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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Developing a Unified Intercamer Compensation Regime	)	CC Docket No. 01-92
	)	

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REPLY COMMENTS OF
FOCAL COMMUNICATIONS CORPORATION,
PAC-WEST TELECOMM, INC.,
RCN TELECOM SERVICES, INC.
AND US LEC CORP.

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SUMMARY

In their initial comments in this proceeding, Focal, Pac-West, RCN, and US LEC opposed implementation of bill-and-keep for any class of traffic. The initial comments of other parties provide no basis for the Joint Commenters to depart from their initial conclusions. If anything. initial comments reinforce the lack of wisdom of bill-and-keep. The record shows that, other than the CMRS industry, no one really wants bill-and-keep. ILECs qualify their support on fundamental preconditions that show that in reality they do not support a unified implementation of bill-and-keep. Instead of urging a rapid implementation of a unified scheme of bill-and-keep, ILECs prefer to use this proceeding as merely another opportunity to repeat their pleas for premature deregulation. State commissions, consumer groups, and ISPs also oppose or offer little support for bill-and-keep. For their part, CLECs also show that bill-and-keep would harm competition and favor ILECs. The nearly total lack of industry support for a unified scheme of bill-and-keep is sufficient reason by itself not to adopt it.

Instead. the Commission should promptly reinstate the determinations of *the Local Competition Order*. There, the Commission considered, and rejected, adoption of bill-and-keep as the default reciprocal compensation rule. None of the comments from the few supporters of bill-and-keep in this proceeding provide any new facts or logic to change that decision. For the Commission to reverse the conclusions in the *Local Competition Order,* the Commission would need far more compelling reasons than anything offered by the few proponents of bill-and-keep.

While it is always useful to take a hard look at current regulatory schemes and to consider wholesale replacements, the current exercise has shown that there is no basis for the sweeping changes contemplated in the *Intercarrier Compensation NPRM*. Comments show that this would

reward ILECs for failing to set reasonable rates for reciprocal compensation, favor carriers with balanced traffic – ILECs, require a host of impossible-to-implement federal regulatory programs. and be unlawful as well. Amazingly, one of the authors of the initial papers that served as a foundation of the ***Intercarrier Compensation*** *NPRM* has filed comments on his own paper virtually eliminating whatever theoretical economic basis bill-and-keep may have appeared to possess initially. At this point, there is no legal or policy justification to move forward with implementation of a unified scheme of bill-and-keep. To the extent the Commission looks to specific guidance in the record, it should look to state commenters, who nearly across-the-board oppose bill-and-keep.

While there is no basis for moving forward with bill-and-keep generally, the worst alternative would be for the Commission to single out one type of traffic for this treatment. If bill-and-keep has any theoretical validity, which it does not, there could not be any basis for applying it based on the nature of the traffic, *i.e.* ISP-bound traffic, rather than all traffic generally. As stated in Joint Commenters' initial comments, to do so would represent a decision by the Commission to punish those carriers that have successfully competed against ILECs in serving ISPs merely because they have been successful. None of the economic theories advanced in the ***Intercarrier Compensation*** *NPRM* justify application of bill-and-keep based on the nature of traffic. It would be arbitrary for the Commission to do so. Instead, if the Commission chooses to move forward with bill-and-keep, it should implement it at the same time for all traffic.

Accordingly, the Commission should abandon its bill-and-keep proposals

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Focal Communications Corporation, Pac-West Telecomm, Inc., RCN Telecom Services, Inc., and US LEC Corp. (collectively "Joint Commenters") submit these reply comments in response to the ***Intercarrier Compensation NPRM,***[1] For the reasons stated below, and as stated by the Joint Commenters in their initial comments, the Commission should not establish bill-and-keep as the required form of intercarrier Compensation for any traffic.

I. THE COMMISSION SHOULD TAKE GUIDANCE FROM STATE AUTHORITIES

The record reflects a remarkable consistency of view among state authorities filing initial comments Nearly across-the-board, on almost every question raised by the ***Intercarrier Compensation NPRM,*** state authorities are opposed to bill-and-keep, have very serious concerns, and believe that the Commission should retain the calling-party's-network-pays ("CPNP") regime. For example, state authorities aver that: bill-and-keep should not be adopted as the

[1] *Developing a Unified Intercarrier Compensation Regrme,* Notice of Proposed Rulemaking, CC Docket No. 01-92, FCC 01-132, released April 27, 2001 ("*Intercarrier Compensation NPRW* or "*NPRW*).

default rule;' bill-and-keep is inconsistent with the 1996 Act;' COBAK and BASICS are anticompetitive. and had they been in effect in prior years. competitive local exchange carriers ("CLECs") probably would not exist;' hill-and-keep could seriously undermine entry;' the *Intercarrier Compensation NPRM* elevates the theoretical goal of economic efficiency over more important goals such as fairness in rate design, minimization of rate shock, and reasonable allocation of joint and common costs;' hill-and-keep would shield incumbent local exchange carriers ("ILECs") from market pressures, whether from CLECs or Internet Protocol telephony;' bill-and-keep would enhance incentives to "cream skim" by serving few customers that originate large volumes of traffic;' tariff arbitrage is likely to result from a federal bill-and-keep regime, especially in the absence of states adopting hill-and-keep for intrastate services;' the proposals would subsidize telemarketers and stimulate telemarketing calls;[10] bill-and keep violates principles of economic efficiency;" the Commission should not preempt state authority over

2 New **York** Public Service Commission Comments at 1-2.

3 National Association **of** State Utility Consumer Advocates Comments (NASUCA) at 6.

4 Maryland Office of People's Counsel Comments at 14.

5 Office of Public Utility Counsel of Texas Comments at 46-47

6 California Public Utilities Commission Comments at 2.

7 *Id.* **at** 8.

8 **New** York Public Service Commission Comments at 2.

