Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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

COMMENTS OF VERIZON
IN RESPONSE TO FURTHER NOTICE OF PROPOSED RULEMAKING

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INTRODUCTION AND SUMMARY

The goal of any intercarrier compensation reform should be the replacement of the existing regimes of top-down regulation with negotiated, commercial agreements between interconnecting carriers. The Commission has repeatedly recognized that such market-based solutions are preferable to regulation and consistent with the deregulatory emphasis of the Telecommunications Act of 1996 ("1996 Act"). A market-based approach, relying upon negotiated, commercial agreements, is the best long-term solution to ensuring the efficiency of the telecommunications markets in the face of substantial technological change. Such an approach permits carriers to craft interconnection agreements that reflect the particular characteristics of the traffic exchanged between them. Moreover, market-based agreements are inherently more flexible and can be modified more easily than complex regulatory regimes, enabling carriers to adapt more quickly to emerging technologies. Indeed, negotiated interconnection arrangements have proven successful in a variety of circumstances – most

[1] The Verizon telephone companies ("Verizon") are identified in Appendix A to these comments.

notably in the Internet – in the absence of either rate regulation or a regulatory mandate to enter into such arrangements in the first place.

By contrast, any attempt to create a one-size-fits-all solution through regulatory mandates, such as a mandatory bill-and-keep regime, cannot produce efficient results given the complexities of today's telecommunications markets. The Commission's experience with the existing intercarrier compensation rules has demonstrated that regulatory compensation regimes, no matter how well-intentioned, can be manipulated by carriers in ways that were unforeseeable at the time the rules were created in order to obtain profits. These manipulations create market inefficiencies that harm consumers. The Commission should abandon such rigid regulatory mandates for intercarrier compensation and instead allow interconnection arrangements to be based on market forces and negotiated commercial agreements.

Given the success of negotiated agreements in other contexts, it is far from clear that a new regulatory regime needs to be created in order for the industry to transition to a regime of negotiated arrangements. Indeed, while much has been made of arbitrage problems under the existing rules, the principal source of that arbitrage has been carriers that have ignored or tried to evade those rules. As an initial matter, therefore, the Commission should make clear that all providers of voice telephone service that use the public switched network are subject to the existing access charge regime, while also expressly allowing carriers to voluntarily negotiate compensation arrangements that depart from the existing rules. Moreover, if the Commission concludes that some transitional default rules are appropriate during the shift to negotiated agreements – whether those rules take the form of a default rate structure or a process for resolving disputes that may arise in negotiations – the Commission should ensure that any such rules are consistent with the following five principles.

First, any such default rule must account for the fact – already reflected in market-based arrangements – that interconnection does not always benefit both networks equally. Carriers make different decisions with regard to the significant investment required to build and improve networks. As a result, although interconnection may result in an equal exchange of value in some cases, in other cases interconnection may provide greater benefits to one of the interconnecting carriers. Commercially negotiated agreements in the context of the Internet recognize this fact, as companies agree to forgo intercarrier compensation where they perceive interconnection as providing equal value to each, but insist on some form of compensation when that is not the case. A default rule that does not recognize this principle – such as a rule imposing a bill-and-keep arrangement for *all* traffic – provides disincentives for investment in network improvements, as network operators will be unable to recoup the value created by those investments and other providers will have strong incentives to free ride on the investments of the network operators.

Second, any transitional default rule should preserve existing negotiated arrangements and facilitate additional ones. In particular, default rules should not interfere with the commercially negotiated arrangements that currently exist between and among the networks that make up the Internet. Nor should default rules apply where networks exchange packets on an Internet protocol ("IP") basis without using the circuit-switched network – regardless of whether the packets are carrying voice, data, or video, and regardless of the carrier involved. Because the goal of any new regime should be to encourage carriers exchanging circuit-switched wireline and wireless traffic to adopt similar negotiated arrangements, the Commission must ensure that any default rule does not become a mandatory rule in practice. This will occur if the default rule enables one class of carriers to insist on results that could not be obtained through commercial, market-based negotiations.

Third, any default rule the Commission establishes should provide for positive rates and a more uniform rate structure for various types of traffic than exists currently. The desirability of these features follows from the first two principles. Positive rates reflect the market outcome that one network is compensated when interconnection does not result in an equal exchange of value and provide appropriate investment incentives, while greater uniformity for various types of traffic reduces opportunities for carriers to benefit from non-compliance with existing rules. In contrast, the default bill-and-keep rule proposed by some would encourage a whole new host of arbitrage opportunities. Nor is there any merit to claims that bill-and-keep is superior from the perspective of regulatory efficiency. In any event, virtually all of the benefits claimed to flow from a bill-and-keep regime actually trace to the establishment of a more *uniform* rate structure for various types of traffic (as opposed to a one-size-fits-all solution for all carriers or all networks). Default rules that provide for positive rates have the significant advantage of avoiding the arbitrage opportunities that would be created by a mandatory bill-and-keep regime for all traffic and all providers.

Fourth, any transitional default rules should provide sufficient flexibility to ensure that carriers can recover the costs currently recovered through intercarrier compensation and can be compensated for the value provided by interconnection with other networks. Intercarrier compensation reform provides the opportunity for the Commission to promote competition and eliminate regulatory arbitrage; the purpose of such reform is not to reduce carrier revenues or end-user rates. The Commission has recognized as much in past reforms of intercarrier compensation and should do so here as well. Therefore, the Commission should ensure that it provides carriers with opportunities to recover costs currently recovered through intercarrier compensation through some combination of intercarrier compensation and end-user charges (whether called retail basic service rates, subscriber line charges ("SLCs"), or otherwise). There is no one-size-fits-all approach applicable to all carriers in all markets, as competitive market conditions will sharply limit many carriers' ability to recover revenues through increases in end-user charges.

Fifth, the Commission should avoid disruptive changes to existing interconnection architectures as it implements intercarrier compensation reform. Carriers have been interconnecting their networks for nearly a decade under the rules implementing the 1996 Act – and for much longer in the case of interLATA and wireless calls. After considerable litigation about the requirements of the statute and the Commission's rules, most of those requirements are settled and have been internalized by market participants. Adoption of a new set of interconnection rules would serve primarily to upset settled expectations. Adapting to those rules, at the same time carriers are transitioning to a new intercarrier compensation regime, will impose significant costs on carriers that will likely outweigh any benefits provided by those rules, while inevitably creating new arbitrage opportunities to be exploited.

All of the proposals made thus far fail to satisfy one or more of these principles. The Intercarrier Compensation Forum ("ICF") proposal, for example, would simultaneously transition to a bill-and-keep system and dramatically restructure carriers' interconnection obligations. This combination would create a host of new arbitrage opportunities, while at the same time failing to provide carriers with a realistic opportunity to recoup the costs currently recovered through intercarrier compensation. Others, such as the National Association of State Utility Consumer Advocates ("NASUCA") and Cost-Based Intercarrier Compensation Coalition

("CBICC") proposals, assume that all carriers – in all markets – can pass on to consumers a substantial portion (or even all) of the costs currently recovered through intercarrier compensation. It would be error for the Commission to adopt any of them as proposed.

Finally, the Commission should not attempt to create new intercarrier compensation rules unless it applies those rules at both the interstate and intrastate levels. As the Commission has recognized, many of the concerns regarding the current regulatory scheme – and some of the primary opportunities for arbitrage – are rooted in the efforts by some carriers to evade the current rules in order to exploit the disparity between the interstate rates regulated by the Commission and the intrastate and local rates currently regulated by state commissions. The Commission therefore cannot remedy those concerns unless it first concludes that it can preempt state regulation and assume control of all intercarrier compensation issues. While this admittedly raises a non-trivial legal issue as to the Commission's authority, there are reasonable arguments supporting preemption of existing state commission authority that are consistent with the statute and Commission precedent. If the Commission nevertheless concludes that it lacks preemptive authority over intrastate traffic, it should not resort to half-measures by adopting new rules for interstate traffic only. Rather, if the Commission concludes that transitional default rules are needed, then under these circumstances it should first seek exclusive authority over intercarrier compensation from Congress, including both interstate and intrastate traffic.

I. INTERCARRIER COMPENSATION SHOULD BE ESTABLISHED THROUGH NEGOTIATED, COMMERICAL ARRANGEMENTS

In the 1996 Act, Congress sought to create a pro-competitive, deregulatory framework for the provision of local telephone service that reflects the "virtues of negotiated competition." *Verizon North Inc. v. Strand*, 367 F.3d 577, 585 (6th Cir. 2004). For this reason, courts have rightly rejected regulations that would "place[] a thumb on the negotiating scales." *Wisconsin*

Bell, Inc. v. Bie, 340 F.3d 441, 444 (7th Cir. 2003), *cert. denied*, 540 U.S. 1142 (2004). Consistent with these principles, the Commission recently eliminated the pick-and-choose rule, precisely because it had proved to be an impediment to voluntary negotiations between incumbents and competitors.[2] In the context of intercarrier compensation as well, the Commission has recognized that negotiated, commercial solutions are superior to regulatory prescriptions, finding that "negotiated agreements between carriers are more consistent with the pro-competitive process and policies reflected in the 1996 Act."[3] Indeed, the Commission routinely recognizes that "the best way to achieve reliable, ubiquitous service . . . is to encourage further reliance on negotiation and market-based solutions to the fullest extent possible."[4]

Consistent with this precedent, the Commission should hold here that comprehensive intercarrier compensation reform will be attained through commercial, "negotiated agreements between carriers," rather than a new set of "detailed rules and regulations."[5] *FNPRM* ¶ 33.[6] Indeed, it is clear from the history of the Commission's various attempts to regulate intercarrier compensation that one-size-fits-all regulatory solutions cannot fully address the complexities of today's telecommunications markets. Such rules have been – and will continue to be – gamed by carriers keen on exploiting arbitrage opportunities rather than engaging in actual competition.

