POSITIONED BY TARGETING CORPORATE ENTERPRISES

The point is this - the telecom industry is undergoing massive change. Certain revenue streams, most notably, circuit switched voice and older data such as private line, are becoming devalued almost overnight due to competition and frankly, transformation of technology into more IP bit-based packet services. In addition, certain services such as dial-up Internet remains under pressure as this is becoming a commodity business.

Thus, no company is immune. WCOM's results were clearly below our revenue expectations given the accelerated slippage in some of these areas. However, when one looks at the totality of these results, WCOM grew its entire \$40 billion annualized revenue base by 12% in the current classification of revenues or if one wants to hold them to the old classification, WCOM grew revenues by 10.7% vs. its two closest comparables, with either 2% in the case of Sprint or -3% in the case of AT&T.

The bottom line is that companies in this industry have to scale and scope of the right network assets over which to drive the right products to get the right revenue mix and have customer connectivity in their target markets. Bells such as SBC and Verizon, clearly have massive scale within their regions especially to consumer and small-business customers, which is why they will rule the roosts in the consumer and small business area. On the other hand, WCOM has an unmatched set of global, commercial-facing assets especially to larger corporate enterprises, in the form of UUNET and its 150 SONET rings around the world and its massive amount of operational fiber miles. We believe WCOM will further optimize these assets by spending to drive growth in the commercial enterprise area. We believe that at next week's analyst meeting, WCOM will discuss the tracker and reset expectations to take into account their strategic initiatives and take advantage of the fact that given its current stock price, there is a lot of wiggle room in terms of resetting earnings guidance and still having a very cheap stock price.

Thus, our point remains as it has always been, that there will be tough navigating through declining revenue streams in this industry. This has resulted in a lowering of revenue expectations across the board for all of the players in the LD industry and chances are, that will ultimately spill over into local over time. However, there are good parts of this business, namely higher protocol data, dedicated Internet, and the overall ability to sell packages of services to corporate enterprises. In fact, we believe that corporate enterprises will be the major drivers of bandwidth growth as these companies get become more e-commerce driven and utilize faster devices, gigabit Ethernet LANs, etc. WCOM's assets are optimized for the commercial services market.

FUTURE OUTLOOK

As far as the future outlook is concerned, we believe that WCOM at its analyst meeting next Wednesday, will do a complete drill down of its strategy, discuss what the new tracker is going to look at and set the bar for next quarter and next year, so that we get out of this negative optionality on the stock relative to outlook.

Our view (we stress OUR) is that it is prudent for WCOM to take expectations down given the realities of this industry. In addition, if we had to guesstimate at the EBITDA margins of WCOM's commercial facing businesses outside of wholesale and consumer, we would guess that the EBITDA margin is higher than the corporate average of 37.8%. Given that this is a business that is growing revenue at a high teens rate, we would argue that WCOM should spend some of this margin in terms of SG&A to drive growth especially in VPNs, hosting, web centers and managed services areas. In addition, we believe that WCOM will want to

take growth in Europe and Asia to another level while also spending money on processes to drive long-term cost structure improvement outside the U.S.

Furthermore, we believe that certain segments of revenue streams, most notably, voice and dial-up will only get worse. Thus, our view is that if one looks at WCOM today with a 19% growth rate in commercial services top-line, we would expect that expectations should probably be set a bit lower to a mid-teens level since voice, in particular, still does represent 36% of commercial revenues.

From an earnings perspective, our all-in cash 2001 EPS estimate of \$2.40. How this will be split among two trackers remains to be seen until next week's analyst meeting. Our view is that as WCOM focuses its company on the commercial facing business with a tracker for wholesale/consumer, that there will clearly be costs deployed to drive growth in the commercial area. Thus, while we are not changing any estimates at this time, we believe that it is likely our EPS estimate will be reduced once WCOM outlines its strategy.