9 Public Utility Counsel of Texas Comments at 38.

10 Maryland Office of People's Counsel Comments at 27-28; Public Utility Counsel of Texas Comments at 18-19.

11 NASUCA Comments at **23-24.**

intrastate interconnection matters and rates;[12] bill-and-keep would harm end users;[13] if ILECs are troubled by the flow of payments to CLECs, they should start to compete for Internet service providers ("ISPs");[14] imposing flat-rated charges on end users would cause low volume subscribers to subsidize high volume subscribers, effectively increase the price of obtaining basic local service. and harm affordability and universal service;[15] and bill-and-keep could make retail rates less affordable, less comparable between rural and urban areas, and less conducive to universal service.[16]

State regulators also contend that instead of bill-and-keep, the Commission should reform the CPNP regime to the extent necessary. They state that: instead of bill-and-keep, regulators should replace charges that are excessive with charges that are reasonable;[17] opportunities for arbitrage under the existing system have been, or can be, reduced by less disruptive regulatory measures or reliance on market forces;[18] and as long as reciprocal compensation rates are based on the ILEC's TELRIC costs, ILECs should he indifferent to paying CLECs **$2** billion in

12 Regulatory Commission of Alaska Comments at 2, 6-8, National Association of Regulatory Utility Commissions (NARUC) Comments at 1; NASUCA Comments at **28.**

13 Maryland Office of People's Counsel Comments at 14.

14 Public Utility Counsel of Texas Comments at 26-28.

15 Maryland Office of People's Counsel Comments at 4445, Public Utility Counsel of **Texas** Comments **at** 20.

16 New York Public Service Commission Comments at 2.

17 Maryland Office of People's Counsel Comments at iii.

18 California Public Utility Commission Comments at 3.

reciprocal compensation because they are saving $2 billion in termination costs on their own networks.[19]

In short. state authorities. far more than the Commission, have gotten this issue right. Joint Commenters urge the Commission to follow the recommendations of the state authorities that have commented in this proceeding

II. THE COMMENTS PROVIDE NO BASIS FOR THE COMMISSION TO REVERSE ITS DECISION IN THE 1996 *LOCAL COMPETITION ORDER* REGARDING BILL-AND-KEEP

The Commission has already considered, and rejected, the adoption of bill-and-keep as the default reciprocal compensation rule. None of the comments from the few supporters of bill-and-keep in this proceeding provide any new facts or logic to change that decision. For the Commission to reverse itself from the conclusions in the *Local Competition **Order,*** the Commission would need far more compelling reasons than anything offered by the proponents of bill-and-keep.

There is nothing new today that the Commission did not already consider in 1996. The Commission already anticipated that "all carriers – incumbent LECs as well as competing carriers - have a greater incentive and opportunity to charge prices in excess of economically efficient levels on the terminating end [than on the originating end]."[20] To avoid this result, the Commission placed limitations on the "additional costs" that could be recovered for transport

[19] Public Utility Counsel of Texas Comments at 31

[20] *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996,* 11 FCC Rcd 15499 (1996), *vacated in part, Iowa Utils. Ed. v. FCC,* 120 F.3d 753 (8th Cir. 1997), *rev'd in part. aff'd in part. AT&T Corp v Iowa Utils. Bd.*, 119 S. Ct. 721 *(1999) ("Local Competition Order")* at ¶ 1058.

and termination under section 252(d)(2).[21]

The Commission even recognized that CLECs would, and should. have a profit motive to provide termination services below ILEC cost: **"A** symmetric compensation rule gives the competing carriers correct incentives to minimize its [sic] own costs of termination because its termination revenues do not vary directly with changes in its own costs."[22] As the Commission said in 1996, "we believe that using the incumbent LEC's cost studies to establish the presumptive symmetrical rates will establish reasonable opportunities for local competition, *including* ***opportunities for small telecommunications companies entering the local exchange marker."***[23] That CLECs have seized the opportunities that the Commission expected does not mean the underlying reasoning was wrong and needs to be changed.

The Commission even considered the favorable economics that arise in a situation in which the traffic exchanged between carriers was "substantially unbalanced."[24] In that situation, the Commission explained how a reduction in the ILEC's terminating switching costs might reduce its reciprocal compensation revenues when it terminated significantly more traffic than it originated, but it would be an overall boon to the ILEC by reducing network costs overall. Because only a relatively small portion of traffic crossing the network would be exchanged between carriers, and the ILEC would retain a vastly greater portion of traffic entirely on its own network. cost-based reciprocal compensation rates gave the ILEC the proper economic

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21 *Id*

22 *Id* at ¶ 1086.

23 *Id* at ¶ 1088 (emphasis added)

24 *Id.* at n. 2624.

Incentives. The Commission used the example of the exchange of traffic between an ILEC and a CMRS carrier, which would be out ofbalance in the ILEC's favor. But "[i]n situations closer to traffic balance, the incentive is even more favorable."[25] It follows that if the "substantial imbalance" were in the *CLEC's* favor, the ILEC has ***an even greater*** incentive to lower terminating switching costs, because it would not only reduce its reciprocal compensation obligation. but it also "reduces its cost of switching on many millions of other minutes that do not involve other networks at the same time."[26] Absolutely nothing has changed between 1996 and the present to change that fundamental logic. None of the comments provide the Commission with any reason to move away from cost-based reciprocal compensation rates in order to maximize efficiency.

The Commission even considered in the ***Local Competition Order*** the potential benefits of bill-and-keep, and nonetheless rejected it. The Commission specifically identified one benefit of bill-and-keep advanced by proponents as "elimination of incentives to 'game' the LEC-to-LEC relationship by soliciting (or avoiding) customers with high incoming or outgoing usage."[27] It identified "economic efficiency" as another purported benefit of bill-and-keep.[28] The Commission even cited the argument of one bill-and-keep opponent that new entrant traffic is likely to be out of balance "because new entrants will engage in niche marketing to get a toehold

[25] *Id.*

[26] *Id.*

[27] *Id.* at ¶ 1101

[28] *Id.*

in a new service area."[29] The Commission also cited one carrier's argument that "using compensation systems other than bill-and-keep would encourage new entrants to focus entry strategies on niches that exploit compensation levels."[30] Ameritech is even cited in the *Local Competition Order for* the wise prediction that "the period during which the new carriers first enter a local market will be the time during which traffic is most unbalanced between the new entrants and the incumbent LEC."[31] There is nothing presented by commenters in this proceeding that the Commission did not already consider in the *Local Competition Order*. Nevertheless. the Commission chose not to adopt bill-and-keep as a default rule for the exchange of traffic in 1996. There is no principled reason to reverse that decision now.