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[2] *See* Second Report and Order, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, 19 FCC Rcd 13494, ¶¶ 12-13 (2004).

[3] Declaratory Ruling and Report and Order, *Developing A Unified Intercarrier Compensation Regime*, CC Docket No. 01-92, FCC 05-42, ¶ 14 (rel. Feb. 24, 2005).

[4] Report and Order, *Cellular Service and Other Commercial Mobile Radio Services in the Gulf of Mexico*, 17 FCC Rcd 1209, ¶ 27 (2002).

[5] The Commission should waive, modify, or forbear from existing rules to the extent necessary to enable carriers to enter into commercially negotiated intercarrier compensation arrangements.

[6] Further Notice of Proposed Rulemaking, *Developing a Unified Intercarrier Compensation Regime*, 20 FCC Rcd 4685 (2005) ("*FNPRM*").

By contrast, a market-based approach, based upon negotiated, commercial agreements, is the best long-term solution to ensuring the efficiency of the telecommunications markets in the face of substantial technological change. Commercial solutions are desirable because they permit interconnecting carriers to develop terms of service between them that reflect the economic substance of their exchanges of traffic. This is because markets are "economizers of information,"[7] enabling parties to reach an efficient outcome through negotiation even when they lack complete information, as each party can use information about its own network to estimate the value of interconnection with another network. Moreover, a market-based approach, by virtue of being technologically neutral, adapts more easily to changing technologies, encouraging their introduction without the need for modification of regulatory regimes.[8]

A. Negotiated, Commercial Arrangements Between Interconnecting Carriers Have Proven Successful

Today's marketplace provides numerous examples of different networks interconnecting on commercially negotiated terms in the absence not only of any regulation of the rates on which they exchange traffic, but also in the absence of any regulatory mandate to interconnect in the first place. The most relevant example for these purposes is the Internet. What is commonly referred to as "the Internet" in fact consists of a series of individual networks, owned and operated by many different entities, that have entered into purely voluntary interconnection arrangements. *See* Declaration of Lyman Chapin ¶¶ 5-8 ("Chapin Decl.") (attached hereto as Attach. A). The structure of this "network of networks" ensures that traffic can flow between

[7] *See, e.g.*, Vernon L. Smith, *Markets as Economizers of Information: Experimental Examination of the Hayek-Hypothesis*, 20 Econ. Inquiry 165 (1982).

[8] *See, e.g.*, Memorandum Opinion and Order, *Petition of SBC Communications Inc. for Forbearance from the Application of Title II Common Carrier Regulation to IP Platform Services*, WC Docket No. 04-29, FCC 05-95, ¶ 14 (rel. May 5, 2005) (noting that SBC sought regulatory relief for "newly constructed . . . IP networks that SBC plans to roll out later this year") ("*IP Platform Forbearance Order*").

any two end points on the Internet, irrespective of whether their service providers are directly connected. *See id.* ¶¶ 11-12, 28. This is made possible through interconnection arrangements entered between various networks, which specify where and how traffic will be exchanged, and whether and how compensation will be paid for the exchange of traffic. *See id.* ¶ 36. Different arrangements can contain vastly different terms, based on the needs of the networks involved, and their assessment of the value that each obtains from interconnecting with the other. *See id.* ¶¶ 36-40.

All such arrangements – whether a simple bilateral agreement to deliver traffic to and from each others' end-user customers or a multi-party agreement to exchange traffic destined to end-user customers of the parties to the agreement as well as other end-users served by non-party networks – are made on the basis of a perceived equitable exchange of value between the interconnecting parties. *See id.* ¶¶ 40. If the parties agree that each network receives equal value from the simple fact of interconnection, they may agree to exchange traffic on what is, in effect, a barter system known as "peering" and that can be more accurately described as an "exchange of value," pursuant to which the parties agree that the exchange of traffic itself provides an equitable exchange of value and therefore require no additional compensation. *See id.* ¶ 39. In other cases, interconnection is not perceived as an equitable exchange; instead, one network is perceived as receiving greater value from interconnection, based on one or more of a variety of characteristics of the two networks. *See id.* ¶¶ 39-40. In these cases, the network receiving the higher value will compensate the network with which it interconnects, on a cash or other basis, through commercial "paid peering" or "transit" arrangements. *See id.* Although the various determinants of value gained by interconnecting any two networks are unique to each particular interconnection, the market has become increasingly transparent and participatory, with many networks openly publishing their interconnection and peering policies. *See id.* ¶ 40 nn.15-16.

These negotiated, commercial agreements – which capitalize on networks' strong incentives to interconnect – have been tremendously successful and have been credited for the rapid growth in the capacity of the Internet. *See id.* ¶¶ 42-43.[9] These agreements, moreover, have ensured that the Internet is always fully interconnected – any end-user connected to the Internet can communicate with any other end-user – regardless of whether any particular pair of networks is directly interconnected. *See id.* ¶ 43. As a result of the availability of connection points and the architecture of the Internet, there is virtually no possibility that a network could find itself disconnected from the Internet, even if one or many other networks refused to interconnect with it, as is their right. *See id.*

Moreover, the success of negotiated interconnection arrangements on the Internet is highly relevant to the Commission's approach to intercarrier compensation in the context of the circuit-switched telephone network. The experience of the Internet demonstrates not just that negotiated agreements can work. Rather, the Internet experience demonstrates that, because carriers have strong incentives to interconnect their networks and to do so in an economically efficient manner, negotiated agreements among carriers are the most effective way of ensuring efficient interconnection arrangements and efficient network development. The Internet

[9] This is true worldwide. For example, the Internet developed later and less rapidly outside North America, such that for a time, networks overseas connected to the Internet through North America. *See* Chapin Decl. ¶ 46. Although there was some pressure, as recently as five years ago, for international regulation of interconnection between North American networks and networks in other countries, market demands for more efficient interconnections overseas led to the development of dozens of viable regional Internet exchanges outside of North America. Thus, market forces and the competitive process, rather than regulation, created more efficient means of connecting overseas networks to the Internet, and any pressure for international regulators to step in dissipated. *See id.* ¶¶ 46-47.

therefore provides a model for a deregulatory approach to network interconnection that this Commission should follow in its review of intercarrier compensation.

B. One-Size-Fits-All Regulatory Regimes Have Not Proven Successful

In contrast to the success of negotiated commercial agreements, one-size-fits-all regulatory regimes have not proven successful. Top-down attempts to craft intercarrier compensation rules to apply to all network interconnections will necessarily fail to foresee how those rules will apply (and can be evaded or misapplied) in all situations. Arbitrage is therefore the inevitable result of any attempt to impose a one-size-fits-all regulatory scheme across the board. This is particularly true in the case of today's telecommunications industry, which is experiencing swift and far-reaching changes driven by constantly evolving technology. Neither regulators nor carriers can possibly foresee the ways in which new technologies may present opportunities for creative carriers to manipulate the regulatory regime in order to obtain arbitrage profits. For this reason, the Commission should not attempt to create a new one-size-fits-all approach to intercarrier compensation, but rather should allow more efficient and effective market forces to drive negotiated commercial agreements.

The Commission's experience with the current intercarrier compensation rules illustrates the difficulties inherent in one-size-fits-all regulatory solutions. For example, carriers have engaged in regulatory arbitrage by camouflaging or denying the true nature of traffic exchanged with other carriers in order to manipulate the current system and receive more favorable treatment under the current rate structure. Some carriers have simply asserted that some feature of their internal network configuration exempts their traffic from certain intercarrier compensation obligations. AT&T, for example, asserted that it could evade its obligation to pay access charges on long-distance calls simply by converting a call that originated and terminated as a circuit-switched call to IP format at some point in the middle. See IP-in-the-Middle Order

¶ 11.[10] The Commission rejected AT&T's claim, finding that AT&T was engaging "in arbitrage at the cost of what other parties are entitled to under the statute and our rules." Id. ¶ 17. Other interexchange carriers have been sued for engaging in this same ploy. The Commission similarly rejected another recent attempt by AT&T to avoid complying with existing rules, this time asserting that it was entitled to pay the lower interstate access charges rather than the higher intrastate access charges, because it made the business decision to route calling card calls through a centralized advertising platform. See AT&T Calling Card Order ¶¶ 6-7.[11] The Commission rejected all of the various grounds on which AT&T asserted that its call routing decisions exempted it from paying intrastate access charges and found, moreover, "that AT&T had no reasonable basis to expect to avoid [existing] obligations merely by adding an unsolicited advertising message to its prepaid calling card service." *Id.* ¶¶ 22-29, 32.