The point is this that with the stock at \$23, WCOM is trading at about 10x our 2001 consolidated cash EPS estimate of \$2.40. If one argued that there is maybe a few dollars of value for the wholesale/consumer business and that this business maybe contributes \$0.30 to \$0.40 to EPS, then WCOM is trading at about 10x an implied earnings estimate for 2001 on the commercial basis. The commercial business is almost \$30 billion in annualized revenues with a sustainable topline growth of 15% to 17% and a bottom line growth rate of above 20%. Given that it makes no sense for WCOM's commercial segment to trade at an implied P/E of 10x, we would argue that WCOM could reset guidance to a point that implies a 15x to 16x multiple on next year's numbers, an implied multiple that would still be quite cheap given that the business will likely have mid-teens topline growth and north of 20% bottom line growth.

WHY WCOM IS A BUY IF AT&T IS NOT

On one other note, a fair question to ask us would be why we are not downgrading WCOM as we did AT&T. Our answer is simple, WCOM did not reverse \$100 billion worth of strategic decisions in one fell swoop, the last of which, MediaOne, only closed four months ago. Secondly, when the day is done, AT&T's communications business has negative growth rates with its business service unit only growing at 2% to 3% , clearly driven by an unoptimal mix of assets and revenue streams. WCOM, despite all the issues, is still growing overall revenues at double digit rates, with its commercial-facing business growing almost 20% and has a set of assets that is very different than T's. Hence, we continue to be very bullish on WCOM. In fact, we believe we are very early on WCOM relative to AT&T. More specifically, we believe that the differentiation between the two will increase over the course of the next 12 months. In fact, we believe that a year from now, WCOM will be the clear undisputed leader in offering a full array of IP-based network services to corporate enterprise customers.

NET/NET:

WCOM did miss our top-line numbers. We think they will reset guidance and focus on their strategic initiatives especially in the commercial facing area. We believe the current stock price reflects a resetting of outlook and our view is that by the end of next week, after the WCOM analyst meeting, this is a stock that will begin to gain traction, as investors realize that WCOM is on a path to resume an accelerating growth profile in the commercial area.

ADDITIONAL INFORMATION AVAILABLE UPON REQUEST

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Wall Street's View of Reciprocal Compensation: Why Resolving the Issue is the Right Thing to Do For Investors

Highlights:

- Delay in resolving reciprocal compensation has injured CLEC stocks across the board by perpetuating the impression that all CLECs are excessively dependent on reciprocal compensation.
- Most CLECs have reduced dependence on reciprocal compensation, and Wall Street analysts who cover CLEC stocks already have built this into their models.
- Resolving the issue promptly and definitively would responsibly inform investors and allow them to make educated choices about their investments, which would benefit the entire CLEC sector.

The long debate over reciprocal compensation has largely been couched as a fight between the CLECs and the ILECs. But it's really investors who count. Policymakers need to take a closer look at the evidence from Wall Street that the delay in resolving the matter has hurt investors and hurt the business plans of CLECs by raising the cost of capital for all CLECs – especially facilities based carriers – at a time when access to capital is becoming increasingly difficult and critical to the execution of CLEC build-out plans.

- Most CLECs are not followed by very many Wall Street analysts due to their relatively low market capitalization. Thus, expert sources of information available to investors are limited and concentrated. Investors may not have ready access to information to assess whether an individual CLEC has built its business plan around unstable sources of revenues such as reciprocal compensation. Thus, when carriers like ICG Communications or Intermedia restate earnings based on these revenues not materializing, other CLECs – including those that do not depend on reciprocal compensation – get tarred with the same brush.
- During the recent debate over legislation that would have eliminated reciprocal compensation for dial up Internet access traffic, several CLECs launched a radio and newspaper ad campaign designed to pressure Congress to avoid enacting legislation. This was done by claiming that the loss of recip comp payments would somehow cause dial up Internet access rates to go up by as much as 30 percent. Even if unfounded, the ads may have cast doubt on the business plans of DLECs, since they suggested that DSL was losing out on a subsidy available only to support dial-up Internet access prices. Thus, the delay in resolving the reciprocal compensation issue may also have contributed to the recent demise of DLEC stock prices which are currently selling 90% below their 52 week highs.