In short, the Commission rejected bill-and-keep arrangements in the *Local Competition Order* on two grounds. First, the Commission rejected bill-and-keep arrangements on statutory grounds. The Commission ruled that bill-and-keep arrangements did not satisfy the standard of section 252(d)(2)(A)(i) because "bill-and-keep arrangements that lack any provisions for compensation do not provide for recovery of costs."[32] Second, the Commission rejected bill-and-keep arrangements as "not economically efficient." In "certain circumstances" the benefits of bill-and-keep arrangements may outweigh the disadvantages, but the Commission did not see "why, in such circumstances, parties themselves would not agree to bill-and-keep

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29 *Id.* at ¶ 1103.

30 *Id.* at n. 2671

31 *Id.* at ¶ 1104.

32 *Id* at ¶ 1112.

arrangements."[33] Nothing in the Comments in this proceeding refutes either of those conclusions. The Commission has no basis to reverse its decision regarding bill-and-keep in the *Local Competition* ***Order*** and should promptly reinstate them.

111. BILL-AND-KEEP SHOULD NOT BE SEPARATELY IMPLEMENTED FOR ISP-BOUND TRAFFIC

In their initial Comments, Joint Commenters urged the Commission not to implement bill-and-keep solely, or separately, for ISP-bound traffic. Joint Commenters noted that such discriminatory implementation would be ill advised for a number of reasons. One, it would send the wrong message to investors, ***i.e.***, that CLECs that developed a legitimate market niche in an area underserved by the incumbents would be penalized, not rewarded, for such industriousness.[34] Two, such an approach would undercut the validity of the Office of Plans and Policy ("OPP") proposals which made no distinction in the type of traffic and called for unified and simultaneous implementation.[35] Three, such **a** selective implementation would contradict the Commission's determination that there is no basis to distinguish between voice and data traffic for purposes of reciprocal compensation.[36] Finally, Joint Commenters noted that implementation of bill-and-keep is not competitively neutral, and singling out ISP-bound traffic for such treatment would exacerbate the anticompetitive effects.[37]

[33] *Id*

[34] Focal/PacWest/RCN/US LEC Comments at 19-22

[35] *Id.* at 22

[36] *Id* at 23.

[37] *Id* at 24.

The positions of the Joint Commenters have generally been echoed by other parties There are some parties. however, that would favor the implementation of bill-and-keep for ISP-bound traffic initially and a later-day implementation of bill-and-keep for access charges.[38] Such a phased-in implementation will be ill-advised, and given the laundry list of issues the proposing carriers want "reformed" before bill-and-keep would be implemented for access charges, would effectively mean that bill-and-keep would only be applied to ISP-bound traffic for years to come. Such an approach would not be desirable, and directly contradicts the stated goal of this proceeding to create a unified compensation mechanism

A. The Call for a Phased-In Approach

There are some carriers that favor a phased-in implementation of bill-and-keep. SBC supports bill-and-keep for local. wireless, and ISP-bound traffic, but suggests that a "comprehensive reform plan" needs to be implemented for access charges before bill-and-keep **is** implemented for access charges.[39] For local traffic, however, SBC argues that end-user-pricing reform needs to take place, suggesting that this will bifurcate implementation for local traffic vis-a-vis ISP-bound traffic. Verizon suggests that the Commission should move to bill-and-keep for ISP-bound traffic in the "near-term,'' but defer implementation of a single intercarrier compensation regime for other types of traffic until certain "long-term" issues are resolved.[40] It should come as no surprise to the Commission that the Bell companies seek immediate conversion to bill-and-keep for traffic for which they are net payors of terminating compensation

[38] *See* SBC Comments at *2;* Verizon Comments at 1; Sprint Comments at 2.

[39] SBC Comments at 1-2.

[40] Verizon Comments at 1-3

(reciprocal compensation), but seek indefinite postponement of conversion to bill-and-keep for traffic for which they are net recipients of terminating compensation (access charges). Indeed. their greed is plainly evidenced by the fact that the terminating compensation that they receive is admittedly well above cost, while the terminating compensation that they pay, and seek to stop paying. is cost-based

Sprint favors the prompt implementation of bill-and-keep for both local and ISP-bound traffic. but says it is premature to apply bill-and-keep to access traffic "at this time."[41] Rural LECs are not as concerned about reciprocal compensation, but call for the delay of consideration of bill-and-keep for access charges at least until reform of rate-of-return LEC access charges has taken effect for a few years."

All the carriers calling for delay of this Commission's consideration of bill-and-keep for access charges have major issues that they say the Commission must address, or reforms that need to take place, before bill-and-keep is implemented. SBC states that residential local service rates must be overhauled to account for implicit subsidies, universal service support must be increased, federal and state end user recovery mechanisms must be implemented, and ILECs will need to be provided with more pricing flexibility.[43] Verizon argues that issues such as so-called "virtual NXX" need to be addressed in what it terms the "near-term" before a unified intercarrier

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[41] Sprint Comments at 2

[42] National Telephone Cooperative Association (NTCA) Comments at 1.5; National Rural Telecom Association and Organization for the Promotion and Advancement of Small Telecommunications Companies (NRTA'OPASTCO)Comments at 3-4.

