rate design issues with respect to the ***end user charges*** through which transport and termination costs would be recovered under any such rule."

"Sham" Networks. Finally, the Commission has ample ability under the existing CPNP regime to deal with end-users that attempt to game the system by claiming to be "carriers." ***See Notice* ¶ 18.** To begin with, both DeGraba and the ***Notice*** merely conjecture that this is a substantial problem. In reality, the costs associated with establishing even a "sham" network are more likely to render this problem a "mere curiosity" rather than a serious, "pressing issue." In all events, the "sham network" problem is not a failing of CPNP; rather, if individual entities are abusing the system, the Commission may address that by properly enforcing "carrier" qualifications under the existing CPNP system.[12] Moreover, any incentive to establish "sham" networks in the first place is removed to the extent that any provider of telecommunications is restricted solely to recovery of forward-looking economic costs for termination of traffic from other carriers.

In sum, a strong commitment to cost-based intercarrier compensation under the existing CPNP convention will deal fully and appropriately with each of the pressing issues identified in the ***Notice.*** Moreover, the Commission need not break any new economic ground to implement that unifying reform. Rather, the Commission should simply apply its time-tested TELRIC rules, ***see*** **47** C.F.R. § 51.505, to the transport and termination of all

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[11] ***Ordover-Willig*** ¶ 22 ("if these end user charges were not regulated, incumbent LECs could exploit their market power ***vis-a-vis*** end users by charging supra-competitive rates for termination (through new termination charges or increases to existing end user charges)").

[12] The DeGraba paper cites the fact that some incumbent LECs have argued that they should not have to pay paging companies to complete calls, although DeGraba does not expressly conclude that paging companies are "sham" networks. ***See DeGraba* ¶ 113.** Since the ***Notice*** issued, the D.C. Circuit has upheld the Commission's determination that paging companies qualify as (continued. . .)

telecommunications. **As** the Commission has consistently recognized, rates based upon those forward-looking, long-run incremental cost principles effectively promote both efficiency and competitive neutrality. *See, e.g.*, *Local Competition Order* ¶ 630 ("economists generally agree that prices based on forward-looking long-run incremental costs (LRIC) give appropriate signals to producers and consumers and ensure efficient entry and utilization of the telecommunications infrastructure").[13] And the mechanisms and procedures that would be used to establish TELRIC-based rates for transport and termination of all telecommunications are already in place. The relevant switching and transport costs must be determined in establishing network element charges, and regulators and carriers now have more than five years' experience in estimating costs and designing rates under the TELRIC standard.[14] AT&T therefore concurs with the Commission's tentative conclusion (*Notice* ¶¶ 99-101) that if it maintains CPNP – as it should – it should require intercarrier transport and termination charges to be based on the TELRIC standard.

(. . . continued)
networks eligible to receive reciprocal compensation. *See Qwest Corp. v. FCC*, 252 F.3d 462 (D.C. Cir. 2001).

[13] *See also Ordover-Willig* ¶ 53 (by measuring intercarrier compensation not on "an individual LEC's expenditures," but "on efficient network design, currently available technologies, and efficient management and operations," TELRIC provides "powerful incentives to operate efficiently"); FCC Brief of the Federal Petitioners, *Iowa Utilities Board v. FCC 11, 00-587,* at 22 (noting that a key benefit of TELRIC is that "a forward-looking methodology would send appropriate signals for entry, investment, and innovation to potential competitors in local telecommunications markets").

[14] *See, e.g., Local Competition Order* ¶ 629 (applying TELRIC as a "single set of pricing rules should minimize regulatory burdens, conflicts, and uncertainties associated with multiple, and possibly inconsistent, rules"); Brief for the Respondents FCC and United States, *Iowa Utilities Board v. FCC II*, 00-587, at 44-49 (noting that TELRIC analysis is superior to historical cost approach in terms of administrative workability).

II. B&K IS NEITHER SUPERIOR, AS A MATTER OF ECONOMIC THEORY, NOR MORE DEREGULATORY THAN CPNP.

It is true, of course, that by reducing certain intercarrier termination charges to zero, a properly administered B&K rule would likewise eliminate both the ability to set those charges at monopoly levels and any artificial incentives based upon those charges to seek out customers with predominantly inbound traffic. *See Ordover-Willig* ¶ 45. But B&K obviously must do more than merely "tie" with cost-based CPNP in addressing those issues given the serious risk that implementation of an untested B&K proposal could also have unintended consequences and create additional problems.[15] Accordingly, proponents of B&K struggle to identify other reasons to favor B&K. First, they contend that B&K has a superior economic pedigree because it better reflects the ways in which costs are caused and externalities are created in the making of a telephone call.[16] Second, they claim that B&K is more "market-oriented" and "self-administering" than CPNP.[17] Both claims are baseless.

A. Cost-Based CPNP Will Promote More Efficient Network Usage Than B&K.

There can be no doubt that both the calling party and the called party benefit from many telephone calls. DeGraba concludes from this that a B&K rule, which effectively requires the calling and called parties to share the costs of such calls, would simulate the arrangements that would prevail in truly competitive markets and would thereby encourage more efficient network usage than CPNP. *See Notice* ¶ 23. **As** Professors Ordover and Willig explain, "[w]hatever the common sense appeal of this notion, it has the economics backwards." *Ordover-Willig* ¶ 25.

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[15] *See Ordover-Willig* ¶¶ 42-66; *Notice* ¶ 64.

[16] *See, e.g.*, *DeGraba* ¶ 59; *Notice* ¶ 37.

[17] *See, e.g.*, *Notice* ¶ 34; *DeGraba* ¶¶ 91-93.