According to a recent Merrill Lynch report, most CLECs have reduced their reliance on reciprocal compensation for terminating one-way dial up Internet access traffic or never became reliant in the first place.

Reciprocal Compensation as a % of Revenue

Companies Under Coverage	3Q99	4Q99	1Q00	2Q00
Adelphia	20%	23%	15%	10%
Allegiance	0	0	0	0
AT&T Canada	0	0	0	0
Covad	0	0	0	0
GT Group	0	0	0	0
Telecom				
Intermedia	9	1	12	3
McLeodUSA	0	0	0	0
Mpower	0	0	0	0
Network Plus	0	0	0	0
NorhtPoint	0	0	0	0

Companies Under Coverage	3Q99	4Q99	1Q00	2Q00
Rhythms	0	0	0	0
Teligent	0	0	0	0
US LEC	62	74	12	12
Winstar	1	5	5	3
XO	4	5	4	4
e.spire	18	18	24	21
Electric	21	18	17	17
Lightwave				
Focal	53	41	41	35
ICG	21%	20%	23%	18%

Source: K. Hoexter, *Broadband Barometer*, Merrill Lynch, 9 October 2000, p. 11.

Even though many-facilities based CLECs, like RCN, have avoided gaming reciprocal compensation provision in the Telecom Act, they are still being penalized. Rather than spend the time and resources required to differentiate individual carriers based on their reliance on questionable revenue sources like reciprocal compensation, many investors, including institutional investors, simply avoid CLEC stocks all together

- “We believe RCN is significantly undervalued and is being unfairly grouped with other CLECs. Even though the difficult issues [like reciprocal compensation] other CLECs face have little impact on RCN... RCN has almost no reciprocal compensation, and switched access and long distance revenues counts for a small percentage of total revenue.” M.J. Recarey, CFA, *RCN Corporation*, Fahnestock & Co., 13 Oct. 2000, p.1.
- “In the near term, we believe the only way for CLECs to regain investor confidence is through simple “blocking and tackling” – strong revenue and access line growth, continued margin improvement, and sustained ARPU. ***In addition, we hope to see migration away from dubious revenue streams such as reciprocal compensation and switched access*** and toward more valuable long-term sources of revenue, including local voice and (increasingly) high-speed and enhanced data services.” C. Carr, *Telecom Services CLECs*, CIBC World Markets, 2 Oct. 2000, p.2-3

Investors and securities analysts that do differentiate CLECs clearly favor those that are not relying on or at the very least moving to immediately reduce their dependence on reciprocal compensation revenues.

- “We are downgrading US LEC to Neutral from Buy... **We believe US LEC is simply a company with zero visibility in evolving to a real business from a pure recip comp play.**” J. Grubman, *CLECs: Clean Up of Ratings, Price Targets & DCFs*, Salomon Smith Barney, 17 Oct. 2000, p. 2.

Finally, the debate over reciprocal compensation is not just about the transfer of revenue and shareholder value between carriers. The FCC also bears some fiduciary responsibility to investors to eliminate regulatory arbitrages like reciprocal compensation that carriers can and have used – usually through “creative” accounting – to artificially inflate revenues, earnings, and stock prices. While such practices may be understandable for start up carriers, those same practices can subject investors to grave risk if not divulged or even well understood.

“We have long held the view that when any given arbitrage opportunity in the telecommunications service space comes to an end, the result is never good for the company who benefited from its exploitation. In the case of WorldCom, separating reciprocal compensation gains from the standard income statement does have the benefit of making the revenue growth more robust... Our traditional problem with such an issue is that with growth companies, such as WorldCom, it becomes more difficult to more than compensate for such growth in the following year, as the arbitrage evaporates, as the company has suggested it will. **The official comment [from WorldCom] that reciprocal compensation is ‘...an artificial payment ... that is going to zero’ is incredibly telling from one of the industry’s leading management teams.** As we had pointed out, ... those companies most reliant upon such arbitrage opportunities are destined to see [this] source of revenue and funding disappear almost over night.” G. Miller, *WCOM: Less than Expected Quarter*, ING Barings, 27 Oct. 2000, p. 4.