[43] SBC Comments at 3-4. Thus while SBC advocates bill-and-keep for both local and ISP-bound traffic, it **is** clear that such implementation would not be simultaneous since bill-and-keep for local traffic would be deferred

(con't.)

compensation scheme is contemplated.[44] Sprint says that implicit subsidies need to be removed from access rates, rate shock to end users needs to be addressed, and jurisdictional obstacles need to be overcome before bill-and-keep for access charges is implemented.[45] Rural and independent LECs seek *to* delay bill-and-keep for access charges until adverse impacts on rural carriers are assessed and addressed.[46]

In addition to demonstrating the numerous implementation issues of bill-and-keep that the OPP Papers did not anticipate, these positions demonstrate that resolution of these issues in regard to access charges could take years. The Joint Commenters agree with the need to defer consideration of bill-and-keep for access charges until these issues are addressed,[47] but strongly disagree with the implicit suggestion in some of these Comments that bill-and-keep for ISP-bound traffic could be implemented before bill-and-keep for other types of traffic. **As** was demonstrated in Joint Commenters' initial comments, and will be demonstrated further in these reply comments, there are significant obstacles for the implementation of ISP-bound traffic as well that counsel against implementation of bill-and-keep for such traffic at all. Implementing bill-and-keep solely for ISP-bound traffic, or earlier for ISP-bound traffic than for other traffic, would undercut the central goal of the OPP proposals and *NPRM* to create a unified intercarrier

pending the pricing reform SBC seeks

44 Verizon Comments at 3

45 Sprint Comments at 2

46 NTCA Comments at I; CenturyTel Comments at 1: National Exchange Carrier Association (NECA) Comments at ii-iii.

47 In fact. Joint Commenters suggest that the numerous implementation issues further demonstrate that the existing system is not only adequate, hut also better attuned to the realities of **the** current industry.

compensation system. There is no operational or legal basis for such a selective implementation. Equally important, such an approach would not be competitively neutral. Implicit in the suggestions of phased-in implementation is the idea that certain revenue streams and market segments should be protected to the detriment of others. For instance, when ILECs talk of residential pricing reform and universal service support reform, they arc clearly asking the Commission *to* protect and enhance their revenues before bill-and-keep is implemented across-the-board. ILECs dominate the residential market and are the primary recipients of universal service support. so calls for "reform" in this area are clearly calls for protection of ILEC revenues.[48] Meanwhile, CLECs would be asked to forego a significant source of revenue with no such offsetting compensation." As AT&T astutely observes, this approach to reform is a type of "reverse triage" which largely ignores areas in which reform is needed and would focus on areas in which reform is least needed." If bill-and-keep is to be implemented, it must be implemented uniformly. As AT&T concludes, "singling out only one compensation regime for reform, while leaving other flawed legacy regimes in place, is more likely to undermine, rather than promote, efficiency and competitive neutrality."[51]

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48 In the residential and small business market, Regional Bell Operating Companies ("RBOCs") alone control over 140 million lines while CLECs have a mere 8 million lines. Jason Krause, ***Dawn of the Big Bells,*** The Industry Standard Magazine, p. 1 (April 22, 2001) ("*Krause* ***Article"***). http:/ www.thestandard.com article 0,1902,23871,00.html

49 For instance, SBC argues that **if** residential rates are "reformed," *i.e.*, made higher. then bill-and-keep would provide for the mutual recovery of costs in regard to local traffic. It is hard to see how this can he the case since ILECs dominate the residential market. This "reform" would only enhance the revenue advantages ILECs would possess in a hill-and-keep regime.

50 AT&T Comments at 2-3

51 ***id.*** at 2

B. The Perils of Phased-ln Implementation

Proponents of bill-and-keep acknowledge that any possible advantages a bill-and-keep approach could provide would be undercut by piecemeal implementation. **As** Mr. DeGraba notes, implementing bill-and-keep for ISP-bound traffic would maintain opportunities for regulatory arbitrage in regard to access services and delay the realization of some of the efficiency "benefits" COBAK is intended to provide.[52] Another proponent of bill-and-keep, Level 3, notes that certain advantages of bill-and-keep are reduced substantially if only some traffic is subject to bill-and-keep and distorts the price signals sent to subscribers.[53] In addition, Level 3 observes that "having two different interconnection pricing schemes for what is largely the same function will open the door to strategic pricing gamesmanship, and potentially impose inefficient network engineering costs."[54] SBC admits that bifurcated approaches create "additional arbitrage opportunities.""

Time Warner observes that piecemeal implementation of bill-and-keep for ISP-bound traffic could result in inefficiencies that are worse than those complained of in the existing regime.[56] It certainly would not reduce the inefficiencies because carriers would simply have the incentive to originate traffic as opposed to terminate traffic. **As** Time Warner notes, under COBAK, "the equation flips and competitive carriers will fight to serve customers with

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52 WorldCom Comments. Attachment, "Implementing Bill and Keep Intercarrier Compensation When Incumbent LECs Have Market Power," Declaration of Patrick DeGraba, Charles River Associates, at 30-32.

53 Level 3 Comments at 24.

54 *Id* at 25.

55 *SBC* Comments ***at 25.***

56 Time Warner Comments at 19

predominantly originating traffic, while ILECs will more likely serve ISPs."[57] ILECs would still argue that a lack of pricing flexibility renders them "unable to meet this competition with lower prices."[58] Thus. according to Time Warner, "even assuming there is a problem with arbitrage for ISP-bound traffic. COBAK may simply replace old inefficiencies created by arbitrage with new inefficiencies ('of unknown magnitude') created by arbitrage."[59] AT&T notes that "B&K would provide carriers with inefficient incentives to target customers that originate more calls than they receive – *e.g.*, telemarketers."[60]

Global NAPs argues that implementing bill-and-keep for ISP-bound traffic before exchange access traffic would only "proliferate opportunities for arbitrage."[61] For instance, ISPs and providers of VoIP traffic would have powerful incentives to disguise ISP-bound traffic as Section 251(b)(5) traffic.[62] Carriers would also have incentives to terminate long distance traffic through ISPs regardless of whether the calls actually traversed the Internet.[63]

AT&T contends that piecemeal implementation would only ***"increase*** the extent to which different types of carriers are arbitrarily subjected to disparate regulatory treatment."[64] The

57 *Id* at 11

58 *Id.*

59 ***id.***

60 AT&T Comments, citing Declaration of Janusz **A.** Ordover and Robert D. Willig On Behalf of AT&T Corp., at 30; **see *also.*** Maryland Office of People's Counsel Comments at 27-28; Public Utility Counsel of Texas Comments at 18-19: NTCA Comments at 18.