Other competitors have widely employed virtual NXX service, which enables them to disguise calls between customers in different local calling areas – and even in different states – and to make such calls appear to be local calls for which the competitor would be entitled to compensation.[12] The purpose of these arrangements, as one competitor candidly admitted, is to "prevent [the incumbent's] switching equipment from identifying the call as crossing a local calling area," because then the incumbent would properly "impose access charges on a call

[10] Order, *Petition for Declaratory Ruling that AT&T's Phone-to-Phone IP Telephony Services are Exempt from Access Charges*, 19 FCC Rcd 7457 (2004) ("*IP-in-the-Middle Order*").

[11] Order and Notice of Proposed Rulemaking, *AT&T Corp. Petition for Declaratory Ruling Regarding Enhanced Prepaid Calling Card Services*; *Regulation of Prepaid Calling Card Services*, 20 FCC Rcd 4826 (2005) ("*AT&T Calling Card Order*").

[12] *See* Memorandum Opinion and Order, *Application by Verizon Maryland Inc., et al. To Provide In-Region, InterLATA Services in Maryland, Washington, D.C., and West Virginia*, 18 FCC Rcd 5212 ¶ 149 (2003) (describing virtual NXX arrangements).

crossing local calling areas."[13] Where these arrangements went undetected, competitors were able to receive compensation on calls for which they should have been paying compensation under existing rules. Other carriers have routed calls, or tampered with data identifying calls, to obtain the same benefits.

Still other carriers have attempted to use consumers' desire to utilize developing technologies – specifically the Internet – to create the largest and most anti-competitive of the arbitrage opportunities to have arisen as a result of the 1996 Act. These carriers exist primarily – or even exclusively – to deliver calls to Internet Service Providers ("ISPs") for further transit onto the Internet, erroneously claiming entitlement to reciprocal compensation on the grounds that they are purportedly terminating local calls.[14] As this Commission has recognized, "convincing evidence" demonstrates that requiring payment of compensation for ISP-bound calls "create[s] opportunities for regulatory arbitrage and distort[s] the operation of competitive markets." *ISP Remand Order* ¶¶ 2, 81.[15] Those arbitrage opportunities "created incentives for inefficient entry of [competitors] intent on serving ISPs exclusively and not offering viable local telephone competition, as Congress had intended to facilitate with the 1996 Act." *Id.* ¶¶ 21, 70. Those arbitrage opportunities have also thwarted technological advancement, as the carriers

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[13] Brief for Plaintiff-Appellant at 3-4, *Global NAPs, Inc. v. Verizon New England Inc.*, No. 04-4685 (2d Cir. filed Nov. 22, 2004).

[14] As Verizon has demonstrated in prior filings, these carriers' claims to reciprocal compensation are entirely unfounded. *See generally* Verizon and BellSouth White Paper, CC Docket Nos. 96-98, 99-68 (filed May 17, 2004) (attached hereto as Attach. B); Verizon and BellSouth Supplemental White Paper, CC Docket Nos. 96-98, 99-68 (filed July 20, 2004) ("Verizon/BellSouth Supp. White Paper") (attached hereto as Attach. C); Verizon and BellSouth Further Supplemental White Paper, CC Docket No. 96-98, 99-68 (filed Sept. 27, 2004) (attached hereto as Attach. D).

[15] Order on Remand and Report and Order, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Intercarrier Compensation for ISP-Bound Traffic*, 16 FCC Rcd 9151 (2001) ("*ISP Remand Order*"), *remanded*, *WorldCom v. FCC*, 288 F.3d 429 (D.C. Cir. 2002), *cert. denied*, 538 U.S. 1012 (2003).

profiting from serving dial-up ISPs promoted dial-up traffic at the expense of broadband, thereby undermining fundamental Commission policies. Despite growth in broadband deployment, dial-up ISP-bound minutes have not declined substantially: indeed, traffic from Verizon to competitors still exceeds traffic in the other direction by a ratio of 14:1 – proof that competitors continue to exploit the windfall of serving ISPs.[16]

These and other problems that the Commission and carriers have faced under the current regime are the inevitable result of top-down attempts to create a regulatory regime to govern all traffic exchanges. Any such attempt at one-size-fits-all regulation would suffer the same flaw, with variations only in the specific way in which the regulation could be gamed. Contrary to the claims of some, a mandatory bill-and-keep regime is no exception; bill-and-keep is no panacea to the problems of arbitrage and fraud. On the contrary, a bill-and-keep regime will spawn its own arbitrage opportunities and uneconomic investment incentives, only some of which can already be predicted today. For example, a bill-and-keep regime will likely lead to arbitrage opportunities that are the mirror image of the problem that the Commission has already seen with ISP-bound traffic. There, carriers attempted to take advantage of rules that imposed a standard per-minute fee for terminating traffic by serving only customers with a high volume of in-bound traffic: ISPs. By contrast, carriers will likely attempt to take advantage of a bill-and-keep regime by serving only customers with a high-volume of outgoing calls, such as telemarketers and other call centers. This is because under a bill-and-keep regime, carriers will be able to hand off their traffic to other networks without paying compensation. Carriers that serve only high-volume callers will therefore be able to pass off a substantial portion of their costs to other networks, by aggregating a large volume of outgoing traffic and handing it off to points on other

[16] *See* Letter from Donna Epps, Verizon, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 03-171, Attach. at 4-6 (filed Dec. 17, 2004).

networks that are as close to their switch as possible to minimize their own transport obligations. The other networks will be forced to bear substantial costs associated with transporting and terminating those calls, yet will receive no compensation from the carrier profiting from serving those high-volume callers. Indeed, this is a key reason that peering arrangements are not extended to all providers under the compensation scheme that prevails in the Internet, and backbone providers typically include a certain ratio of incoming to outgoing traffic in their peering policies.

Nor is bill-and-keep any more deregulatory in nature than other options. Adopting a bill-and-keep regime would necessarily require the Commission to make substantial regulatory determinations about the exchange of value provided by interconnection. In a bill-and-keep system, the exchange is still priced, but in terms of barter rather than money (while erroneously assuming that all traffic exchanges resulting from interconnection provide equal value). The Commission would therefore still be called upon to establish the terms of the barter – such as limitations on the network location or locations where traffic can be exchanged in order to obtain "free" exchange, technological standards for such exchanges, and the like. Indeed, the lengthy and detailed rules of the ICF plan make clear that a broad and complex new set of regulations would accompany any "deregulatory" bill-and-keep approach and would require the Commission to resolve a host of disputes about the application of those new rules.

II. PRINCIPLES FOR THE ADOPTION OF ANY TRANSITIONAL INTERCARRIER COMPENSATION DEFAULT RULES

In the event that the Commission concludes that some modification to existing rules is necessary for use as a default during the transition to a regime of negotiated arrangements, the default rules that it adopts as a backstop to commercial negotiations must be carefully structured. The wrong reforms of intercarrier compensation rules could exacerbate existing arbitrage opportunities or replace current problems with new ones that are equally bad or worse. Thus, the Commission must ensure that any reforms it adopts provide better overall incentives – not merely different incentives – for carriers and, therefore, better outcomes for consumers. Among other things, the more complex the new rules required to implement "reform," the greater the likelihood for imprecision and ambiguity to give rise to disputes and unforeseen arbitrage opportunities. Below, Verizon addresses five principles for the creation of any such default rules.

A. Any Transitional Intercarrier Compensation Default Rules Should Recognize, As The Market Does, That Different Networks Have Different Values

To the extent the Commission adopts new, transitional intercarrier compensation default rules to allow for a transition to negotiated agreements, the Commission – no different from the market – should acknowledge the economic truth that interconnection does not always benefit both networks equally. That is because different networks have different values, which arise from the significant investment necessary to build and enhance those networks. The relevant characteristics of a network include the relative volume of traffic exchanged, the technological sophistication of the network, the particular geographic areas covered, the number of customers served, the characteristics of those customers, the data and other content available on the network, and the overall reliability, quality, and speed of the network. These characteristics ultimately reflect the payoff from a varying array of network-specific investment decisions and are not necessary correlated with one another. The Commission must be careful in adopting changes to the current system of intercarrier compensation not to upset the incentives to invest in order to enhance and improve existing networks and to build new ones.

The fact that interconnection can provide the interconnecting networks with an equal *or an unequal* exchange of value is reflected in the market-based arrangements discussed above for

Internet networks and for wireless carriers. Networks in each of these industries willingly enter into "peering" or "paid-peering" arrangements – that is, they agree to interconnect either without compensation or with compensation depending on their perception of the value that each network obtains from interconnecting with the other. Any default rule the Commission adopts as a transition to market-based arrangements should reflect this salient feature of network interconnection that is well-recognized in the market.