Reciprocal Compensation: The Recent View From Wall Street

GENERAL

From Gregory P. Miller, ING Barings. From "Reciprocal Compensation – The End of Another Arbitrage (Part 1 of 2)." September 14, 2000

"The cost of providing dial-up access has been reduced by more than two-thirds over the past 24 months alone due to dramatic advances in carrier grade modem databanks as well as by the dramatic decrease in the cost of long haul fiber optic circuits (an estimated 75% over the past two years alone). An increase in the price (which is unlikely anyway) of the short-haul circuits that are responsible for reciprocal compensation generation would have almost no impact on the cost of Internet access. Elimination of reciprocal compensation payments would only work to equalize the playing field with the CLECs that provide these circuits to ISPs on a bill and keep billing arrangements that have no reciprocal compensation associated with them."

"The arbitrage is over – We understand that a few select CLECs are arguing that the adoption of such a proposal would not be feasible due to the fact that we are in an election year and that such a move by Congress would represent a tax on the Internet. We believe that is simply crazy. In our view 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."

"Tax on the Internet – you have got to be kidding me. Many of the so-called emerging CLECs that have managed to tap the public equity markets on the premise of generating positive EBITDA sooner than their more fiber-intensive counterparts have done so largely as a result of their ability to book and bill reciprocal compensation revenues. Accordingly, we believe many of these particular CLECs have priced their services on basic PRI circuits at or below actual cost in hopes of more than offsetting such a loss with high reciprocal compensation payments (the arbitrage exploitation). If the existing trend in dramatically declining reciprocal compensation rates continues, as the arbitrage evaporates, then it will become increasingly difficult for these carriers, which may have mistakenly priced their services, to earn a reasonable rate of return. We do not think any legislative body should be responsible for ensuring all companies generate a return on capital in spite of their own misplaced activities."

From Vik Grover, Kaufman Bros., L.P. From "All the King's Horses and All the King's Men: Emerging Telcos – The State of the Market." September 6, 2000

"Yet while the sizzle may have come off of the steak for investors in this space this year, we do not see evidence of a secular bearish trend in communications services. In our view, investors that look beyond current volatility and bring their guns to bear on a basket of companies with quality revenues, scalable business plans, ample capital resources, and aggressive management teams, will reap significant rewards going into the New Year. In general, we have tried to pick the best of the best from this field of companies by pursuing the following strategies:

- Avoiding CLECs exposed to collection risk for reciprocal compensation from the ILECs and favoring those companies with "smart build" strategies, high quality local and Internet/data revenue streams, and strong direct sales models."

From Vik Grover, Kaufman Bros., L.P. From "KBRO Morning Notes – Part 2/3." September 26, 2000
"It is our view that the Street has removed recip comp revenue from all CLEC models pending resolution of this matter."

From Gregory P. Miller, ING Barings. From "MCLD: Another Strategic, Opportunistic Acquisition." October 3, 2000

"One of the best attributes of the CapRock transaction is that the company adds absolutely no arbitrage related revenues to the income statement of the combined company. The company generates no reciprocal compensation revenue to speak of and its switched terminating access charges are in line with the CLEC industry average. We cannot say the same for the other CLECs that McLeodUSA might have been in talks with on an earlier date. As much as we fear the quality of the receivables associated with such revenue and EBITDA streams, we remain even more concerned with the forecast for these companies attempting to exploit this short-term arbitrage opportunity, as the high growth forecast becomes even more difficult to obtain, as the arbitrage opportunity evaporates. McLeodUSA and CapRock should not face such problems following the completion of the merger.