Under the CPNP convention, the calling party ultimately bears all of the costs of originating and terminating the call that he or she initiates. This is a straightforward application of the fundamental economic principle of cost causation that the costs of network usage should generally be borne by the party that causes those costs to be incurred. *See id.* ¶ 27. **As** the Commission has long recognized, adherence to the cost causation principle in rate design generally encourages efficient usage by requiring the "cost causer" to internalize the network costs associated with decisions to use the network.[18] *See also Competitive Telecommunications Ass'n* v. *FCC*, 87 F.3d 522, 529 (D.C. Cir. 1996) (holding that Commission must provide adequate justification for departure from cost-causative pricing).

The *Notice* acknowledges that "[m]odern economic analysis" uniformly treats the calling party as the cost causer, but "question[s] this assumption" based solely upon the commonplace observation that called parties can benefit from telephone calls. *Notice* ¶¶ 19, 37. But the fact that the called party may derive some benefit from receiving a call does not change the fact that the calling party is the cost causer. Rather, the existence of such benefits simply establishes that there may be "externalities" associated with a telephone call: in addition to the direct costs of network usage, the placing of a telephone call may confer benefits – or impose costs – on the called party. *Ordover-Willig* ¶¶ 27-28. To be sure, externalities are a relevant consideration. Absent mechanisms to "internalize" the positive externalities conferred upon called parties, for example, calling parties might, from a social welfare perspective, under-utilize telephone networks. *Id.* ¶ 27.

[18] *See, e.g., Local Competition Order* ¶ 1112; ***Ordover**-Willig* ¶¶ 29-30; *Access Reform Order* ¶ 24 ("costs of interstate access should be recovered in the same way that they are incurred, consistent with principles of cost-causation").

But the existing CPNP rule already provides effective and flexible mechanisms for the private internalization of positive externalities, which B&K would only weaken. For example, consumers routinely agree (expressly or tacitly) to take turns calling each other "so that each bears the full costs [under CPNP] of the share of calls that roughly reflects that party's share of the total benefits associated with their calls." *Id.* ¶ 30. Or the parties may internalize the relative benefits and costs associated with their calls by adjusting the length of time that they talk when one party or the other initiates the call (as in the case of a student who initiates a call, but then asks a parent to call back when it is clear that the conversation will continue for more than a few minutes). *Id* As the *Notice* recognizes (¶ *63* & n.84), called party pays options – *e.g.*, collect calls, *800* numbers, and calling cards purchased by one party for another – are also available.[19] In combination, these alternatives allow calling and called parties virtually unlimited discretion to allocate the costs of their calls in whatever proportions best fit their individual preferences and demand profiles. *Ordover-Willig* ¶ *30.*

B&K would substitute for these flexible, private cost internalization solutions a one-size-fits-all regulatory solution that is necessarily inefficient. The positive externalities associated with the placing of a telephone call obviously vary greatly from call to call. Sometimes the calling party experiences almost all of the benefits; sometimes the called party does. **As** the *Notice* concedes, "regulators cannot know how benefits are distributed between the parties." *Notice* ¶ 39. "Any allocation that a regulator can make is arbitrary (in the economic sense), yet even a small allocation error can produce massive distortions." *Id.* B&K would

[19] The *Notice* ironically attempts to illustrate the supposed failure of CPNP to accommodate positive externalities by noting that "[i]f a caller telephones a catalog merchant, surely that merchant benefits at least as much as the caller." *Id.* ¶ 37. Of course, that caller almost certainly uses a toll free 800 number to call the merchant, which only confirms that the existing CPNP convention effectively accommodates such positive externalities.

institutionalize such allocation errors and the associated distortions by arbitrarily assigning to *all* called parties for *all* received calls the costs of terminating the call.[20] To the extent that parties do not place equal value on a call – and the *Notice* identifies no evidence they usually or even often do – there is no ready mechanism under a B&K regime that would permit the parties to opt out of the arbitrary regulatory split to reflect their actual preferences.[21] Thus, contrary to the claims of proponents of B&K, abandoning CPNP would make it much *more* difficult for calling parties to internalize the positive externalities associated with the calls they make.[22]

Even more importantly, proponents of B&K entirely overlook the fact that many telephone calls impose *negative* externalities and that these externalities too must be considered in evaluating any intercarrier compensation rule. When a telemarketer calls during the middle of dinner or a bath, for example, the harm to the called party, who would strongly prefer not to be interrupted, can be quite large. More generally, a called party may not want to receive a call

[20] *See Ordover-Willig* ¶ 34; *DeGraba* ¶ 24

[21] DeGraba describes a possible "50/50" cost split between calling and called parties. He admits that there is no empirical basis for that arbitrary allocation. *See DeGraba* ¶ 59 & n.53; ***id.*** ¶ 65. In fact, B&K would produce an even more arbitrary split determined in each case by the particular point of interconnection between the called party's network and the calling party's network. *Ordover-Willig* ¶ 34 (B&K "requires each party's carrier (and therefore each carrier's end user) to bear its own costs, and the cost of originating the call may be much less than or much greater than the cost of terminating the call").