A transitional default rule that acknowledges that different networks can receive different values from interconnection ensures that all network operators will have the appropriate economic incentives with respect to further investments in their networks, as they negotiate commercial intercarrier compensation arrangements. Networks that provide more value can be assured that they will recoup investments in improving the attributes of their network both by attracting new customers and because they can charge other networks that have not made comparable investments. Similarly, less valuable networks will have appropriate incentives at the make-or-buy point – balancing the cost of paying others to accept their traffic against the cost of investing to increase the value of their network and, thereby, their number of potential peers. On the other hand, if the Commission adopted a transitional default rule that presumed that interconnection always provides both networks with equal value – so that no network has to provide any additional compensation to the other – network operators will have a reduced incentive to invest in network improvements. This is true for all networks, as such a default rule will eliminate the competitive advantages that, as the market recognizes, result from such investments and warrant compensation from interconnecting carriers. *See, e.g.*, Chapin Decl. ¶ 40.

Some of the proposals that have been made to the Commission acknowledge the basic principle that interconnecting networks can receive different value from the exchange of traffic, but they fail adequately to ensure that carriers are compensated when, through interconnection, they provide more value than they receive. For example, the ICF proposal, like others, distinguishes between hierarchical networks, which include network access tandems subtended by end offices, and non-hierarchical networks, which do not.[17] Nonetheless, the ICF proposal would require all networks to pay the same amount – nothing – when they exchange traffic. Although this may be the outcome that results from voluntary negotiations between comparable networks, it provides no recognition of the unequal exchange of value that may occur when different networks interconnect, depending on the characteristics of each of the networks. The CBICC proposal also ignores the value of networks and interconnection by basing all intercarrier compensation on TELRIC rates.[18] By requiring that all networks exchange traffic at below cost rates, the CBICC proposal fails to compensate carriers for the different levels of value provided through interconnection. Because the proposals currently before the Commission do not recognize and compensate for the possibility of unequal exchanges of value in interconnection, all should be rejected.

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[17] *See* Letter from Gary Epstein, counsel for the Intercarrier Compensation Forum, to Marlene H. Dortch, Secretary, FCC, CC Docket No. 01-92, Appendix A at 9-10 (filed Oct. 5, 2004) ("ICF Proposal" or "ICF Ex Parte Brief"); *see also* Letter from David Sieradzki, counsel for Western Wireless Corp., to Marlene H. Dortch, Secretary, FCC, CC Docket No. 01-92, at Slide 12 (filed Feb. 3, 2005) ("Western Wireless Ex Parte").

[18] *See* Letter from Richard Rindler, counsel for the Cost-Based Intercarrier Compensation Coalition, to Marlene H. Dortch, Secretary, FCC, CC Docket No. 01-92, at 1 (filed Sept. 2, 2004) ("CBICC Ex Parte Materials") (TELRIC pricing).

B. Any Transitional Intercarrier Compensation Default Rules Should Facilitate And Not Impede Commercially Negotiated Arrangements

To the extent the Commission establishes new, transitional default rules, the Commission should both refrain from interfering with existing commercial arrangements and ensure that any rules that it adopts as a "default" do not become mandatory in practice.

First, the Commission should take no action to regulate the existing regime of negotiated compensation arrangements between carriers that exchange traffic on an IP-to-IP basis. As explained above, these arrangements, particularly in the context of the Internet, have proved robustly successful without any regulation at all, and would be harmed by the overlay of a new federal regulatory regime. *See* Chapin Decl. ¶¶ 9, 48-52. Such top-down regulation would surely fail in its aim of "improving" upon existing commercial arrangements, as top-down regulation is inherently contrary to the decentralized manner in which the Internet ensures universal connectivity. *See id.* As Chairman Martin recently reiterated, it is the "*removal* of legacy regulations" that will "spur investment and the deployment of new packetized networks and facilities that will bring new broadband services to all Americans throughout the nation." *IP Platform Forbearance Order*, Sep. Statement of Chairman Martin (emphasis added). The Commission, moreover, should strive to "creat[e] a level-playing field for the provision of advanced services by similarly situated service providers" by ruling that all traffic exchanged on an IP-to-IP basis – regardless whether the packets are carrying voice, data, or video, and regardless of the carrier involved – shall have the advantages of the same deregulatory framework that applies today to the Internet. This is especially necessary given the rapid convergence of voice and data being transmitted on the same IP basis as all other Internet traffic.

Second, with respect to the circuit-switched networks that will be transitioning to these voluntary, commercial arrangements, the Commission must be careful that any default rules it adopts do not in practice degenerate into mandatory rules with results that are inconsistent with efficient, market-based intercarrier compensation arrangements. For example, if the networks that make up the Internet always had the "default" option of entering into a non-paid peering agreement, there would be no economic incentive for the network that receives greater value from interconnection to consider any arrangement that would compensate the network that provides that value – the so-called "default" would quickly devour all possible bargaining alternatives even if such alternatives were efficiency-enhancing. Networks of equal value would continue to enter into peering arrangements under such a hypothetical "default" option, but a default is not necessary to ensure that efficiency-enhancing outcome, as the market has demonstrated. As a result, any default rule the Commission may adopt for circuit-switched networks should enable carriers to depart from those rules to make alternative arrangements that the parties deem appropriate given the relative value provided by interconnection between them.

The proposals currently before the Commission are not consistent with this principle. To be sure, many of these proposals describe their rules as mere default rules and state that carriers are free to negotiate alternative arrangements.[19] But the relevant question is not whether carriers are permitted to negotiate around the default rule, it is whether *both* parties to the negotiation will have the incentive to pursue such alternative arrangements. Where a default rule unduly benefits one class of carriers, those carriers are unlikely to enter into negotiated agreements that give up those benefits, even if such agreements are efficiency-enhancing.

[19] *See, e.g.*, ICF Proposal, Appendix A at 2; Letter from Glenn Brown, EPG Facilitator, to Marlene Dortch, Secretary, FCC, CC Docket No. 01-92, at 6, 15 n.10 (filed Nov. 2, 2004) ("EPG Ex Parte Materials"); CBICC Ex Parte Materials at 2; Letter from Philip F. McClelland for NASUCA, to Marlene Dortch, Secretary, FCC, CC Docket No. 01-92, at 1 (filed Dec. 14, 2004) ("NASUCA Ex Parte Materials"); Western Wireless Ex Parte at Slide 8.

That is the case with the proposals currently pending before the Commission. As discussed above, these proposals – such as the "bill-and-keep" proposals of the ICF and Western Wireless – fail to implement the principle that interconnection does not always result in an equal exchange of value between networks. Instead, they treat all networks identically (save for a carve out for rural networks), thereby foreclosing any incentive for lower value networks to negotiate alternative arrangements that result in payment of compensation to the higher value network, as would occur in a market-based system.

C. Any Transitional Intercarrier Compensation Default Rules Should Provide For A Positive Default Rate

Consistent with the principles discussed above, to the extent the Commission adopts default rules for use as a backstop during the transition to commercial arrangements, whether structured as default rates or as processes to resolve disputes, those default rules should provide for *positive* rates that are *more uniform* for various types of traffic than the current regimes. Any default rules should require that networks pay for the extent of their use of another network if they cannot reach agreement on an alternative arrangement. Such rules would ensure that the default replicates the result that would occur in the market in such circumstances. At the same time, such a default will do nothing to alter the incentive of comparable networks to negotiate peering-style arrangements, when it is efficient to do so, based on their recognition that interconnection provides each with roughly equal value and their desire to avoid the transaction costs associated with billing for the traffic they exchange.[20]

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[20] Any default rules adopted by the Commission should not, however, require any payment of intercarrier compensation for so-called "local" calls delivered to ISPs for further transit onto the Internet. As discussed above, ISP-bound traffic has proven to be the largest and most troublesome example of arbitrage under the 1996 Act. *See ISP Remand Order* ¶¶ 2, 21, 71, 80.

A default rate structure that is more uniform and positive will also provide a more efficient outcome than other alternatives, while substantially reducing opportunities for uneconomic arbitrage. Indeed, the current variety of intercarrier compensation regimes serves primarily to provide incentives for carriers to flout the existing rules and assert the right to pay (or to receive) more advantageous rates. A more uniform rate structure not only will reduce opportunities for carriers to benefit through non-compliance with current rules, but also will "be more technologically and competitively neutral than the current regimes." *FNRPM* App. C at 104. Indeed, as the staff report rightly notes, such benefits will exist, "as compared to the current regimes, [with] *any unified approach*." *Id.* (emphasis added). The decision whether to adopt a default rate structure with positive rates or to require bill-and-keep, therefore, is entirely independent of the benefits of default rules that contain a more uniform rate structure than currently exists.

A bill-and-keep regime – regardless of whether it is mandated by rule or in practice – also creates a host of new arbitrage opportunities and inefficiencies, thereby undermining the purpose of intercarrier compensation reform to create a more efficient system that promotes competition and consumer welfare. Any regime that requires networks to interconnect without regard to whether they provide each other with an equivalent exchange of value – and implicitly to let one network pay nothing for any additional benefits it receives – will lead to economically inefficient behavior. In the context of intercarrier compensation, a bill-and-keep regime would give less valuable networks a free ride on more valuable networks, which would bear the additional cost of carrying such calls with no offsetting compensation for the greater investments they have made in improving their networks in any of the various ways that give networks value. The free ride would lead to overuse by other networks, and the uncompensated costs would lead to diminished investment and innovation in networks.