From Manuel Recarey, Fahnstock & Company. From "RCNC: Undervalued CLEC With Strong Balance Sheet & Unique Strategy." September 28, 2000

"We believe RCN is different than all other CLECs due to its residential focus and strategy to construct its own network, thereby eliminating the need to interact with the competitor to provide service. In addition, RCN does not face the issues that have negatively effected other competitive local carriers. It has almost no reciprocal compensation, and switched access and long distance revenue counts for a small percentage of total revenue."

From Linda B. Meltzer, UBS Warburg. From "Telecom Services: Second Quarter 2000 Preview

"We note that the earlier stage CLEC's (CWON, MPWR, ALGX) are experiencing higher growth rates in revenues, net line additions and collocations, while the more mature CLEC's (ICGX, ICIX) are characterized by comparatively lower revenue growth, stronger margins (notably ICGX in light of ICIX's July 11 downward estimate revision), and comparatively higher levels of reciprocal compensation as a proportion of revenues."

INTERMEDIA

From J. Henry/W. Fore, Bear Stearns. From "ICIX: WorldCom Will BUY Intermedia For \$6.0 Billion." September 5, 2000

"WorldCom's acquisition of Intermedia will likely be perceived as a positive move for Intermedia's investors in particular and CLEC investors in general. That said, we remain cautious on the group based on the mixed bag of positive and negative catalysts that the CLECs face in the near future. On the positive side, the CLECs offer highly compelling valuations coupled with the ongoing potential for improving fundamentals and additional M&A activity. On the negative side, many CLECs have excessive exposure to sticky issues such as reciprocal compensation, long distance, switched access,

access to capital, and the Verizon strike. ... We believe that investors may be best served by sitting on the sidelines in the near term until these issues sort themselves out."

FOCAL

From Mark Kastan, CS First Boston. From "FCOM: Pre-Announces 3Q Revenues Above Expectations FBC." September 28, 2000

"We reiterate our Buy rating on FCOM shares. We note that given the worst case scenario and assuming that reciprocal compensation as a revenue stream goes away beginning in January '02, we still come up with a 10-year DCF derived price target of \$84 (22% below our current target of \$107), or a six-fold increase from current levels."

From Jeremy Bunting, Thomas Weisel Partners LLC. From "Telecom: (TWP) Telecommunications Industry Overview (Part 1 of 2)." September 8, 2000

"Focal Communications (FCOM: Strong Buy \$29.75), in our view, represents one of the better values in the CLEC space. We believe that with reciprocal compensation issues behind it and a large customer focus, FCOM is poised for better-than-industry-average growth and operating performance."

Why A Timely Transition From Reciprocal Compensation to Bill & Keep Will Not Harm CLECs or Their Shareholders