61 Global NAPs Comments at n. 30

62 Time Warner Comments at 20.

63 Public Utility Counsel of Texas Comments at 53, 78-79

64 AT&T Comments at **47** (emphasis in original).

Illinois Commerce Commission discourages the Commission from implementing bill-and-keep only for ISP-bound traffic, noting that it would be "discriminatory to differentiate compensation mechanisms based upon the types of services being provided without making determinations as to the cost of service."[65] The Public Utility Commission of Texas would not support a "regime for local intercarrier compensation that differentiated between voice and ISP-bound traffic."[66]

C. Piecemeal Implementation Would Not Be Competitively Neutral

Numerous parties find the implementation of bill-and-keep would benefit ILECs to the detriment of competitive carriers. Joint Commenters observed that bill-and-keep would favor mature carriers with balanced traffic because only mature carriers have ubiquitous networks serving a sufficiently large customer base so that individual customer imbalances will cancel each other out. The balanced traffic of ILECs would give ILECs a substantial advantage in recovering their costs.[67] Allegiance noted how bill-and-keep gives substantial advantages to carriers with established networks.[68] KMC observed that since CLECs have a much smaller customer base over which to spread termination costs, it will make it more difficult for CLECs to recover these costs.[69]

65 Illinois Commerce Commission Comments at 2-3

66 Public Utility Commission of Texas Comments at 11

67 Focal/PacWest/RCN/US LEC Comments at 12.

68 Allegiance Comments at 18-22.

69 KMC Comments at 4.

The Maryland Office of People's Counsel contends that the OPP proposals are so "anti-competitive" that had they been in effect in prior years. CLECs "probably would not exist."'" The Office of Public Utility Counsel of Texas remarks that under the FCC's estimates, "the CLEC industry is about to forfeit about two billion dollars in annual intercarrier compensation payments" when bill-and-keep is implemented for ISP-bound traffic." As the Public Utility Counsel of Texas goes on to observe:

> The ILECs have a much greater ability than the CLECs to absorb increases in end-user rates that the FCC's bill-and-keep proposal may cause. As a result of their large and diverse customer base, ILECs will be able to strategically raise some rates while leaving other rates relatively unaffected. That is, ILECs can selectively raise certain rates – *in regions or for customer **classes** where competition **is** absent* – and keep other rates – *in regions or for customer classes where they do face competition* – relatively stable. By contrast, most CLECs have a far smaller and more homogeneous customer base, ***all** of which is subject to competition.*[72]

As the Public Utility Counsel of Texas concludes, "one may cynically note, that a few more regulatory shocks, and the issue of compensation between competing carriers for intercarrier traffic will be permanently resolved – there won't be such **traffic**."[73]

The competitive advantages that ILECs possess will be exacerbated because ILECs set local rates using a sent-paid methodology to ensure recovery from a subscriber of all costs of local calls that the customer originates, including originating switching, interoffice transport, and

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Maryland Office of the People's Counsel Comments **at** 14

71 Public Utility Counsel of Texas Comments **at** 45.

Id. at 46.

Id. at 37.

terminating switching.[74] Under a bill-and-keep regime, ILECs would not need to recover extra termination costs since they are already recovering those costs.[75] Under the existing regime. if termination rates are set at the ILEC's forward-looking costs, ILECs should be indifferent to whether CLECs terminate their traffic or they terminate it themselves.[76] Under a bill-and-keep approach. ILECs would receive a windfall

D. Impact on Market to Serve ISPs

The selective implementation of bill-and-keep for ISP-bound traffic could have a detrimental impact on the market to serve ISPs. The Joint Commenters noted that implementation of bill-and-keep for ISP-bound traffic will limit the amount of competitive options that ISP providers have.[77] **As** noted, ILECs will experience a windfall under bill-and-keep because termination costs are built into their local rates. Thus, ILECs may not need to raise rates, and may even be able to reduce rates temporarily to reclaim ISP market share.[78] CLECs, however, would be forced to pass on their higher termination costs to the ISPs, who in turn would have to pass on the higher costs to their end users. In this environment, many ISPs may be forced to migrate to ILECs.[79] This would not be an economically efficient decision, however,

74 Focal/PacWest/RCN/US LEC Comments at 10; Time Warner Comments at 23.

75 Time Warner Comments **at** 24

76 Public Utility Counsel of Texas Comments at 31; AT&T Comments **at** 15.

77 Focal/PacWest/RCN/US LEC Comments at **25**

78 *Id*

79 *Id*

because it is a choice that ISPs would not normally make in the absence of this Commission's regulatory intervention

As Joint Commenters noted in their initial Comments, and corroborated by many parties, ISPs chose to he served by CLECs because they offered "efficient and affordable high quality networks and connections."'" The Public Utility Counsel of Texas contends that "ILECs have consistently been at war with ISPs and when given the opportunity will discriminate against this class of customers."" To demonstrate ILEC unwillingness to serve ISPs, the Public Utility Counsel of Texas quotes from a brief filed by the Texas Internet Service Provider Association ("TISPA") in which that organization stated:

> ISPs have been fortunate that competitive carriers have sought to provide service to them – at reasonable prices and terms. SWBT never competed for service to ISPs; rather the ILEC has been ***hostile, unyielding,*** *and* ***antagonistic.*** SWBT has refused to provide PRI service to ISPs in many areas, despite Commission rules requiring statewide availability. SWBT favors the SBC Internet affiliate in numerous ways, for dial-up and DSL service. SWBT has continually sought to leverage its continued dominance in the local market into a large share of the enhanced services market and has done everything it can to harm ISPs. At every turn, ISPs throughout the state have discovered that SWBT perceives them to be competitors; a group that must be driven from business, and certainly not deserving of high-quality, reliable and affordable local service.''