[22] Taking turns calling each other would be a much more complex and less effective strategy under B&K, because both parties would incur costs on every call, regardless of which party initiated the call, and the relative proportion of the costs borne by each party could, as noted above, vary from call to call. Moreover, B&K would weaken even 800 number and other called party pays options for allocating costs because, under B&K, the calling party's network would have to charge the calling party, rather than the called party's network, for costs associated with delivering 800 calls to the point of interconnection between the carriers' networks. DeGraba notes (¶ 32) that under B&K an interexchange carrier could offer an "800 service" in which the called party pays for the inter-city transport portion of the call, but *not* the originating and terminating ends of the call. But this type of "800 service" is a far cry from the type of 800 service offered today in which the called party pays *all* of the costs associated with the call.

because of the identity of the caller, the subject matter of the call, or the time that the call is placed. ***Urdover-Willig*** ¶ 28. ***An*** efficient compensation rule would seek to minimize this over-utilization of the network by requiring the calling party, to the greatest extent possible, to bear the costs caused by the call. *Id.* B&K would do just the opposite. By shifting some share of the direct costs of every call to the called party (and effectively allowing the calling party to terminate calls for free), B&K would encourage *more* unwanted calls. ***Id.* ¶ 32.**

CPNP, in contrast, forces the calling party to bear all of the direct costs of the call, and therefore, discourages more unwanted calls than would B&K. *Id.* ¶ 31 Of course, no rule for allocating the direct costs of placing a telephone call can force calling parties to internalize *all* of the harm to recipients of unwanted calls, but CPNP "does the best job possible by not allowing the calling party to shift any of the direct costs of the call to the called party." *Id.*

To add insult to injury, a B&K rule would force recipients of unwanted calls to pay for the "pleasure" of receiving those calls. Because consumers would understandably balk at that outcome, the ***Notice*** inquires whether a "first minute free" rule could solve the unwanted call problem. It could not. Although a first minute free rule might eliminate the insult, it would do nothing to address the injury – the negative externalities exacerbated by a B&K rule. In this regard, the most significant aspect of the negative externality is the interruption itself. **As** explained above, B&K would, in effect, subsidize unwanted calls, and thereby, increase the supply of such calls, causing more such costly interruptions. *Id.*[23]

[23] Moreover, there is no practical way for carriers to differentiate between unwanted and "wanted' calls. Thus, any first minute free rule would have to apply to all calls, and would introduce still further economic distortions by shifting the costs of very short calls to other consumers (whose rates would necessarily be increased to pay for the "free" first minutes).

In short, far from being superior, as a matter of economic theory, to the existing CPNP convention, B&K would send all of the wrong economic signals and result in much more inefficient network usage. Some telephone calls confer positive externalities, some confer negative externalities, and some impose no externalities at all; the variation from call to call is enormous; and the size of the externalities associated with any given call may bear no relation to the direct costs of originating and terminating the call. The search must therefore be for the rule that minimizes negative externalities by forcing callers to at least internalize all of the direct costs associated with their calls, but also is flexible enough to allow calling and called parties to internalize positive externalities. Cost-based CPNP is that rule.

B. B&K Would Not Reduce The Need For Regulatory Intervention.

Proponents of B&K also claim that B&K is more "deregulatory," "market-oriented," and "self-administering" than cost-based CPNP. ***See, e.g.*, *Notice* ¶ *37.*** But B&K merits none of these adjectives. Under B&K, regulators would focus less on intercarrier charges, but would need to focus ***more*** on end user charges. In regulating the new end user charges, regulators would still have to determine what costs are to be recovered in those regulated charges. ***See Ordover-Willig*** ¶ 20. Moreover, resolving these issues would likely be more, rather than less, difficult in the context of end user charges.

Because they control the bottleneck local telephone facilities over which virtually all telephone calls travel, the BOCs and other incumbent LECs that serve more than 90 percent of the nation's local telephone consumers – and, in most localities, *all* consumers – have substantial market power over consumers. That is why incumbents' retail charges to consumers must be regulated, and the level of local competition sufficient to do away with end-user rate regulation cannot be expected under any realistic near-term, or even mid-term, scenario.[24] It "would certainly be folly to set regulatory policy on the assumption that all (or even most) local markets will become sufficiently competitive in the next few years to justify ending retail rate regulation." *Id.*

A B&K rule would shift the costs of termination from the calling party's carrier to direct billing of called party end users. Unless the Commission regulated end user charges in such a B&K regime, incumbent LECs could exploit their market power over end users by charging supra-competitive rates for termination (whether charged separately from existing end user charges or reflected in increases to existing end user charges). *See id.* ¶ 22. Incumbent LECs could also exploit their market power by using termination charge rate design to favor their long distance, information service, and advanced service affiliates at the expense of competing providers. *Id.* Accordingly, the Commission would need to regulate charges for termination of telephone calls regardless of whether it retains CPNP or adopts B&K. Moreover, although the calling party's carrier would be obliged to pay for transport on the terminating end of the call (at least under the DeGraba proposal), the incumbent LEC would still be the most likely transport supplier and could continue to exert market power in the absence of regulated transport rates.

[24] See *Id.* ¶ 21 ("We, like the Commission, look forward to the time when all local telephone markets are fully competitive, all customers have multiple alternative suppliers, and rate regulation is unnecessary. But more than five years after the passage of the Telecommunications Act of 1996, it is all too obvious that this dream world not only does not exist today, but is not even on the horizon. In the wake of the collapse of much of the competitive LEC industry in the past year, many have begun to question whether significant local competition outside a handful of major metropolitan areas can be expected even in the mid-term, five to ten years.").

In either case, the Commission would need to cap rates at the levels that would prevail in a workably competitive market. Thus, regulators would engage in the same, admittedly difficult, ratemaking exercise, regardless of the choice between CPNP and B&K.