- Nearly all securities analysts that follow CLEC stocks are not factoring recip comp revenues into stock valuations unless and until that revenue is actually received. Thus, if the FCC were to establish a reasonable transition to Bill & Keep for all local traffic, including dial up Internet traffic, that decision should not adversely effect CLEC stock prices.
- As **Vik Grover of Kaufman Bros.** wrote on Sept. 26, "It is our view that the Street has removed recip comp revenue from all CLEC models pending resolution of this matter [by the Congress or the FCC]."
- On Sept. 28, **Manuel Recarey of Fahnstock & Co.** noted: "We believe RCN is different than all other CLECs due to its residential focus and strategy to construct its own network, thereby eliminating the need to interact with the competitor to provide service. In addition, *RCN does not face the issues that have negatively effected other competitive local carriers. It has almost no reciprocal compensation, and switched access and long distance revenue counts for a small percentage of total revenue.*" [*Italics added*]
- If the FCC established a reasonable transition to Bill & Keep for dial up Internet traffic that effectively eliminated uncertainty about ILEC payment of carrier compensation to the CLECs during this transition, resolving the matter might actually give selected CLEC stocks a near term boost.
- On Sept. 5, **J. Henry and W. Fore of Bear Stearns** opined that: "WorldCom's acquisition of Intermedia will likely be perceived as a positive move for Intermedia's investors in particular and CLEC investors in general. That said, we remain cautious on the group based on the mixed bag of positive and negative catalysts that the CLECs face in the near future. On the positive side, the CLECs offer highly compelling valuations coupled with the ongoing potential for improving fundamentals and additional M&A activity. On the negative side, many CLECs have excessive exposure to sticky issues such as reciprocal compensation, long distance, switched access, access to capital, and the Verizon strike. ... *We believe that investors may be best served by sitting on the sidelines in the near term until these issues sort themselves out.*" [*Italics added*]
- Most CLECs like **Focal Communications (FCOM)** that count reciprocal compensation for dial up Internet traffic as material percentage of their total revenues have taken steps to dramatically reduce that percentage. They have done so out of concern that investors will not capitalize business models based on an unreasonable regulatory arbitrage that securities analysts do not believe will continue.
- **Credit Suisse/First Boston** estimates that for Focal Communications recip comp as a percentage of total revenues declined from 73% in 1Q99 to 35% in 2Q00. (See Attachment A)
- On Sept. 26, **Mark Kasten of CS First Boston** wrote: "We reiterate our Buy rating on FCOM shares.... [A]ssuming that reciprocal compensation as a revenue stream goes away beginning in January '02, we still come up with a 10-year DCF derived price target

of \$84 (22% below our current target of \$107), or a six-fold increase from current levels." [*Italics added*]

- On Sept. 8 **Jeremy Bunting of Thomas Weisel Partners LLC.** advised his clients: "Fcom Communications (FCOM: Strong Buy \$29.75), in our view, represents one of the better values in the CLEC space. We believe that with reciprocal compensation issues behind it and a large customer focus, FCOM is poised for better-than-industry-average growth and operating performance."
- The FCC should not reward CLECs for attempting to hamstring the policymaking process by shamelessly claiming that replacing reciprocal compensation with Bill & Keep will somehow cause dial-up Internet access rates to go up by 30% or more.
 - On Sept. 14, **Gregory Miller of ING Barings** in a report *Reciprocal Compensation – The End of Another Arbitrage* noted: "The cost of providing dial-up access has been reduced by more than two-thirds over the past 24 months alone due to dramatic advances in carrier grade modem databanks as well as by the dramatic decrease in the cost of long haul fiber optic circuits (an estimated 75% over the past two years alone). An increase in the price (which is unlikely anyway) of the short-haul circuits that are responsible for reciprocal compensation generation would have almost no impact on the cost of Internet access. Elimination of reciprocal compensation payments would only work to equalize the playing field with the CLECs that provide these circuits to ISPs on a bill and keep billing arrangements that have no reciprocal compensation associated with them."

"The arbitrage is over – We understand that a few select CLECs are arguing that the adoption of such a proposal would not be feasible due to the fact that we are in an election year and that such a move by Congress would represent a tax on the Internet. We believe that is simply crazy. *In our view, 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.*"

"Tax on the Internet – you have got to be kidding me. Many of the so-called emerging CLECs that have managed to tap the public equity markets on the premise of generating positive EBITDA sooner than their more fiber-intensive counterparts have done so largely as a result of their ability to book and bill reciprocal compensation revenues. Accordingly, we believe many of these particular CLECs have priced their services on basic PRI circuits at or below actual cost in hopes of more than offsetting such a loss with high reciprocal compensation payments (the arbitrage exploitation). If the existing trend in dramatically declining reciprocal compensation rates continues, as the arbitrage evaporates, then it will become increasingly difficult for these carriers, which may have mistakenly priced their services, to earn a reasonable rate-of-return. *We do not think any legislative body should be responsible for ensuring all companies generate a return on capital in spite of their own misplaced activities.*" (See Attachment B for full text of Miller report) [*Italics added*]

**A Legal Roadmap for Implementing
A Bill and Keep Rule for All
Wireline Traffic**

Prepared by Qwest Communications International, Inc.