TISPA goes on to note that "ISPs use CLECs because they were chased away by the ILECs."[83] CLECs "welcomed ISPs and provided them with all the services and responsiveness

80 *Id* at 27

81 Public Utility Counsel of Texas Comments at 26-27

82 *Id* at 27. ***quoting*** Proceeding to examine Reciprocal Compensation Pursuant to Section 252 of the Federal Telecommunications Act of 1996. Public Utility Commission of Texas. Docket No. **2** 1982. Texas Internet Service Providers Association (TISPA) ***Amicus Curiae*** Brief at 3.

83 *Id* at 29. n. 45. *quoting*, TISPA ***Amicus Curiae*** Brief at 3, n. 2.

they did not receive from ILECs" such as "efficient collocation arrangements, affordable ISDN services. and timely responses to service requests."“

As NASUCA observes, "CLECs and ISPs have become natural business associates because CLECs also provide certain synergies that are not present in the ILEC-ISP relationship."*' As NASUCA goes on to conclude:

> The FCC has failed to provide any evidence that the traffic imbalances observed for CLECs serving ISPs is a result of structural flaws in the intercarrier compensation mechanism, or reciprocal compensation rates that have been set at excessive levels by the state commissions. Conversely, there is evidence indicating that CLECs have gained a disproportionate share of ISP business because the CLECs made a conscious effort to tailor collocation rates and services to the fast growing ISP market. The cost savings provided by the CLECs to ISPs through collocation are substantial. Therefore, the FCC should not contribute to the ILECs anticompetitive tactics by eliminating just and reasonable reciprocal compensation payments that are required by law. Rather, the FCC should do more to encourage the ILECs to comply with the competitive provisions of the 1996 Act.[86]

AOL remarks that if the Commission "raises CLEC costs to offer services to ISPs, the Commission will constrain competition between CLECs and ILECs and ultimately undermine transmission options for ISPs and consumers alike."[87] The Public Utility Counsel of Texas suggests that "these proceedings may mark the end of the independent ISP industry" particularly given the fact that "the ISP industry is in such bad shape."[88] The Maryland Office of People's

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84 *Id*

85 NASUCA Comments at 20

86 *lli*

AOL Comments at 6

88 Public Utility Counsel of Texas Comments at 36

Counsel suggests that "both [OPP] proposals propose effectively to kill the Internet for the general public."[89]

IV. THE ECONOMIC THEORIES UNDERPINNING BILL-AND-KEEP PROPOSALS HAVE BEEN INVALIDATED

A. The "Equal Benefits" Principle Has Been Discredited

The Joint Commenters noted in their initial Comments that the fundamental premise of the OPP Papers for a change to bill-and-keep, *i.e.*, that the responsibility for paying for calls should be based on "benefits," which the bill-and-keep proponents view as being shared equally by the calling and called party, does not support abandonment of the CPNP regime." In fact, Joint Cornmenters observed that it is hard to imagine a more unsatisfactory basis for the wholesale shifting of billions of dollars in industry cost recovery from carriers to end users than an evaluation of "benefits" between the calling and the called party.[91] The Joint Commenters also stated that any evaluation of benefits in this area is unverifiable.[92] Joint Commenters noted that, as explained in the *ETI Report*, it is more reasonable to assume that the calling party benefits more.[93] When one adds unsolicited calls into the equation, which would increase under bill-and-keep and which many consumers do not view as conferring any benefit, the more

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89 Maryland Office of People's Counsel Comments at 18.

90 Focal/PacWest/RCN/US LEC Comments at 43.

91 *Id*

92 *Id*

93 *See* ETI Report at 46-47, attached to Focal/PacWest/RCN/US LEC Comments.

reasonable conclusion is that the calling party benefits more overall.'"

This view has been echoed by numerous commenters, particularly those that, like the Joint Commenters, commissioned third-party economic analysis of the OPP Proposals Economics and Technology, Inc. ("ETI") has issued a follow-up report that reviews the economic analysis elicited in this proceeding. This report is attached to these Reply Comments ("*ETI Reply Report*"). ETI found that the economic studies offered by other commenting parties confirm ETI's conclusion that the bill-and-keep approach, as manifested in the OPP proposals, offers no efficiency advantages or other net benefits over existing arrangements.[95]

AT&T obtained the analysis of two economists, Professors Ordover and Willig, to review the economic underpinnings of the bill-and-keep approach in general, and the OPP Papers in particular.[96] **As** noted in the *ETI Reply Report*:

> Ordover and Willig recognize this shortcoming [invalid assumption of equal benefit] of the COBAK proposal. They find that "there is...little basis in logic or economics for this assumption," and provide further examples that contradict the assumption of equal benefits.[97]

Professors Ordover and Willig note that the "equal benefit" assumption is particularly inapplicable to unwanted calls such **as** a telemarketing call occurring at the recipient's dinnertime.[98] Bill-and-keep also does a particularly poor job, relative to CPNP arrangements, of

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94 Focal/PacWest/RCN/US LEC Comments **at 44**

95 *ETI Reply* ***Reporr*** at 1

96 AT&T Comments, Declaration of Janusz **A.** Ordover and Robert D. **Willig** On Behalf of AT&T Corp. at ¶11 ("Ordover/Willig Declaration").

97 *ETI Reply* ***Reporr*** at 2, *citing* Ordover/Willig Declaration at ¶¶ 32-33.