A switch to end user charges for transport and termination could, however, present additional regulatory difficulties. To the extent that the costs of transport and termination are usage-sensitive, then economic efficiency dictates that charges for those services should also be usage-sensitive.[25] Regulators may be reluctant to impose usage sensitive charges on end users, however – indeed, this fact is identified by the Commission as one of the principal reasons why there are "arbitrage" opportunities in the context of ISP-bound traffic. But if state commissions (with regard to end user charges for terminating "local" traffic) or this Commission (with regard to end user charges for terminating "long distance" traffic) were to require flat-rated end user charges for the recovery of usage sensitive costs, new arbitrage opportunities would be created and inefficient network usage would be encouraged.

Moreover, B&K, at least as proposed in the *Notice* would not even obviate the need for regulation of intercarrier charges and practices. The COBAK proposal, for example, would eliminate intercarrier charges only for loop, local switching and originating transport.

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[25] *See, e.g., In The Matter Of Access Charge Reform,* Sixth Report & Order, 15 FCC Rcd. 12,962, ¶ 12 (2000) *("CALLS Order"), pets. for review pending sub nom. Texas Office of Public Utility Counsel* v. *FCC*, No. 00-60434 (5th Cir.) ("In promulgating its access charge rules, the Commission has recognized that, to the extent possible, costs of interstate access should be recovered in the same way that they are incurred. This approach is consistent with principles of cost-causation and promotes economic efficiency. Thus, non-traffic sensitive costs should be recovered through fixed, flat-rated fees. Similarly, traffic sensitive costs should be recovered through corresponding per-minute access rates."); *In the Matter of Access Charge Reform,* Second Order on Reconsideration and Memorandum Opinion & Order, 12 FCC Rcd. 16606, ¶ 62 (October 9,1997) ("For our rate structure to be 'cost-based,' costs must be recovered (1) only from the party that causes the costs to be incurred; and (2) in the manner in which the costs are incurred (e.g., non-traffic-sensitive costs should be recovered on a non- traffic sensitive basis).").

Where, as in most areas of the country, the incumbent LEC controls bottleneck transport facilities, market power could, absent rate regulation, just as easily be exercised through transport or trunk port charges. ***Ordover-Willig* ¶ 23.** Strict regulation of those charges would therefore be required to discourage monopoly abuses. ***See Notice* ¶ 61**

In sum, the choice between CPNP and B&K is not a choice between a "regulatory" solution and a "deregulatory" solution. Rather, the "deregulatory" virtues of a B&K rule are illusory, and thus, there is no legitimate reason to prefer B&K over cost-based CPNP

111. B&K WOULD PRODUCE REGULATORY ARBITRAGE, MONOPOLY ABUSE, AND RADICAL RETAIL PRICING CHANGES.

Not only would B&K offer no clear advantages over CPNP, a switch to B&K would usher in an entirely new set of problems and abuses. For example, rather than solving problems of regulatory arbitrage, B&K would create new arbitrage opportunities. B&K would likewise facilitate a broad range of monopoly abuses by incumbent LECs. Any such rule would, for example, give incumbent LECs unilateral control over originating-side trunking used by IXCs, which would provide incumbent LECs that offer interexchange services new opportunities to discriminate in favor of their affiliated long distance services. B&K would also harm local competition by eliminating incumbent LECs' limited incentives to establish reasonable UNE switching and transport rates.

In addition, B&K would cause fundamental changes in telecommunications pricing that would undermine well-entrenched customer expectations about how telephones are used and would almost certainly be greeted with widespread consumer complaints and confusion. These radical pricing changes would have far-reaching consequences, both foreseeable and unforeseeable. ***See Notice* ¶ 58**.

And the particular B&K proposals of DeGraba and Atkinson-Barnekov contain additional complexities, problems, and ambiguities that would cause further distortions.

A. Bill And Keep Would Foster Regulatory Arbitrage And Monopoly Abuse.

Regulatory Arbitrage. The Commission's concern about "regulatory arbitrage" in the context of reciprocal compensation payments for ISP-bound traffic appears to be the tail that is wagging the *Notice's* very large dog of abandoning CPNP for B&K. But trading CPNP for B&K would simply trade one form of arbitrage incentives for another, because B&K would unduly encourage carriers to seek out customers that originate more traffic than they receive.

As Professors Ordover and Willig explain, B&K inherently creates incentives to seek out originating traffic in ways that are inefficient. B&K by definition breaks the linkage between end-user prices and costs, because it requires the called party to subsidize the costs of calls that are caused by, and therefore attributable to, the calling party. Accordingly, "B&K would provide carriers with inefficient incentives to build networks that target customers that originate more calls than they receive – *e.g.*, telemarketers." *Ordover-Willig* ¶ 45. Indeed, the Commission has already recognized this point. *See Local Competition Order* ¶ 1112 ("bill-and-keep arrangements are not economically efficient because they distort carriers' incentives encouraging them to overuse competing carriers' termination facilities by seeking customers that primarily originate traffic"). Therefore, to the extent that some new entrants' targeting of end-users with terminating traffic, in fact, reflects arbitrage, adopting B&K would at most replace one set of inefficient incentives (*i.e.*, to win customers who primarily terminate calls) with another set of inefficient incentives (*i.e.*, to win customers who primarily originate calls). CPNP, by contrast, would create no such incentives, provided that compensation is set at economic cost.

Monopoly Abuse. B&K would also foster a broad array of new monopoly abuses by incumbent LECs. ***See** Ordover-Willig* ¶¶ 55-60. For example, B&K would give incumbent LECs much greater control over the end-to-end quality of long distance calls. Today, IXCs decide what transport trunks they will order and use, and an IXC can thus achieve substantial control over network efficiency and call quality by purchasing what it needs to attain certain levels of call blocking, call setup times, and related measures of quality. In a B&K world, however, the originating incumbent LEC would have unilateral control over these decisions, which would dramatically increase the incumbents' ability to discriminate against unaffiliated IXCs through degradation of quality.