For Inclusion in CC Docket Numbers 96-98 and 99-68
Implementation of the Local Competition
Provisions of the Telecommunications Act of
1996: Inter-Carrier Compensation for
ISP-Bound Traffic

DATE 11-22-00

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Appendix A

Appendix B

EXECUTIVE SUMMARY

The Commission is continuing to struggle with the conundrum posed by what is called “ISP reciprocal compensation” — the massive diseconomies created when a CLEC serves a large number of Internet Service Providers and establishes a huge subsidizing revenue stream from a neighboring ILEC solely on account of one-way connections between the ILEC’s customers and the Internet. While the Commission has been considering this issue for some time, its current deliberations are guided by the Court of Appeals decision in *Bell Atlantic*, in which an earlier Commission determination that ISP reciprocal compensation was not subject to the reciprocal compensation provisions of section 251(b)(5) of the Telecommunications Act was reversed for lack of sufficient reasoned decision making.

This paper examines the Commission’s options in dealing with the ISP reciprocal compensation issue in light of *Bell Atlantic*. We have proposed legal arguments designed to support the economic and public policy analyses that document that the best method of treating inter-carrier compensation in the context of ISPs is what is called “bill and keep,” where both carriers participating in a partnership to provide a connection between the ISP customer of one carrier and the end user customer of the other bear their own costs. As we demonstrate, there are various means of approaching a bill and keep regime in the wake of the *Bell Atlantic* decision. One legal quandary that we address is the fact that the Commission has suggested that section 252(d) of the Act permits mandatory bill and keep for local traffic *only* when traffic between two carriers is relatively in balance; thus, in the case of ISP reciprocal compensation, it would seem potentially anomalous to order bill and keep for the express reason that the traffic is so seriously out of balance as to create public policy dangers. Nevertheless, we conclude that proper analysis fully supports a regulatory structure in which ISP reciprocal compensation is handled via bill and keep, either alone or in conjunction with bill and keep for traffic more clearly identified as local in nature. Indeed, we suggest that this approach is possible even if the Commission does not revisit its rule concerning the need for traffic to be balanced, although it certainly may do so.

This paper presents two approaches which provide a legal foundation for a bill and keep regime for ISP and local traffic:

- ISP traffic can be treated as non-local in nature and not subject to the reciprocal compensation provisions of section 251(b)(5) at all. This is the approach initially taken in the order reversed in *Bell Atlantic*. However, review of the record and the *Bell Atlantic* decision demonstrates that the Commission can quite comfortably conclude that, consistent with the directions of the Court and with reasoned decision making, delivery of ISP traffic to a CLEC is not subject to the reciprocal compensation provisions of section 251(b)(5) because delivery of Internet-bound traffic to the ISP does not constitute either transport or termination of that traffic. A bill and keep structure can still be made applicable to other local traffic pursuant to the provisions of section 251(b)(5).
- ISP traffic can be treated as subject to 251(b)(5), but still subject to a bill and keep regulatory structure. This conclusion does not require that the Commission abandon its prior analysis that section 252(d)(2) requires that costs be reasonably in balance as a prerequisite to ordering bill and keep as a regulatory requirement. Bill and keep for ISP traffic pursuant to

section 252(d)(2) can be ordered simply on the recognition that, in the case of ISP traffic, the originating LEC is not the cost causer in any cognizable economic sense. So long as the structure permits the CLEC to recover its costs from the entity with which such costs are "associated" — the ISP which is its customer — bill and keep would be consistent with the Act.

The Commission could also implement bill and keep for ISP traffic by denying reciprocal compensation for carriers that offer service only to a limited number of customers based on Internet arbitrage, and by forbearing from enforcing the reciprocal compensation pricing rules in section 251(d)(2). While these are discussed in this paper, they are not optimal and we do not recommend that they be adopted.