98 *Id.* ***at*** 3, *citing* Ordover/Willig Declaration at ¶ 31

treating negative externalities, *i.e.*, the costs arising from unwanted calls. including but not limited to telemarketing calls. Since bill-and-keep would shifi some of the costs of placing a call onto the call recipient, it would reduce the calling parties' share of the costs of unwanted calls and increase the supply of unwanted calls.[99] Other commenters have also recognized this adverse outcome of bill-and-keep.[100]

Another shortcoming of bill-and-keep is that "B&K actually restricts the ability of consumers to internalize the positive externalities of a call"[101] As noted in the *ETI Reply Report:*

> [Professors Ordover and Willig] explain that CPNP has the flexibility to allow end users to more closely match cost recovery to their respective benefits from calling. so that, for example, businesses that expect to gain disproportionate benefits from customer calls can subscribe to 800-number services and absorb the costs of inward calls. In contrast, 800-type services would not be workable under bill-and-keep, because the interexchange carrier would be able to offer called-party-pays pricing on only the interexchange portion of the call. The loss of this flexibility means that, all other things being equal, bill-and-keep would be 'less likely to produce efficient results.'[102]

This shortcoming has been highlighted by other commenters. CompTel remarks that the OPP proposals would wrest control of costs away from subscribers because they would no longer be able to reduce costs by choosing to place fewer calls.[103] NTCA observes that by shifting costs to the called party and its carrier, bill-and-keep provides incentives to the calling party to place

99 *Id.*, *citing* Ordover/Willig Declaration at ¶ 36 and n. 9.

100 *Id.*, *citing Maryland OPC Comments* at 26-28, *NASUCA Comments* at 33.

101 *Id.*, *citing* Ordover/Willig Declaration at ¶ 35.

102 *Id.*, *citing* Ordover/Willig Declaration at ¶¶ 30. 35.

103 CompTel Comments at 12-13.

calls that otherwise would not have been cost effective under a CPNP approach."[104] The calling party is the party with the complete information. The called party may not want the call. but the OPP proposals impose the costs on the called party.[105] The Maryland Office of People's Counsel contends that the OPP proposals create economic inefficiency because only the calling party is in a position to know the content and therefore the benefit of the call, and that rational decision-making requires a comparison of costs and benefits.[106] While a called party may be an "accomplice," any assignment of costs, whether 50/50 or otherwise, under a benefit theory is arbitrary because regulators cannot truly measure the relative benefits of the call.[107] NASUCA notes that "we do not deny that the call receiver benefits from SOME calls, but it is impossible to say how the benefits of the call are shared, and therefore it is bad policy to assume that both parties benefit equally. and to base policy changes on this assumption."[108] This sentiment is echoed by the Ad Hoc Telecommunications Users Committee ("Ad Hoc Telecom Users"), a coalition of end users.[109] The Ad Hoc Telecom Users note that the "equal benefit" assumption is unproven and not likely to be true. If, in fact, benefits inure disproportionately to the calling party, then shifting half of the cost-recovery burden to the called party would be inefficient."[110]

104 NTCA Comments at 18.

105 *Id* at 16.

106 Maryland Office of People's Counsel Comments at 24-26.

107 Public Utility Counsel of Texas Comments at 55-57: *see also,* CompTel Comments at 14-16.

108 NASUCA Comments at 21 (emphasis in original).

109 Economics and Technology. Inc., served as economic consultant to the Ad Hoc Telecom Users in the preparation of their comments.

110 The Ad Hoc Telecommunications Users Committee Comments at 5.

Time Warner likewise solicited the analysis of two economists. Professors Farrell and Hermalin. Accompanying the analysis was a paper by Dr. Hermalin and Dr. Michael Katz. Both Professors Farrell and Katz were former Chief Economists at the Commission. Professors Farrell and Hermalin note that the bill-and-keep proposal, and COBAK in particular, are based on two "implausible" assumptions."' The first is that the caller and called party derive ***equal*** benefit from the call. This is a much stronger assumption than the assumption that both parties benefit.'" COBAK also assumes that the marginal costs of interconnecting networks are precisely equal, but this assumption is "unlikely to hold, because different networks use different technologies and have different blocking probabilities."[113]

The paper by Drs. Hermalin and Katz provides insights into bill-and-keep when the "equal benefits" and/or "equal marginal costs" conditions are violated. **As** observed in the *ETI Reply Report:*

> [Drs. Hermalin and Katz] have developed a series of economic models of two-party communications (including, but not limited to, telephone calls) that analyze the welfare consequences when benefits of the communication may be shared between the two parties. One of those models encompasses the scenario relied upon by Mr. DeGraba in his construction of the COBAK mechanism, as a special case of their more generalized model.[114] They demonstrate that, within the limits of this model, Mr. DeGraba's finding that a zero interconnection charge (i.e., bill-and-keep) is an efficient solution holds only for a very narrow range of conditions,

111 *ETI **Reply Report*** at 3

112 *Id., citing* Time Warner Comments, Exhibit 1, Drs. Farrell and Hermalin, Analysis of Central Office Bill and **Keep** at 4 (August 2001) ("Farrell/Hermalin Analysis").

113 *Id., citing*, Farrell/Hermalin Analysis at **4**

114 Hermalin and Katz. Section 5 ("Stochastically Dependent Message Values"). In addition to allowing the marginal costs of the two interconnecting networks to **vary.** their model assumes that the expected values of the communication for each end user are in a linear relationship, which is an extension of Mr. DeGraba's assumption that they are **equal.** *ETI **Reply Report*** at ***3, citing***, *id.* at pages 22. 26.

outside of which a positive interconnection charge (i.e., an explicit reciprocal compensation scheme) will be the efficient solution *(id.,* at page ***26).*** *This finding means that. even in the ideal case (abstracting away from all of the daunting implementation problems addressed elsewhere in these reply comments). COBAK, along with other similar forms of bill-and-keep, is unlikely to result in socially optimal, efficient retail prices for telephone service.* [115]

B. Bill-and-Keep Would Not **Be** Prevalent **In An** Unregulated, Competitive Market

A particularly damaging point against bill-and-keep is the fact that it would not be the likely compensation scheme to emerge in an ideally competitive market. **As** Professors Ordover and Willig note:

> We think it would be highly unlikely for B&K to emerge as a unique *equilibrium* interconnection and access regime in an effectively competitive telecommunications market. The simple reason is that B&K encourages more unwanted calls by effectively allowing telemarketers and others to terminate their unwanted calls for free. Worse yet, it forces the called parties to pay terminating charges for the privilege of receiving such unwanted calls. Because most consumers would justifiably resist the imposition of such costs, carriers seeking to satisfy consumers (as would any carrier seeking success in the hypothetical world of effectively competitive markets) would be unlikely to enter into B&K arrangements.[116]

