ORIGINAL

EX PARTE OR LATE FILED

W. Scott Randolph
Director - Regulatory Affairs

verizon

RECEIVED
JAN 12 2001
FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Verizon Communications
1850 M Street, NW
Suite 1200
Washington, DC 20036

Phone: 202 463-5293
Fax: 202 463-5239
srandolph@verizon.com

January 12, 2001

Ms. Magalie R. Salas
Secretary
Federal Communications Commission
445 Twelfth Street, S.W.
Washington, DC 20554

Ex Parte: Intercarrier Compensation for ISP-Bound Traffic – CC Docket No. 99-68

Dear Ms. Salas,

On Friday, January 12, 2001, the attached letter from Thomas J. Tauke, Senior Vice President – Public Policy and External Affairs, was provided to Chairman William E. Kennard, Commissioner Harold Furchtgott-Roth, Commissioner Susan Ness, Commissioner Gloria Tristani, and Commissioner Michael K. Powell.

Pursuant to Section 1.1206(a)(1) of the Commission's rules, and original and one copy of this letter are being submitted to the Office of the Secretary. Please associate this notification with the record in the proceeding indicated above.

If you have any questions regarding this matter, please call me at (202) 463-5293.

Sincerely,

W. Scott Randolph

W. Scott Randolph

Attachment

cc: Kathryn Brown
Anna Gomez
Rebecca Beynon
Jordan Goldstein
Deena Shetler
Kyle Dixon
Dorothy Attwood
Glenn Reynolds
Tamara Preiss

No. of Copies rec'd 0+1
List A B C D E

Thomas J. Tauke
Senior Vice President
Public Policy & External Affairs

veri on

Verizon Communications
1300 I Street, N.W., Suite 400 West
Washington, DC 20005

Phone 202.336.7904
Fax 202.336.7914
thomas.j.tauke@verizon.com

January 12, 2001

Chairman William Kennard
Commission Harold Furtchgott-Roth
Commissioner Susan Ness
Commissioner Michael Powell
Commissioner Gloria Tristani
Federal Communications Commission
445 12th Street, S.W.
Washington, D.C. 20554

Re: Reciprocal Compensation on Internet Traffic

Dear Chairman and Commissioners:

The Commission should move quickly to end the market dislocations caused by the payment of reciprocal compensation on Internet traffic by adopting a mandatory transition toward bill and keep for this traffic.

It has been almost two years since the Commission last addressed reciprocal compensation for Internet-bound traffic. In that order, the Commission confirmed that, because Internet traffic is inherently interstate and interexchange rather than local, it is *not* subject to reciprocal compensation under the 1996 Act. But it left the application of that decision up to individual states. Unfortunately, the lack of an explicit directive led to a hodgepodge of state decisions that not only allowed the problem to fester, but allowed it to grow exponentially.

The situation today is dire. Carriers that interpose themselves between incumbent carriers and Internet service providers ("ISPs") act as toll collectors for the Internet. These carriers provide no real service and no added value, yet they skim off literally billions of dollars in subsidies for doing nothing more than allowing calls to the Internet to pass through their gates. This is now a billion dollar drain for Verizon alone, and is still growing.

This is not just Verizon's problem, however. The payment of reciprocal compensation on Internet traffic has grossly distorted the market and has become a significant unproductive drain on the national economy.

First, it affirmatively deters local competition. Indeed, as one analyst put it, paying reciprocal compensation on Internet traffic converts customers from assets into liabilities.[1] When a CLEC adds a new residential customer, it loses reciprocal compensation revenues it would receive when the customer calls an ISP served by that CLEC, plus it risks having to pay reciprocal compensation to another CLEC that interposes itself between that customer and his or her ISP.

Second, it affirmatively deters investment. In the case of incumbent carriers, it deters investment by draining dollars that otherwise could be put to productive uses, such as investing in the network or in the development of innovative advanced services. In the case of CLECs, it deters investment by making it infinitely more lucrative to simply pocket free cash than to build a real business that provides real services. In the words of the Commission's own economists, it is a form of "regulatory arbitrage" that serves to "distort the incentives of carriers to invest and deploy facilities efficiently and to offer services to customers."[2]

Moreover, today's problem is entirely a creation of the regulatory process. The problem arose initially because a number of state commissions incorrectly interpreted prior orders of this Commission to classify ISPs as local end users for purposes of applying the reciprocal compensation provisions. And while the Commission's previous order corrected that mistaken impression, it nonetheless perpetuated the problem by allowing state commissions to continue to require the payment of reciprocal compensation on this traffic -- regardless of what carriers actually agreed to -- instead of definitively resolving the issue.