Supporters of a default bill-and-keep rule for virtually all traffic overlook these costs, but identify two grounds on which bill-and-keep is purportedly the superior default rate. *First*, they claim that bill-and-keep is simpler from a regulatory perspective, as it "eliminates the need for regulators to set the level and structure of termination rates." *E.g.*, *id.* at 106. But this argument proceeds from a fundamental mistake. Bill-and-keep involves a decision about the proper "level and structure of termination rates," namely, whether carriers that obtain the lion's share of the benefit from interconnection should have to compensate the other carrier for that benefit – as occurs in market-based arrangements – or may obtain it at no cost. The Commission will therefore be required to defend any decision to permit such carriers to obtain something for nothing – or, alternatively, the plainly erroneous premise that interconnection always provides roughly equivalent benefits to the interconnecting carriers – under the same standards that would apply were it to choose any positive rate.[21] In light of the flaws inherent in bill-and-keep regimes, including the disincentives to investment, the failure to provide compensation for value provided, and the institution of new arbitrage opportunities, a bill-and-keep default rule for virtually all traffic is not a legally defensible outcome.

Nor, contrary to the claims of some, would the establishment of a default rate structure that utilizes positive rates raise insurmountable difficulties. The Commission can craft such default rates from the variety of different rate levels in effect today that, taken together, attempt to provide carriers with compensation for the value provided for their networks. Indeed, any

[21] *See, e.g.*, *Southwestern Bell Tel. Co. v. FCC*, 153 F.3d 523, 543-44, 552-53 (8th Cir. 1998); *People of State of Cal. v. FCC*, 75 F.3d 1350, 1363-64 (9th Cir. 1996); *Aeronautical Radio, Inc. v. FCC*, 642 F.2d 1221, 1243-44 (D.C. Cir. 1980).

overhaul of intercarrier compensation should look to all existing rates in crafting a more unified rate scheme that will adequately compensate networks for their value.

Second, supporters of a bill-and-keep regime claim that, once the transition to bill-and-keep is complete, it would "dispose of most, if not all, of the existing compensation disputes between carriers," by virtue of "eliminat[ing] intercarrier compensation payments." *FNPRM* App. C at 109. On the contrary, as discussed above, disputes would simply shift to other areas, including over the terms on which carriers interconnect and the alternative methods by which carriers will be permitted to recoup the costs currently recovered through intercarrier compensation. In any event, any social benefits from reducing the total number of intercarrier disputes that might result from the adoption of a bill-and-keep rule would easily be outweighed by the social harms of bill-and-keep, discussed above.

For the foregoing reasons, the default rules in the various proposals presented to the Commission should be rejected. The ICF and Western Wireless proposal can be rejected out of hand because, although they establish a uniform rate structure, they do so through a bill-and-keep regime for virtually all traffic. Other proposals fail to establish a more uniform rate structure. Under the CBICC and NASUCA proposals, there would be a gap – and, therefore, an arbitrage opportunity – between interstate and intrastate rates, because they permit state commissions to adopt rates for intrastate traffic different from those applicable to interstate traffic.[22] Because none of the plans presented to the Commission provide for more uniform, positive rates for various types of traffic, the Commission should reject them.

[22] *See* CBICC Ex Parte Materials at 1-2 (state-established intrastate access rates may not match interstate rates); NASUCA Ex Parte Materials at 1 ("encourag[ing]" states to meet interstate access rates, but leaving those rates in states' discretion).

D. Any Transitional Intercarrier Compensation Default Rules Should Provide Flexibility For Carriers To Recover Costs Currently Recovered Through Intercarrier Compensation

The purpose of comprehensive intercarrier compensation reform, as the Commission has long explained, is to "encourage [the] efficient use of, and investment in, telecommunications networks, and the efficient development of competition." *NPRM* ¶ 2.[23] The Commission recently reiterated "that any new approach should promote economic efficiency." *FNPRM* ¶ 31. New rules, therefore, should "encourage[] the development of efficient competition, [which] is consistent with the goals of the 1996 Act," and should "accommodate continuing change in the marketplace and . . . not distort the opportunity for carriers using different and novel technologies to compete for customers." *Id.* ¶¶ 31, 33. In short, the goal of intercarrier compensation reform is to modify the sources from which carriers recover the costs currently recovered through the variety of current intercarrier compensation regimes.

Contrary to the claims of some, the goal of such reform is not to reduce carriers' revenues or end-user rates. In past decisions restructuring intercarrier compensation rules, the Commission has repeatedly recognized that such rule changes should "generate workable competition," which in turn will cause rates "to be driven to competitive levels," and has rejected claims that it should prescribe rate reductions. *Access Charge Reform Order* ¶ 48.[24] That is because rules that encourage the "development and operation of competitive markets, . . . will maximize the efficient allocation of telecommunications services and promote consumer welfare." *Id.* ¶ 260. Rule changes that directly cause "a substantial decrease in revenue for

[23] Notice of Proposed Rulemaking, *Developing a Unified Intercarrier Compensation Regime*, 16 FCC Rcd 9610 (2001) ("*NPRM*").

[24] First Report and Order, *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Transport Rate Structure and Pricing End User* Charges, 12 FCC Rcd 15982 (1997) ("*Access Charge Reform Order*").

incumbent LECs," on the other hand, "could prove highly disruptive to business operations." *Id.* ¶ 46. The Commission followed this approach in adopting the CALLS proposal, noting that it had "compared LEC revenues over the five-year period under the modified CALLS Proposal with what their revenues would be under the status quo, and conclude[d] that they are roughly the same." *CALLS I Order* ¶ 41.[25] The Commission had done the same thing earlier in its Local Transport Restructure proceeding, when it adopted the residual interconnection charge and instituted a "transitional measure" – the "TIC" – that ensured that the "transport rate restructure" would leave LECs with roughly the same revenue as under the old rules.[26] And the D.C. Circuit has upheld the Commission's prior refusals to transform proceedings designed to rationalize intercarrier compensation into proceedings designed to decrease LEC revenues and end-user charges. *See NASUCA v. FCC*, 372 F.3d 454, 459-60 (D.C. Cir. 2004).

The Commission should follow the same course here, and should reject calls by some to require substantial reductions in the amounts LECs currently receive through intercarrier compensation or that end-users currently pay through flat-rated charges. Indeed, such drastic changes in the way in which revenues are recovered would raise "serious constitutional questions" if the Commission did not provide alternatives through which carriers can recover amounts that had been obtained under prior rules. *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 315 (1989). As the D.C. Circuit has explained, such changes in rate methodologies can be "of

[25] Sixth Report and Order in CC Docket Nos. 96-262 and 94-1; Report and Order in CC Docket No. 99-249; Eleventh Report and Order in CC Docket No. 96-45, *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Low-Volume Long-Distance Users; Federal-State Joint Board on Universal Service*, 15 FCC Rcd 12962 (2000) ("*CALLS I Order*"), *aff'd in part, remanded in part, Texas Office of Pub. Util. Counsel v. FCC*, 265 F.3d 313 (5th Cir. 2001).

[26] *See* Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Transport Rate Structure and Pricing; Usage of the Public Switched Network by Information Service and Internet Access Providers*, 11 FCC Rcd 21354, ¶ 96 (1996).

constitutional significance when [adopted] in isolation," but will "have no constitutional effect if they are compensated by countervailing factors in some other aspect." Illinois Bell Tel. Co. v. FCC, 911 F.2d 776, 780 (D.C. Cir. 1990) (internal quotation marks omitted). In other words, the Commission cannot, in adopting new rules, ignore that carriers made investments in light of the current rules, with the perfectly reasonable expectation that regulators would allow them an opportunity to recover their costs. For this reason, the Commission has previously recognized that it would have to consider explicit compensation for incumbent LECs if a "transformation" in the existing intercarrier compensation rules meant they would "have no reasonable opportunity to recover" "any historical costs." Access Charge Reform Order ¶ 49.

For these reasons, to the extent it adopts transitional intercarrier compensation default rules, the Commission should again ensure that it provides carriers with opportunities to recover costs currently recovered through intercarrier compensation. These costs can be recovered through some combination of intercarrier compensation and end-user charges (whether retail rates, SLCs, or other charges). The Commission should provide carriers with sufficient flexibility to utilize all of these methods, because no one approach will be appropriate for all carriers in all markets. In particular, the Commission cannot blithely assume that carriers will be able to increase charges to end-user customers where other sources of compensation are reduced. *See, e.g.*, *FNPRM* App. C at 104 (deeming it a "benefit of a bill-and-keep regime" that all carriers "must recover their own costs from their own retail customers," without addressing the mechanism through which this could lawfully and practically be accomplished).