Prior to the advent of telecommunications regulation, when parties could freely choose any type of intercamer compensation arrangements, bill-and-keep was not the compensation regime of choice. As **NASUCA** observes, however:

> Beginning in 1894, the Bell System had to enter into interconnecting contracts with Independent telephone companies, and the Independents similarly entered signed contracts with each other that governed the terms of interconnection. Bill-and-Keep was adopted in certain situations, but the most prevalent form of interconnection was revenue

[115] *ETI Reply Report* at 4. Hermalin and Katz **also** reject Atkinson and Barnekov's assumption that retail prices are independent of the way interconnection is priced. *Id.,* ***citing.*** Hermalin and Katz, page 3. This fundamental problem with the Atkinson and Barnekov analysis was also identified in the *ETI* ***Report*** (pages 39-40).

[116] Ordover/Willig Declaration at ¶ 14

> sharing. For example, the typical interconnection contract for a toll camer required that fifteen to twenty-five percent of the originating revenue be paid to the terminating local exchange camer. The contracts discussed in the prior paragraph were established prior to the advent of federal or state regulation of the telephone industry. The terms varied little after regulation was established. Bill-and-Keep contracts were negotiated some of the time. but only where traffic was balanced. In those situations where traffic was out of balance, a settlement payment was made by the company that originated the majority of the calls.”’

Even today, in unregulated markets, bill-and-keep is not the prevailing compensation mechanism where traffic is unbalanced. The Internet, which is often invoked as a paradigm example of use of bill-and-keep arrangements, actually undercuts the case for bill-and-keep. Where the “terms of trade are balanced,” the largest carriers do use a bill-and-keep, or peering, arrangement when they interconnect.”’ **As NASUCA** observes:

> Smaller ISPs, on the other hand, pay for the privilege of interconnection to backbone carriers by leasing lines from one of the major backbone operators. ***Or*** stated differently, where the benefits of interconnection are unbalanced, camers in this unregulated market enter into a commercial relationship in which the party who provides a greater service to the smaller network receives compensation from the smaller camer. Conceptually the payment by the smaller carrier is the same as in the world of telecommunications where the network that originates the majority of the minutes of traffic compensates the terminating network.”’

Another example of where the cost-causer pays for “the privilege of using another network basis” is roaming charges for wireless communications networks.’” The network was “created for its subscribers. but the incremental costs attributable to the caller who ‘roams’ onto the network

117 NASUCA Comments **at** 7.

118 NASUCA Comments **at** 10

119 *Id.*

120 *Id*

pays these costs.'"[121] As NASUCA appropriately concludes:

> These examples illustrate a powerful trend in network economics – that the party which causes the increase in network costs pays. This is true in cases where the cost-causer benefits 100% or when the benefits are shared with another party. Moreover. because of the existence of positive network externalities, it is more likely that these externalities will be properly internalized through a cost-causer pays arrangement.[122]

Thus. bill-and-keep would not emerge as the prevailing compensation scheme in unregulated markets where the "terms of the trade" are not balanced. The reality of the telecommunications market is that traffic will be unbalanced, and will continue to be unbalanced for some time. This Is not an unexpected or undesirable result.[123] As the Ad Hoc Telecom Users contend:

> The authors of both papers appear to subscribe to the view that any intercarrier compensation structure that results in a less than balanced flow of traffic between one carrier and another is somewhat flawed and must be changed. As with their "equal benefit" theory, this premise is also unsupported by factual or economic evidence, Is untested, and is most likely untrue. Prior to the introduction of competition in the local service market, when LECs provided service within non-geographically overlapping service areas, the expectation (and the reality) was that the transfer of traffic between carriers would be relatively in 'balance." The introduction of competitors into this segment changes the paradigm, and there is no longer any reason for the expectation that traffic will be in balance.[124]

Since unbalanced traffic is the reality of the marketplace, and is likely to be the reality for some time, bill-and-keep is a compensation mechanism ill suited to this reality.

C. Bill-and-Keep Does Not Provide "Equal Responsibility" Far A Call

Another fundamental principle in the OPP Papers, particularly in the BASICS proposal, is

121 *Id*

122 *Id*

123 Focal/PacWest/RCN/US LEC Comments at 12-14

124 The Ad Hoc Telecom Users Comments at 6-7.

that both parties will share equal responsibility for a call.[125] Bill-and-keep, however, "requires each party's carrier (and therefore each carriers's end-user) to bear its own costs, and the cost of originating the call may be less than or greater than the cost of terminating the call."[126] **As** noted in the *ETI Reply Report*, "the failures of COBAK and BASICS to live up to this principle are particularly noticeable in the varying (and inconsistent) treatments of transport cost, neither of which would result in equal sharing of those costs between the two parties to the call."[127]

D. Proponents of Bill-and-Keep Do Little To Shore Up Their Case

The proponents of bill-and-keep do little to shore up the economic foundations of the theory Qwest contends merely that bill-and-keep is "as least as efficient" as any CPNP approach and concedes that even under a CPNP regime, carriers will have a substantial incentive to reduce their termination costs."[128] The other proponents of bill-and-keep "fail to provide any meaningful economic support for adopting COBAK, BASICS, or any other bill-and-keep arrangement on a mandatory basis."[129] USTA offers "economic efficiency" as the basis for adopting bill-and-keep, and also asserts vaguely that bill-and-keep properly allocates "cost causation" between the calling party and the called party. USTA, however, "supplies no further analysis of calls' cost causation, or precisely *how* the costs of calls should be split between the caller and the called party."[130]

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125 *ETI **Reply Report*** at 2.

126 *Id.*, *citing* Ordover/Willig Declaration at ¶ 34.

127 *Id* at 2

128 Qwest Comments at 21; ***ETI Reply Reporr*** at ***4***

129 *ETI **Reply Report*** at 4

130 *Id.*, ***citing*** Qwest Comments at 21