The problem cannot, as some have suggested, be laid at the feet of the 1996 Act. On the contrary, the Act by its own terms merely provided a mechanism for local exchange carriers to compensate one another for the "reciprocal" exchange of traffic. But Internet-bound traffic is entirely one-way, and is in no sense reciprocal. And it is simply inconceivable that the 1996 Congress intended to create a massive new uneconomic subsidy flow by requiring the payment of reciprocal compensation on the manifestly *non*-reciprocal flow of traffic to the Internet.

---

[1] Cleland, The Precursor Group/Legg Mason Research Technology Team, *Reciprocal Compensation for Internet Traffic — Gravy Train Running Out of Track*, June 24, 1998.

[2] Patrick DeGraba, OPP Working Paper 33, "Bill and Keep at the Central Office As the Efficient Interconnection Regime," ¶ 17 (rel. Dec. 2000).

But just as the problem was created by the regulatory process, it can and should be solved by the regulatory process.

1. The solution to the current crisis is to move quickly toward a mandatory nationwide bill and keep system for Internet-bound calls. This is the only result that will close the existing regulatory loophole once and for all, and put an end to the uneconomic (and unproductive) behavior that is so grossly distorting the market. It will restore incentives for all carriers to make the investments necessary to provide real services to real customers. And it will allow all carriers to recover their own costs from their own customers, just as the Commission previously required incumbent carriers to do when it re-affirmed the so-called ISP exemption that applies to Internet traffic.[3]

Claims by some that adopting a bill and keep system will result in higher Internet access rates are nothing but irresponsible scare tactics, plain and simple. The proof is in the pudding. In states such as Massachusetts where forward-looking state regulators already have eliminated reciprocal compensation for Internet-bound traffic, there has been no increase in rates charged by ISPs for Internet access.[4] This is hardly surprising. There already is significant competition to serve ISP customers that will keep rates to these customers low. Indeed, Verizon certainly has no plan to raise rates for these customers. And the overwhelming majority of CLECs (85 percent) conceded in response to an independent survey that they likewise do not plan to raise their rates to ISPs after a bill and keep system is adopted.[5]

2. In order to be effective, any transition arrangement must be mandatory. The CLECs have now had two years since the Commission's last order that Internet-bound traffic is not subject to the Act's reciprocal compensation provisions to ensure that they are not dependent on reciprocal compensation revenues. As a result, the CLECs already have benefited from a lengthy "transition" period. Nonetheless, in an effort to bring this issue to a close, Verizon and other ILECs have not objected to a short *additional* transition period.

Unlike its last order, however, the Commission should now adopt a firm federal rule that imposes mandatory caps during the transition toward bill and

---

[3] *See Access Charge Reform*, 12 FCC Rcd 15982, 16134 (1997).

[4] Joel Popkin & Co., "Reciprocal Compensation Has No Effect on Internet Prices" (Sept. 12, 2000).

[5] Eastern Management Group, "Reciprocal Compensation: The CLEC View" (rel. Dec. 7, 2000).

keep. A mandatory federal policy is both consistent with the Commission's conclusion that it has jurisdiction over this traffic, and avoids a patchwork state-by-state approach that provides inconsistent regulation of the Internet.

More important, the absence of a clear federal rule has allowed the problem to balloon since the last order. Indeed, reciprocal compensation billings have doubled in that time and continue to grow. An order that is only voluntary will make things worse rather than better, since it would merely perpetuate the problem and allow it to continue to grow further.

Of course, this does not mean that the states would be left without a role if the Commission establishes a federal rule. They would still be responsible for arbitrating interconnection agreements and determining the compensation rate for compensable traffic. And they will continue to be called on to interpret contracts. To the extent carriers have made explicit voluntary agreements to pay compensation for Internet-bound traffic and those agreements have no change of law provision, they would be unaffected by a new federal rule.

3. In order to be effective, any transition must have an immediate impact. If the Commission is to succeed in limiting the severe economic distortions caused by reciprocal compensation on Internet traffic -- and provide carriers with an immediate incentive to adjust their business plans -- it is critical that any transition plan produce an immediate reduction in reciprocal compensation payments.

While ILECs currently send CLECs 18 times more minutes than they receive, the growth in traffic bound for the Internet continues unabated. Because of this fact, even adopting initial caps of 12 to 1 -- which is the ratio that the press has reported is under consideration -- would not reduce payments. Quite the contrary, it would actually preserve the current level of reciprocal compensation billings for still longer, and merely maintaining existing levels is no transition at all. Indeed, the rate of growth in Internet minutes is such that even an initial cap of 6 to 1 would only cut billings by half, and result in payments of more than $1 *billion* to CLECs.