The plans currently before the Commission do not abide by this principle. Instead, all of the plans assume that carriers would be able to pass a substantial portion (or even all) of the costs currently recovered through intercarrier compensation to end-users, with little regard for the different regulatory and associated competitive conditions in different markets.[27]

For example, consistent with its past efforts to use intercarrier compensation reform as a means of reducing LEC revenue, NASUCA's proposal provides no opportunity for carriers to recover the costs currently recouped through intercarrier compensation. Indeed, the NASUCA proposal would substantially reduce interstate rates, stripping carriers of much of the revenues currently used to cover network costs, while providing no alternative federal mechanism for the recovery of those costs. NASUCA goes so far as to urge states to reduce intrastate rates by an even greater margin, again without providing an alternate recovery scheme.[28] But as the Supreme Court has held, and the Commission has recognized, regulators cannot simply take for granted that other regulators will devise some opportunity for carriers to recover amounts previously recovered through the old regulatory regime.

The bill-and-keep proposals before the Commission pose similar problems. The ICF proposal would eliminate intercarrier access and reciprocal compensation revenues entirely, assuming that the bulk of the costs now covered by those charges could be passed to consumers through SLC increases.[29] Western Wireless similarly assumes that substantial costs can be shifted to end-user customers through SLC increases, and provides that carriers' only avenue for

[27] *See* Letter from Keith Oliver, Home Telephone Company, to Marlene H. Dortch, Secretary, FCC, CC Docket No. 01-92, at Slide 8 (filed Nov. 9, 2004) (end-user "access" charge); NASUCA Ex Parte Materials at 1 (assuming state-authorized retail rate increases); Western Wireless Ex Parte at 6 (retail rate increases); ICF Proposal, Appendix A at 62-69 (SLCs); Letter from Wendy Thompson Fast and Ken Pfister for the Alliance for Rational Intercarrier Compensation, to Marlene H. Dortch, Secretary, FCC, CC Docket No. 01-92, at 60-67 (filed Oct. 25, 2004) (retail rate "rebalancing"); EPG Ex Parte Materials at 23-26 (retail rate "benchmarks"); CBICC Ex Parte Materials at 2 (end-user charge).

[28] *See* NASUCA Ex Parte Materials at 1-2.

[29] *See* ICF Proposal, Appendix A at 62-68.

recovering costs associated with carrying others' traffic would be to increase end-user charges.[30] These proposals do not provide the necessary flexibility that different carriers will need in different markets. As a result, even where they promise opportunities for cost recovery on paper, the proposals are certain to fall short of the mark in practice.

E. The Commission Should Preserve Established, Working Interconnection Arrangements

In 1996, the Commission established a comprehensive set of rules governing the interconnection of incumbent and competitor networks. Except for some occasional modifications to those rules in the intervening years – predominantly with respect to collocation – the 1996 regulations continue to govern carriers' obligations with respect to interconnection architecture. Incumbents and competitors have negotiated, arbitrated, and litigated against this background, entering into thousands of interconnection agreements. Those agreements, and the rights and duties they impose upon the parties, often differ by state and even by carrier, reflecting the various interconnection arrangements that these carriers have put in place. Although some litigation over the scope of carriers' obligations continues, most of the hotly disputed issues have been resolved at the state and federal levels. These include, for example, whether state commissions can require a competitor to establish multiple points of interconnection in a LATA,[31] whether an incumbent can charge a competitor for costs resulting from the competitor's chosen point of interconnection ("POI"),[32] and when a competitor must deliver traffic to an

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[30] *See* Western Wireless Ex Parte at 14-18.

[31] *See, e.g., MCI Telecomm. Corp. v. Bell Atlantic Pa.*, 271 F.3d 491, 517-18 (3d Cir. 2001).

[32] *See, e.g., MCImetro Access Transmission Servs., Inc. v. Bellsouth Telecomms., Inc.*, 352 F.3d 872, 881 (4th Cir. 2003); *Southwestern Bell Tel. Co. v. Public Utils. Comm'n of Tex.*, 348 F.3d 482, 484 (5th Cir. 2003); *see also NPRM* ¶ 113.

incumbents' end office rather than requiring the incumbent to switch that traffic at a tandem.[33] Although these issues have not been resolved to the uniform satisfaction of incumbents or competitors, they have been resolved, providing carriers with necessary certainty.

New regulations that require modification to existing interconnection arrangements would not only upset settled expectations, but also impose significant costs on carriers. Relocating POIs, redeploying facilities, and establishing trunk groups require carriers to expend resources – in terms of money, equipment, and time – that could better be used to provide newer and better services to end-user customers. Even if new rules only reallocate the financial responsibility for existing interconnection arrangements, carriers would likely be required to expend resources negotiating, arbitrating, and litigating amendments to interconnection agreements. In all events, because interconnection architecture is a highly carrier-specific, technical, and fact-intensive issue, any modification to the rules inevitably will create unintended opportunities for regulatory arbitrage.

Such arbitrage opportunities are exacerbated if the Commission engages in wholesale modification of its interconnection architecture rules at the same time it is implementing intercarrier compensation reform. As the Commission has previously recognized, the two sets of rules are interrelated and "the interplay of [interconnection architecture] rules and . . . compensation rules may lead to the deployment of inefficient or duplicative networks." *NPRM* ¶ 114. That is because these rules assign financial responsibility for both the traffic that carriers

[33] *See, e.g.*, Arbitration Order, *Petition of Cablevision Lighpath, Inc., Pursuant to Section 252(b) of the Telecommunications Act of 1996, for Arbitration To Establish an Intercarrier Agreement with Verizon New York Inc.*, Case 03-C-0578, at 6-9 (NY PSC Oct. 24, 2003). Memorandum Opinion and Order, *Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc., and for Expedited Arbitration*, 17 FCC Rcd 27039, ¶¶ 88-91 (2002).

exchange and the facilities over which that traffic is exchanged, and the combination of the rules can reduce the cost of, and therefore encourage, inefficient network deployment. For example, the result of the combination of the Commission's single-POI-per-LATA rule and the reciprocal compensation obligation has been to require incumbents to subsidize a competitor when it decides to serve an end-user customer located a substantial distance from its switch. Although the competitor bears the cost of transporting the call between its switch and its end-user customer, the incumbent finds itself required to transport across a LATA a call that, in fact, is between two neighbors. By insulating competitors from this cost, competitors' incentives are skewed in favor of deploying transport and loops and against deploying additional switches.

To reduce arbitrage opportunities from the concurrent introduction of two sets of rules that have never been tested in the real world, and subjected to the creativeness of competitors, the Commission should largely hold its existing interconnection rules constant, while allowing carriers to negotiate agreements that vary from those rules. Indeed, the Commission should reject any intercarrier compensation reform plan that would require – or would provide overwhelming economic incentives for – carriers to engage in simultaneous and extensive network modifications.

Many of the plans proposed to the Commission, however, contemplate just such simultaneous, radical reform of both sets of rules. The ICF, for example, proposes to introduce the new concept of a "Network Edge" to the interconnection architecture rules. Under that proposal, a carrier would designate one or more Network Edges per LATA, irrespective of the number of points at which that carrier's network is interconnected with other carriers' networks, and irrespective of the locations of those points. Originating carriers would then be required to hand off traffic at the terminating carrier's Network Edge, if they desired to do so at no charge.[34]

The introduction of the Network Edge concept would lead to substantial reconfiguration of existing interconnection arrangements – and similarly significant changes to their respective financial obligations for the facilities used to interconnect those networks. For example, current regulations provide for points of interconnection at any technically feasible point within an incumbent's network. *See* 47 C.F.R. § 51.305(a)(2). Under the ICF proposal, Network Edges are limited to a far smaller set of "Functional Network Locations" – which excludes many incumbents' end office switches, contrary to current Commission rules, *see id.* § 51.305(a)(2)(i) – but at the same time permits competitors to insist on a Network Edge that is outside the incumbent's network.[35] Although the ICF proposal permits carriers to exchange at other locations, it provides substantial incentives to exchange traffic only at Network Edges, by imposing no charge for traffic exchanged at an Edge. Thus, carriers that previously found it economic to interconnect with incumbents at an end office, for example, would have every incentive to re-route that traffic through a tandem to avoid paying intercarrier compensation. But tandem-routing is often inefficient and places unnecessary strain on the incumbents' network, while at the same time eliminating the obligation to pay compensation for this use of that network.

In addition, some opportunities for gaming this new Network Edge concept are readily apparent; others are likely less so. For example, a competitor could seek to sign up only those end-users located close to the incumbents' Network Edge. If that competitor then identified its

[34] *See* ICF Proposal, Appendix A at 2. Western Wireless adopts this aspect of the ICF Proposal. *See* Western Wireless Ex Parte at 12.

[35] *See* ICF Proposal, Appendix A at 2-10.

own Network Edge at a point adjacent to the incumbents', the competitor would essentially eliminate its costs of transporting calls exchanged with the incumbent in that LATA. On outbound calls, the competitor would be responsible for carrying the traffic the very short distance to the incumbent's Network Edge, with the incumbent then responsible for transporting the traffic to end-users located throughout the LATA. Although the competitor would not receive compensation on inbound calls, it would receive those calls at a point close to its end-user customers' premises, while the incumbent, again, would bear the costs of hauling traffic from across the LATA to the competitor's Network Edge. Such a competitor would retain all of the revenues from its end-users, while shifting the costs of those customers' outbound calls to another carrier.