This point is directly related to one of the fundamental flaws in the ***Notice's*** case for B&K. The Commission states that one of the two principal problems that B&K would avoid is "the sense that end users have no direct control over access arrangements under current regimes." ***Notice*** ¶ 40. With respect to call quality, however, B&K would not confer such control on end-users. Interexchange carriers have far superior information and expertise with respect to, and are in a far better position to monitor, the quality of the specific facilities arrangements used to provide interstate access. Under a B&K regime, if an end-user experiences no difficulties completing local calls, but finds that call quality is degraded when making long distance calls (due to deficiencies in LEC facilities used only for access), the end-user will blame the IXC, not the LEC. Therefore, although in a B&K world end-users would be theoretically "empowered" to choose their own access arrangements, it does not follow that end-users actually have the information, expertise, or ability to take the action necessary to discourage LEC abuses.

One obvious way that incumbent LECs could degrade the quality of their long distance competitors' calls is through the sizing of transport trunks devoted to their competitors.

See Ordover-Willig ¶ 60. By devoting insufficient trunking resources to long distance competitors, the incumbent could increase the incidence of call blocking. That would prove extremely costly to the competitors, and cost-free to the incumbent LEC, because end-users would blame their IXC, not the LEC, for long distance problems.

B&K would also harm local competition by eliminating the only incentive incumbent LECs have not to oppose cost-based UNE switching rates. ***Id.*** **¶ 62.** Under today's system, state commissions typically borrow UNE switching rates when determining the appropriate rates for reciprocal compensation. The reality that they might be net payors of reciprocal compensation provides incumbent LECs with at least some (albeit far from perfect) incentives to seek reasonable, cost-based UNE switching rates in an effort to lower their potential reciprocal compensation payments. In the *ISP* ***Remand Order,*** the Commission ironically relies on the fact that reciprocal compensation rates have come down in recent years as a partial justification for its premature transition to B&K, without acknowledging that the only reason those rates have been reduced is because the existing CPNP system has given incumbent LECs some incentive to abandon their earlier, well-documented efforts to seek grossly inflated reciprocal compensation rates. B&K, by eliminating all reciprocal compensation payments, would eliminate with it the principal check on exorbitant UNE switching rates.

B. B&K Would Radically Change Retail Telecommunications and Information Service Pricing In Ways That Consumers Would Find Undesirable.

B&K would completely up-end well-established practices for pricing telecommunications and information services. Most obviously, under B&K, consumers would be forced to pay for the receipt of all calls, including unwanted calls. ***See Notice*** ¶ 60. It is one thing to pay to receive calls in return for the substantial benefit of mobility in the wireless context where telemarketing calls are rare (and, indeed, restricted by regulation, 47 C.F.R.

§ 64.1200(a)(1)(iii)), and quite another to be forced to pay for the "pleasure" of receiving unwanted calls at home at all hours of the day and night from telemarketers, stock brokers, and others. **As** noted above, "first incoming minute free" pricing plans could not solve this inherent defect of B&K, because the negative externalities associated with unwanted calls occur at the moment the call is received. In other words, even if the consumer manages to get off the phone in the first minute, the damage is largely done. It takes little imagination to predict the consumer opposition to these inevitable consequences of B&K or the "sound bite" that would accompany that opposition: "every call a collect call."

B&K would cause additional radical changes to long distance pricing. Today, competing providers advertise, and consumers generally pay, a single price for long distance service. In a B&K world, consumers would have to add up the charges of three carriers – the originating LEC, the IXC, and the terminating LEC in order to determine what they are paying for long distance calls. Moreover, because access charges vary considerably from one LEC to the next, total end-to-end per minute long distance charges would vary from consumer to consumer and, indeed, from call to call.

B&K would also likely affect the retail prices for Internet services in ways that consumers would find highly distasteful. In particular, elimination of intercarrier payments would force LECs to recover all costs of termination from ISPs, which would likely require increases in the local business rates that ISPs pay pursuant to the ESP exemption. In addition, B&K would put increasing pressure on LECs to charge ISPs usage-sensitive rates, which would in turn put pressure on ISPs to charge end users usage-sensitive rates.

C. The Specific B&K Proposals Mentioned In The *Notice* Have Additional Flaws That Would Further Distort Investment Incentives.

The specific B&K proposals in the *Notice* would also greatly distort carriers' incentives with respect to investment, the placement of central offices, and establishment of points of interconnection. One of the most important issues in any B&K regime is how to determine the point of interconnection ("POI") between networks, because that determines which costs must be borne by each carrier. Both of the Commission Staff papers struggle at length with this question and offer proposed default rules ostensibly designed to determine an efficient point of interconnection (or other split of costs). But neither proposal would, in fact, accomplish that goal.

DeGraba's COBAK proposal, for example, contains the default rule that each carrier is obligated to carry its traffic all the way to the central office of the terminating carrier.[26] DeGraba's rationale is that, although the default rule is clearly inefficient, the desire of both carriers to avoid the default rule would lead them to negotiate the most efficient point of interconnection (without Commission intervention). But as explained in detail below in Part VI, the COBAK default rule would permit incumbent LECs to engage in a whole range of anticompetitive practices that would effectively choke off facilities-based entry, and they would therefore have no incentive to depart from the inefficient default rule.