Moreover, the underlying growth assumption on which these numbers are based is quite conservative. These figures assume that dial-up Internet traffic will grow at a 42 percent rate, which is lower than the current growth rate. Indeed, MCI, one of the biggest recipients of reciprocal compensation, has reported a growth rate of 49 percent from the third quarter of 1999 to the third quarter of

2000.[6] And the number of minutes actually billed to the ILECs grew by 58 percent from 1999 to 2000.

Some CLECs have complained that with already weak stock prices, they will suffer financial hardships if the Commission implements a true transition that results in a significant reduction in their reciprocal compensation revenues. But Wall Street has already assumed that the Commission will act decisively and factored this in. For example, Legg Mason has anticipated that if Commission "adopts a cap system during [a transition to bill and keep], reciprocal compensation revenues could be cut by 66% in 2001."[7] Moreover, Wall Street views such an action as a positive, not only for the ILECs but for the CLEC industry as well. As one analyst explains "[c]ompetititive carriers that serve enterprise versus Internet Service Providers or other specialized in-bound call centers would benefit from the bill and keep system."[8]

Moreover, even for those carriers that today have significant reciprocal compensation revenues, Wall Street has excluded those revenues in its evaluations.[9] As one analyst simply explained, "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."[10]

4. The Commission should not require any reciprocal compensation payments in excess of its caps. Because of the rapid growth in Internet-bound traffic, even reduced rates (where they have been adopted) have resulted in an increase in reciprocal compensation payments. We know this all too well from first hand experience. For example, in New York, where the state commission

---

[6] WorldCom 10-Q filed Nov. 14, 2000.

[7] Daniel Ernst Legg Mason, "Biller Keeps All; FCC Expected to Set Zero Price Target for Reciprocal Comp." (Nov. 27, 2000).

[8] *Id.*

[9] *See* Vik Grover, Kaufman Bros., L.P., "KBRO Morning Notes – Part 2/3," (Sept. 26, 2000) ("It is our view that the Street has removed recip comp revenue from all CLEC models pending resolution of this matter."); *see also* Mark Kastan, CS First Boston, "FCOM: Pre-Announces 3Q Revenues Above Expectations FBC" (Sept. 28, 2000) (reiterating a buy recommendation for Focal Communications: "assuming that reciprocal compensation as a revenue stream goes away beginning in January '02, we still come up with a 10 year [discounted cash flow] derived price target of . . . a six-fold increase from current levels").

[10] Gregory P. Miller, ING Barings, "Reciprocal Compensation – The End of Another Arbitrage (Part 1 of 2), (Sept. 14, 2000).

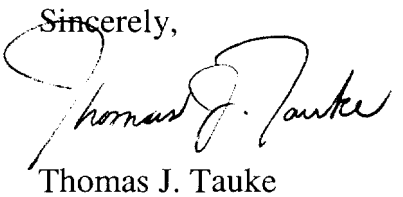
instituted a reduced rate for traffic above an imbalance of three to one, the amount Verizon has been billed for reciprocal compensation has continued to grow at a rate well in excess of 50 percent.

This result should not be surprising. Because carriers can use existing technologies -- such as so-called "soft switch" technology -- that result in virtually no per-minute costs for one-way traffic, retaining *any* rate for traffic above the caps will encourage carriers to continue to interpose themselves in front of ISPs solely to rake off reciprocal compensation payments. Again, we know this from cold, hard experience. For example, even where the rate applicable to Internet-bound traffic is as low as $.0012, it led the CLEC involved to announce almost immediately that it would be providing dial-up switched ISP access for Internet giant AOL through its soft switch network.

5. The Commission should not upset orders by state commissions that have already moved toward bill and keep. Some forward-looking state commissions have already moved to fix the reciprocal compensation problem, for example by adopting bill and keep or by adopting caps lower than those reportedly being considered by the Commission. The Commission should make it crystal clear in any order here that those states are not required to increase reciprocal compensation payments (only to transition them back down). Indeed, no one could seriously claim that it makes sense to knowingly make the problem worse before making it better.

To avoid inadvertently undercutting these state decisions, the Commission should also reaffirm its prior conclusion that traffic to the Internet is interstate and interexchange (rather than local), and, therefore, is not subject to section 251(b)(5). But regardless of how the Commission comes out on this legal issue, the Commission should expressly preserve state decisions that already have moved toward bill and keep.

Sincerely,



Thomas J. Tauke