III. THE COMMISSION'S LEGAL AUTHORITY TO ADOPT COMPREHENSIVE INTERCARRIER COMPENSATION REFORM IS UNCERTAIN

The Commission should not adopt new rules regarding intercarrier compensation unless it applies those rules to both interstate and intrastate traffic. If the Commission were to adopt new intercarrier compensation rules on a transitional or other basis, a primary reason for doing so would be to move toward a more uniform intercarrier compensation regime for various types of traffic, in order to provide fewer opportunities for arbitrage. Comprehensive reform, therefore, would have to address intercarrier compensation for both interstate and intrastate traffic.

While this admittedly raises a non-trivial legal issue, there nonetheless are reasonable arguments supporting the Commission's authority to establish an intercarrier compensation regime that applies to all traffic in today's environment. Under the existing Communications Act, Congress has expressly given the Commission direct authority to regulate intercarrier compensation for interstate and wireless traffic. The Commission can also regulate intercarrier compensation for non-local, intrastate traffic in certain circumstances, where the Commission preempts the states' historical authority over such traffic. For example, it is beyond question that the Commission has authority over interstate and intrastate voice over IP ("VoIP") and wireless traffic. In addition, there is a reasonable argument, detailed below, that the same principles that provide the basis for the Commission's authority over all VoIP and wireless traffic also give the Commission authority over interstate and intrastate intercarrier compensation in today's increasingly complex technological and market environment. If the Commission concludes that new, transitional rules are warranted but that the Commission does not have the authority to assume jurisdiction over both interstate and intrastate intercarrier compensation, it should seek such authority from Congress. Most importantly, the Commission should not attempt to reform intercarrier compensation on a piecemeal basis, crafting new compensation rules to apply to interstate traffic while leaving compensation for intrastate traffic in the hands of more than 50 states and territories.

What is certain is that the Commission should reject arguments by some parties that it can regulate intercarrier compensation for all traffic through 47 U.S.C. § 251(b)(5). Properly interpreted, § 251(b)(5) reaches only intraexchange traffic exchanged between two local telephone companies. In any event, the Commission has authority only to establish general rules governing intercarrier compensation for traffic subject to § 251(b)(5); the state commissions have the authority to apply those general rules and set the actual rates. Reliance on § 251(b)(5), therefore, would destroy the Commission's ability to establish any kind of uniform intercarrier compensation regime and would instead create more than 50 separate state regimes.

A. The Commission's Authority To Establish Rules Governing Intercarrier Compensation For All Traffic In Today's Environment

As noted above, comprehensive intercarrier compensation reform must address intercarrier compensation for both interstate and intrastate traffic. Congress has explicitly given the Commission authority over intercarrier compensation for interstate traffic. *See* 47 U.S.C. § 201(b).[36] Congress has also expressly extended the Commission's authority under § 201(b) to all wireless traffic. *See* 47 U.S.C. § 332(c)(1).[37] In particular, because Congress has expressly preempted state "regulat[ion] [of] . . . the rates charged by any commercial mobile service," "[n]otwithstanding section[] 2(b)," the Commission also has sole authority to regulate intercarrier compensation for intrastate wireless traffic.[38]

To the extent that any new intercarrier compensation rules address other forms of intrastate traffic, those rules would have to be reconciled with § 2(b), which generally prevents the Commission from regulating "charges . . . for or in connection with intrastate communication service." 47 U.S.C. § 152(b). As the Supreme Court has explained, § 2(b) is "not only a substantive jurisdictional limitation on the FCC's power, but also a rule of statutory construction," and will normally "den[y] the FCC the power to preempt state regulation of . . . intrastate ratemaking." *Louisiana Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 373 (1986). While any attempt by the Commission to regulate intrastate traffic would admittedly raise a non-trivial legal question, the Supreme Court has not interpreted § 2(b) as an absolute bar on the preemption of state regulation of intrastate traffic. Rather, the Court has recognized that the Commission

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[36] *See* Order, *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Transport Rate Structure and Pricing; End User Common Line Charges*, 12 FCC Rcd 10175, ¶ 7 (1997) ("[N]o one has questioned (or plausibly could question)" that § 201(b) provides the Commission with "authority over interstate access charges"); Seventh Report and Order and Notice of Proposed Rulemaking, *Access Charge Reform; Reform of Access Charges Imposed by Competitive Local Exchange Carriers*, 16 FCC Rcd 9923, ¶ 21 (2001) (§ 201(b) provides Commission with authority over CLEC interstate access charges); *FNPRM* ¶ 78.

[37] *See* Declaratory Ruling, *Petitions of Sprint PCS and AT&T Corp. for Declaratory Ruling Regarding CMRS Access Charges*, 17 FCC Rcd 13192, ¶¶ 8-12 (2002); Second Report and Order, *Implementation of Sections 3(n) and 332 of the Communications Act; Regulatory Treatment of Mobile Services*, 9 FCC Rcd 1411, ¶ 179 (1994).

[38] *See Iowa Utils. Bd. v. FCC*, 120 F.3d 753, 800 n.21 (8th Cir. 1997) (subsequent history omitted); *NPRM* ¶ 82.

properly preempts state authority "where it [is] not possible to separate the interstate and intrastate components" of the services at issue. *Id.* at 375-76 n.4. Thus, the D.C. Circuit in *Public Service Commission of Maryland v. FCC*, 909 F.2d 1510, 1515 (D.C. Cir. 1990), upheld the Commission's authority to preempt state regulation of rates LECs charged IXCs for disconnect-for-nonpayment ("DNP") service. The D.C. Circuit noted that it had "frequently held that services provided locally by the LECs which support access to the interstate communications network have interstate as well as intrastate aspects." *Id.* at 1515. The D.C. Circuit held that disconnection of local service "falls within the FCC's regulatory jurisdiction because it would be impossible to separate the interstate and intrastate components of DNP," in light of the Commission's finding that "disconnecting a customer's local service for nonpayment . . . must also disconnect his interstate service." *Id.* at 1516. The D.C. Circuit has similarly held that the Commission can issue "a valid . . . preemption order" with respect to state regulation of inside wiring, if that order is limited to state rules "that would necessarily thwart or impede the operation of a free market in the installation and maintenance of inside wiring." *NARUC v. FCC*, 880 F.2d 422, 430 (D.C. Cir. 1989). The Ninth Circuit has upheld the Commission's preemption of information services that have both interstate and intrastate components on the same grounds. *See California v. FCC*, 39 F.3d 919, 932 (9th Cir. 1994).

Applying these principles, the Commission has asserted unquestionable preemptive authority over intrastate traffic in the context of VoIP and wireless telecommunication. Most recently, in the *Vonage Order*, the Commission concluded that preemption was appropriate in the context of Vonage's VoIP service because there was no "plausible approach to separating

DigitalVoice into interstate and intrastate components." *See Vonage Order* ¶ 23.[39] As the Commission explained, information regarding the jurisdiction of calls was not "reliably obtainable," and the "significant costs and operational complexities" of attempting to track, record, and process jurisdictional information were prohibitive. *See id.* ¶¶ 23, 25. Similar inseparability concerns formed the basis of the Commission's preemption of state authority with regard to wireless communications. *See Local Competition Order* ¶ 1044 (recognizing that, among other things, "it may be difficult for CMRS providers to determine, in real time, . . . the customer's specific geographic location")[40]; *NPRM* ¶ 80 (noting prior observation that "preemption of intrastate regulation [of compensation for LEC-CMRS traffic] may be warranted on the basis of inseverability").

Relying on this precedent, the Commission can reasonably assert preemption over state regulation of intrastate access charges. The same inseparability concerns that gave rise to the Commission's preemption authority with regard to VoIP and wireless calls increasingly apply to all telecommunications traffic. As telephone numbers become increasingly detached from their historical, geographic affiliations – through consumers' increasing use of wireless and VoIP services, which offer both mobility and the assignment of telephone numbers unrelated to the subscriber's residence – it will become increasingly difficult to separate traffic into intrastate and interstate components. Consumers' ability to port telephone numbers between different modes of telecommunication will also increasingly frustrate any ability to separate intrastate wireless and IP-enabled traffic – all of which is subject to the Commission's authority – from intrastate

[39] Memorandum Opinion and Order, *Vonage Holdings Corporation, Petition for Declaratory Ruling Concerning an Order of the Minnesota Public Utilities Commission*, 19 FCC Rcd 22404 (2004) ("*Vonage Order*").

[40] First Report and Order, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 FCC Rcd 15499 (1996) ("*Local Competition Order*") (subsequent history omitted).

wireline communications, which currently is not. As was the case in the *Vonage Order*, the "significant costs and operational complexity" that would be associated with modifying or supplementing carriers' systems for tracking and segregating these different categories of traffic would serve "no legitimate policy purpose." *See Vonage Order* ¶¶ 23, 25. The Commission therefore has good grounds for preempting state authority over intrastate intercarrier compensation. But, if the Commission were to conclude for any reason that it lacks authority to regulate intercarrier compensation for intrastate traffic, the Commission should seek such authority from Congress so that the Commission could address issues related to intercarrier compensation comprehensively, rather than piecemeal.