Moreover, the entire rationale behind the default rule is that both carriers will want to avoid the unnecessary costs of building transport links to each other's central offices and

[26] *See, e.g.*, *DeGraba* ¶ 24 ("For calls traversing two networks, the calling party's network is responsible for the cost of transporting the call to the called party's central office."); *id.* ¶ 29 ("COBAK is a default interconnection regime which would apply only if two interconnecting carriers are unable to reach a negotiated agreement on the terms of interconnection.").

would thus have an incentive to establish efficient meet points to hand-off traffic.[27] The fatal flaw in this theory is that, where traffic is *out of balance,* the carrier terminating most of the traffic has no incentive to negotiate – which DeGraba concedes.[28] The carrier terminating most of the traffic is better off refusing to negotiate and simply relying on the default rule. Thus, under the COBAK rule, carriers could have an incentive to negotiate an efficient meet point only in the one situation where the CPNP/B&K choice does not matter – when traffic is in balance. In short, although the DeGraba interconnection rule may be only "default" in theory, it would be mandatory in practice.

The COBAK rule would also require the Commission to enact a series of regulations designed to determine precisely what constitutes a "central office" for purposes of the default POI interconnection rule. *Ordover-Willig* ¶ 63. For example, one can be sure that incumbent LECs would argue that remote switch modules or even remote digital loop carrier terminals should be treated as a "central office" for purposes of the default rule, which would increase enormously the costs a new entrant would incur in serving a local market.

Nor is the Atkinson-Barnekov BASICS proposal workable. *Id.* ¶¶ 65-66. Although they do not propose a specific rule to govern interconnection between local telephone carriers, Atkinson and Barnekov advocate that, as a general matter, interconnected carriers should "divide equally the costs that result purely from interconnection." *Notice* ¶ 25. Atkinson and Barnekov assert that all of the costs of handling all the possible traffic that their subscribers generate in making or receiving calls should be considered "'intra-network costs"' that are to be recovered from end users. *Id.* ¶¶ 25-26. On the other hand, those "additional" costs that "result

[27] *Id.* ¶ 19 n.36

[28] *Id.* ¶ 74 (asserting, without cited support, that "most networks do originate some traffic" but not stating whether "most networks" originate and terminate traffic in commensurate amounts).

purely from interconnection" should be split equally between the carriers through a non-usage sensitive fixed charge. *Id.*

But Atkinson and Barnekov propose no mechanism that would allow regulators accurately to distinguish between a carrier's "intra-network costs" and the "incremental costs of interconnection." *Id.* ¶ 28. Intra-network costs are defined as "[t]he facilities required within a network to handle calls to and from that network's own subscribers." *Id.* ¶ 26. As Professors Ordover and Willig explain (¶ 66), there appears to be no principled way to determine such costs because the size of a particular carrier's network would depend upon whether it can interconnect with other networks.

IV. THE ACT PROHIBITS AN ACROSS-THE-BOARD B&K RULE FOR THE TRANSPORT AND TERMINATION OF "TELECOMMUNICATIONS."

A. Section 252(d)(2) Forecloses Mandatory Bill-And-Keep For Traffic Subject To Section 251(b)(5).

LECs must "establish reciprocal compensation arrangements for the transport and termination of telecommunications." 47 U.S.C. § 251(b)(5). Section 252(d)(2)(A), in turn, provides that:

> [f]or the purposes of compliance by an incumbent local exchange carrier with section 251(b)(5), . . . a State Commission shall not consider the terms and conditions for reciprocal compensation to be just and reasonable unless –
>
> > (i) such terms and conditions provide for the mutual and reciprocal recovery by each carrier of costs associated with the transport and termination on each carrier's network facilities of calls that originate on the network facilities of the other carrier; and
> >
> > (ii) such terms and conditions determine such costs on the basis of a reasonable approximation of the additional costs of terminating such calls.

Section 252(d)(2)(B)(i) clarifies that "arrangements that waive recovery (such as bill-and-keep arrangements)" may satisfy this standard *if* they "afford the mutual recovery of costs through the offsetting of reciprocal obligations." The plain language of the Act thus prohibits B&K arrangements that do not afford the mutual recovery of costs.

When two carriers' traffic is roughly in balance, a B&K arrangement can afford the mutual recovery of costs because the B&K outcome of no intercarrier termination payments is economically equivalent to the offsetting payments that would be made under a cost-based CPNP arrangement. As the Commission has expressly recognized, however, a B&K arrangement just as plainly does *not* afford the mutual recovery of costs when traffic is significantly out of balance, because the amount that the carrier that terminates more traffic is relieved of paying is much less than the forward-looking termination costs that carrier incurs. As the Commission explained in the *Local Competition Order:*

> In general, we find that carriers incur costs in terminating traffic that are not *de minimis,* and consequently, bill-and-keep arrangements that lack any provisions for compensation do not provide for recovery of costs. In addition, as long as the cost of terminating traffic is positive, bill-and-keep arrangements are not economically efficient because they distort carriers' incentives, encouraging them to overuse carriers' termination facilities by seeking customers that primarily originate traffic.

Local Competition Order ¶ 1112. That is why the FCC's implementing rules allow state commissions to impose B&K arrangements only "if the volume of terminating traffic that originates on one network and terminates on another network is approximately equal to the volume of terminating traffic flowing in the opposite direction, and is expected to remain so." *See Local Competition Order* ¶ 1111. Because the intent of Congress is clear – an across-the-board B&K rule that ignores traffic imbalances is foreclosed by the Act – "that is the end of the matter." *Good Samaritan Hosp. v. Shalala*, 508 U.S. 402, 409 (1993) *(quoting Chevron,* ***U.S.A., Inc.*** *v. Natural Res. Def. Council, Inc.,* 467 U.S. 837, 842 (1984))

The *Notice* acknowledges that there currently are "imbalances in traffic exchanged among interconnected networks." *Notice* ¶ 69. Nevertheless, the *Notice* reverses course and suggests that B&K may be permissible even "when traffic is not in balance." *Id.* ¶ 75. That suggestion cannot withstand scrutiny.

The *Notice* points out that "the statute explicitly identifies bill and keep as one arrangement that affords 'the mutual recovery of costs through the offsetting of reciprocal obligations."' *Notice* ¶ 75 *(quoting* 47 U.S.C. § 252(d)(2)(B)). But the statute does not say that bill-and-keep *necessarily* "afford[s] the mutual recovery of costs through the offsetting of reciprocal obligations"; rather, it says only that "bill-and-keep arrangements" are not precluded ***when*** they "afford the mutual recovery of costs through the offsetting of reciprocal obligations." 47 U.S.C. § 252(d)(2)(B)(i). And, as the Commission has recognized, B&K does not afford such mutual recovery of costs when traffic is significantly out of balance. *See Local Competition Order* ¶ 1112.

Nor does the "opportunity to recover costs from end users 'afford the mutual recovery of costs"' as required by Section 252(d)(2). ***See*** *Notice* ¶ **76** (quoting 47 U.S.C. § 252(d)(2)). Section 252(d)(2)(A) states that an interconnection agreement between an incumbent LEC and a new entrant cannot be found just and reasonable unless the agreement itself "provide[s] for the mutual and *reciprocal* recovery by each carrier of costs associated with the transport and termination on each carrier's network facilities of calls that originate on the network facilities of the other carrier." *Id.* § 252(d)(2)(A)(i) (emphasis added). Thus, each carrier must recover, from the other, the costs associated with the transport and termination of traffic.

Subsection 252(d)(2)(B)(i), in turn, provides that subsection (d)(2)(A) does not "preclude arrangements that afford the mutual recovery of costs *through the offsetting of reciprocal obligations." Id.* § 252(d)(2)(B)(i) (emphasis added). **A** carrier forced to recover transport and termination cost from the called parties plainly does not recover those costs "through the offsetting of reciprocal obligations" as required by Section 252(d)(2)(B)(i). In other words, the proponents of B&K would have the Commission "construe" Section 252(d)(2) to require a state commission to approve an interconnection agreement that (i) did not "provide for the mutual and reciprocal recovery by each carrier of costs," and (ii) did not afford the recovery "through the offsetting of reciprocal obligations" if (iii) the carrier is not prohibited by law from recovering those costs from third parties that are not parties to the interconnection agreement. That position is squarely foreclosed by Section 252.

Recognizing as much, the *Notice* suggests that the Commission could impose an across-the-board B&K rule notwithstanding the contrary requirements of Section 252(d)(2) by forbearing from those requirements under 47 U.S.C. § 160. *Notice* ¶ *77*. Forbearance is not an option either, however, because the statutory forbearance criteria have not been satisfied. The Commission may forbear from applying regulations or provisions of the Act only if it can reasonably conclude that:

> (1) enforcement of such regulation or provision is not necessary to ensure that the charges, practices, classifications, or regulations by, for, or in connection with that telecommunications carrier or telecommunications service are just and reasonable and are not unjustly or unreasonably discriminatory;
>
> (2) enforcement of such regulation or provision is not necessary for the protection of consumers; and
>
> *(3)* forbearance from applying such provision or regulation is consistent with the public interest.

47 U.S.C. § 160(a). The Commission has made clear that it is authorized to "forbear from applying a provision of the Act only if *all* of the three criteria of [Section 160(a)] are met."[29]

The *Notice* does not (and cannot) contend that there has been any fundamental change in the relationship between incumbent and competitive LECs that would justify lifting the regulatory obligations reflected in Section 252(d)(2).[30] To the contrary, the Commission just recently re-confirmed its concern regarding "the superior bargaining power of incumbent LECs." *ISP Remand Order* ¶ 89. *See* 160 U.S.C. § 160(b) (requiring Commission to consider whether "forbearance from enforcing the provision . . . will promote competitive market conditions"). And, as detailed above, B&K would favor incumbent LECs and have precisely the anticompetitive effects that Section 252(d)(2) was designed to prevent."

In any event, as the *Notice* (¶ 77) recognizes, Section 160 provides that "the Commission may not forbear from applying the requirements of . . . section 271 . . . until it determines that those requirements have been fully implemented." 47 U.S.C. § 160(d). Section 271, in turn, states expressly that its requirements can only be fully implemented if the

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[29] *Petition of Ameritech Corp. for Forbearance from Enforcement of Section 275(a) of the Communications Act of 1934, as Amended,* Memorandum Opinion & Order, 15 FCC Rcd. 7066, ¶ 7 (1999) (emphasis added) ("*Ameritech Forbearance Order*"); *see also 1998 Biennial Regulatory Review of ARMIS Reporting Requirements; Petition for Forbearance of the Independent Telephone and Telecommunications Alliance,* Report & Order, 14 FCC Rcd. 11443, ¶ 32 (1999) (denying forbearance where petitioner "has not demonstrated that the three requirements of Section [160(a)] have been satisfied").

[30] *See Ameritech Forbearance Order* ¶ **8** (rejecting forbearance because petitioner failed to identify "any changed or unanticipated circumstance" that would justify upsetting a legislative judgment "based on arguments Congress found unpersuasive in 1996").