B. The Commission Should Reject Arguments That § 251(b)(5) Authorizes It To Adopt Rules To Govern Intercarrier Compensation For All Traffic Exchanged Between Carriers

Some have suggested that the Commission could (and should) avoid § 2(b) by reading § 251(b)(5) to cover all traffic exchanged between and among all carriers. *See, e.g.*, ICF Ex Parte Brief at 28-35. They do so because the Supreme Court, in *Iowa Utilities Board*, held that the Commission has authority to regulate intrastate traffic in the course of prescribing rules, under § 201(b), to implement the provisions added by the 1996 Act, including §§ 251 and 252. *See AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 377-81 (1999). But reliance on § 251(b)(5) would create more than 50 separate state intercarrier compensation regimes, rather than a single federal regime, because § 251(b)(5) does not authorize the Commission to regulate intercarrier compensation directly. In any event, § 251(b)(5) cannot lawfully be read to apply to long-distance and other interexchange traffic. The Commission, therefore, should reject any suggestion that it find in § 251(b)(5) authority to adopt comprehensive intercarrier compensation reform.

Although the Supreme Court held in *Iowa Utilities Board* that the Commission can regulate intrastate traffic when it implements the local competition provisions of the 1996 Act, the Court did not read those provisions to give the Commission direct control over intrastate rates. Instead, in the related context of the Commission's authority to implement § 252(d)(1),[41] the Court held that the "Commission has jurisdiction to design a pricing methodology." *Iowa Utils. Bd.*, 525 U.S. at 385. But it "is *the States* that will apply th[e] [statutory pricing] standards and implement th[e] [Commission's] methodology, determining the concrete result in particular circumstances." *Id.* at 384 (emphasis added).

No different from the Supreme Court, the Commission has recognized as a general matter that "the obligations created by section 251 *and our rules* are effectuated through the process established in section 252," which envisions state commission arbitration of disputes about the implementation of the § 251 obligations and the Commission's rules implementing them.[42] Courts of appeals have similarly held that "[i]nterconnection agreements are . . . the vehicles chosen by Congress to implement the duties imposed in § 251." *Verizon Md. Inc. v. Global NAPs, Inc.*, 377 F.3d 355, 364 (4th Cir. 2004); *see BellSouth Telecomms. Inc. v. MCImetro Access Transmission Servs., Inc.*, 317 F.3d 1270, 1278 (11th Cir. 2003) (en banc) ("Interconnection agreements are tools through which the [1996 Act is] enforced").

Therefore, if the Commission were to interpret § 251(b)(5) to apply to all traffic, it would be limited to designing a "pricing methodology" for state commissions to follow; but it would be

[41] Just as Congress gave state commissions the authority to "[d]etermin[e] . . . the just and reasonable rate for network elements," it gave those commissions the authority to determine whether "the terms and conditions for reciprocal compensation [in an interconnection agreement are] just and reasonable." 47 U.S.C. § 252(d)(1), (2)(A).

[42] Memorandum Opinion and Order, *Core Communications, Inc. v. SBC Communications Inc.*, 18 FCC Rcd 7568, ¶ 30 (2003) (emphasis added), *vacated and remanded on other grounds*, *SBC Communications Inc. v. FCC*, No. 03-1147, 2005 U.S. App. LEXIS 8404 (D.C. Cir. May 13, 2005).

the various state commissions that would each have the authority to implement that methodology and determine the "concrete result" in any case through the § 252 process. *Iowa Utils. Bd.*, 525 U.S. at 384-85. The federal district courts, not the Commission, would have the authority to review such state commission decisions for compliance with the Commission's regulations. *See* 47 U.S.C. § 252(e)(6). For these reasons, reliance on § 251(b)(5) would doom any effort to establish a uniform intercarrier compensation regime, and would instead create more than 50 separate regimes, outside of the Commission's direct control.

In addition, because state commissions have authority over *any* traffic that the Commission concludes is subject to § 251(b)(5), embracing arguments that interstate traffic comes within § 251(b)(5) would give states authority over compensation for traffic that has previously been within the Commission's exclusive control, including Internet traffic and interstate long distance traffic. Therefore, while there is no question of the Commission's authority, today, to establish a single regime for interstate traffic, interpreting § 251(b)(5) to apply to all traffic exchanged between all carriers would spread the *dis*uniformity inherent in the § 252 process to these other types of traffic.

In any event, the Commission cannot rely on § 251(b)(5) as a source of authority to regulate all traffic. Verizon has previously catalogued at length the various reasons that § 251(b)(5), along with § 252(d)(2), can only be read to apply to traffic that originates on the network facilities of one local exchange carrier and terminates on the network facilities of an interconnecting local exchange carrier within the same local calling area.[43] While we will not repeat that entire discussion here, the salient points can be briefly summarized as follows:

- *First*, the express terms of the 1996 Act make clear that reciprocal compensation applies only to traffic that *terminates* on the network of an

[43] *See supra* note 14 & Attachs. B-D.

interconnecting local exchange carrier and that excludes long-distance traffic, which does not terminate on the LEC network. *See* §§ 251(b)(5), 252(d)(2)(A).

- *Second*, historical background and the legislative history reinforce the conclusion that § 251(b)(5) is limited to local telecommunications: reciprocal compensation was intended to fill a gap by addressing compensation for calls exchanged between local carriers competing in the same calling area; Congress did not intend for § 251(b)(5) to modify the existing compensation regimes for long-distance and other interexchange calls, which were already well established.

- *Third*, the reciprocal compensation obligation imposed by § 251(b)(5) applies to "[e]ach *local* exchange carrier"; it would be unworkable to read that provision as applying to traffic that LECs exchange with IXCs, because IXCs have no obligation under that provision to agree to pay LECs for the termination of traffic.

- *Fourth*, § 251(g) further emphasizes that Congress did not intend reciprocal compensation to displace the existing access regimes – to the contrary, given the care that Congress took to preserve the access regimes, it would be bizarre to read § 251(b)(5) to convert traffic for which LECs had long *received* originating access charges into traffic for which LECs would be required to *pay* reciprocal compensation.

- *Fifth*, this conclusion is still further reinforced by § 251(i), which says that nothing in § 251 shall be construed to limit or otherwise affect the Commission's authority under § 201. Extending § 251(b)(5) to interstate access traffic would be flatly inconsistent with that rule of construction, because, as explained above, it would subject that traffic to reciprocal compensation at rates set *by the states*, not by the Commission, thereby limiting the Commission's prior authority under § 201 – the very result that Congress barred.

See Verizon/BellSouth Supp. White Paper at 17.

The Commission itself concluded in the *Local Competition Order* that § 251(b)(5) cannot be read to preempt state authority to establish intrastate access charges, and that conclusion was never challenged. *See Local Competition Order* ¶¶ 732, 1033. Instead, as the Commission has repeatedly held – and, as the D.C. Circuit noted, "everyone agrees" – § 251(b)(5) "doesn't apply" to an "interexchange carrier phone call," whether interstate or intrastate. Transcript of Oral Argument, *WorldCom, Inc. v. FCC*, Nos. 01-1218 *et al.*, at 9-10 (D.C. Cir. Feb. 12, 2002);

see also ISP Remand Order ¶ 37 n.66 ("we again conclude that it is reasonable to interpret section 251(b)(5) to exclude traffic subject to parallel intrastate access regulations"). Any attempt to expand the reach of § 251(b)(5) to cover all traffic could not be squared with these statutory provisions or the Commission's prior rulings.[44]

CONCLUSION

For the foregoing reasons, the Commission should resolve the issues in this proceeding in accordance with these Comments.

Respectfully submitted,

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[44] Nor can § 254 provide the Commission with sufficient authority to require bill-and-keep for all intrastate access traffic. *See FNPRM* ¶ 82. Indeed, commenters that support this view argue only that *existing* intrastate access charge regimes are inconsistent with § 254. *See* ICF Ex Parte Brief at 35-38. But that is a far cry from proving that *any* state regulation of intercarrier compensation for intrastate traffic is inconsistent with § 254 and must be preempted.

APPENDIX A

THE VERIZON TELEPHONE COMPANIES

The Verizon telephone companies are the local exchange carriers affiliated with Verizon Communications Inc. They are:

Contel of the South, Inc. d/b/a Verizon Mid-States
GTE Southwest Incorporated d/b/a Verizon Southwest
The Micronesian Telecommunications Corporation
Verizon California Inc.
Verizon Delaware Inc.
Verizon Florida Inc.
Verizon Maryland Inc.
Verizon New England Inc.
Verizon New Jersey Inc.
Verizon New York Inc.
Verizon North Inc.
Verizon Northwest Inc.
Verizon Pennsylvania Inc.
Verizon South Inc.
Verizon Virginia Inc.
Verizon Washington, DC Inc.
Verizon West Coast Inc.
Verizon West Virginia Inc.