[31] *See Policy and Rules Concerning the Interstate Interexchange Marketplace; Implementation of Section 254(g) of the Communications Act of 1934, Petitions for Forbearance,* Memorandum & Order, 14 **FCC** Rcd. 391, ¶ 30 (1998) (denying forbearance where petitioner failed to demonstrate that, in the absence of regulation, "rates will be just and reasonable and not unjustly or unreasonably discriminatory").

interconnection arrangements provided by incumbent LECs include "[r]eciprocal compensation arrangements in accordance with the requirements of section 252(d)(2)." 47 U.S.C. § 271(c)(2)(B)(xiii). Thus, Commission forbearance from the requirements of Section 252(d)(2) and the imposition of a B&K regime would categorically preclude the BOCs from satisfying the Section 271 requirements for long distance authority.

B. The Commission's Existing Reciprocal Compensation Rules Are Efficient, Competitively Neutral, And Effective And Should Serve As The Model For A Unified Approach To Intercarrier Compensation.

The Commission implemented the plain meaning of Sections 251(b)(5) and 252(d)(2) in 1996 when it promulgated its rules implementing those statutory provisions. In so doing, the Commission crafted standards that, if applied properly, are fully consistent with the Commission's efficiency and competitive neutrality goals. *See, e.g.*, *Ordover-Willig* ¶¶ 38-41.

Under the Commission's existing rules, LECs must enter arrangements "in which each of the two carriers receives compensation from the other carrier for the transport and termination on each carrier's network facilities of local telecommunications traffic that originates on the network facilities of the other carrier." 47 C.F.R. § 51.701(e). This reciprocal compensation must be based on "the forward-looking economic costs of such offerings," *id.* § 51.705(a)(1), and "bill-and-keep" can be mandated only where "traffic from one network to the other is roughly balanced . . . and is expected to remain so." *Id.* § 51.713(b). Thus, the existing rules provide economically appropriate compensation for the transport and termination of telecommunications and encourage economically efficient levels of investment and network use. *See Ordover-Willig* ¶¶ 30-32, 38-41.[32]

[32] *See also Deployment of Wireline Services Offering Advanced Telecommunications Capability and Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, Third Report & Order and Fourth Report & Order, 14 FCC Rcd. 20912, ¶ 150 (1999) (explaining (continued . . .)

The existing rules also require efficient, cost-causative rate structures. State commissions are required to "establish rates for the transport and termination of telecommunications traffic that are structured consistently with the manner that carriers incur those costs, *and* consistently with the principles" for the forward-looking, economic cost of an element. 51 C.F.R. § 51.709(a) (emphasis added). Thus, to the extent that transport and termination costs are traffic sensitive, the Commission's existing rules require usage sensitive rate elements. In short, the existing rules provide a comprehensive framework that – if properly enforced – can be implemented to establish efficient, competitively neutral intercarrier compensation for all telecommunications. In this regard, it is important to recognize that most complaints about reciprocal compensation rates established pursuant to the Commission's rules have come in the context of rates set shortly after the rules were promulgated at a time when incumbent LECs were vigorously advocating massively inflated rates and state commissions were far less experienced at applying forward-looking, economic cost-based pricing.

C. ISP-Bound Traffic Is Subject To Section 251(b)(5) And Should Be Governed By The Same Cost-Based Reciprocal Compensation Rules As Other Section 251(b)(5) Traffic.

These existing reciprocal compensation rules should apply equally to ISP-bound traffic. In its recent *ISP Remand Order,* the FCC concluded that Section 251(g) was a "carve-out" that exempts certain classes of traffic (including ISP-bound traffic) from the requirements of

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(. . continued)
that TELRIC-based pricing will "encourage efficient levels of investment and entry by competitive LECs") *Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of* ***1934,*** *as amended, To Provide In-Region, InterLATA Services In Michigan,* Memorandum Opinion and Order, 12 FCC Rcd. 20543, ¶ 290 (1997) ("TELRIC principles ensure that the prices for interconnection and unbundled network elements promote efficient entry decisions").

Section 251(b)(5) and Section 252(d)(2). That conclusion is contrary to the plain language of the Act and should be abandoned.

As the Commission recognized, Section 251(b)(5), "[o]n its face," requires "reciprocal compensation arrangements for the transport and termination of *all* 'telecommunications' . . . without exception." *ISP Remand Order* ¶ 31. The Commission concluded that "section 251(g)" evinces Congress' intent to exclude ISP-bound traffic from the reciprocal compensation requirements of subsection (b)(5)." ***Id*** **¶ *33*, 34.**

The Commission's conclusion that Section 251(g) "carves out" ISP-bound traffic from the requirements of Section 251(b)(5) is fundamentally misguided. Section 251(g) provides:

> On and after February 8, 1996, each local exchange carrier, to the extent that it provides wireline services, shall provide exchange access, information access, and exchange services for such access to interexchange carriers and information service providers in accordance with the same equal access and nondiscriminatory interconnection restrictions and obligations (including receipt of compensation) that apply to such carrier on the date immediately preceding February 8, 1996 under any court order, consent decree, or regulation, order, or policy of the Commission, until such restrictions and obligations are explicitly superseded by regulations prescribed by the Commission after February 8, 1996.

Section 251(g), by its terms, is a narrow transitional provision that ensures that the 1996 Act amendments did not inadvertently relieve dominant incumbent LECs of their pre-existing equal access and non-discrimination obligations to interexchange carriers and information service providers.

Prior to the enactment of the 1996 Act, various antitrust consent decrees and related regulations imposed obligations on incumbent LECs with respect to their relationships with IXCs and ISPs. *See, e.g.*, *United States* v. *AT&T Corp.*, 552 F. Supp. 131 (D.D.C. 1982). Section 601(a) of the 1996 Act, however, relieved incumbent LECs of their "obligations imposed