

BEFORE THE
Federal Communications Commission
WASHINGTON, D.C.

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

**COMMENTS OF TIME WARNER TELECOM, CONVERSENT COMMUNICATIONS
INC, CBeyond COMMUNICATIONS LLC, AND LIGHTSHIP TELECOM**

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May 23, 2005

Comments of Time Warner Telecom,
Conversent Communications Inc.,
Cbeyond Communications LLC and
Lightship Telecom
CC Docket No. 01-92
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TABLE OF CONTENTS

	<u>Page</u>
I. INTRODUCTION AND SUMMARY.....	1
II. CONCLUSION.....	53

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Time Warner Telecom, Inc. (“TWTC”), Conversent Communications LLC (“Conversent”), Cbeyond Communications LLC (“Cbeyond”) and Lightship Telecom (“Lightship”) (collectively, the “Joint Commenters”), by their attorneys, hereby submit these comments in response to the Further Notice of Proposed Rulemaking regarding Developing a Unified Intercarrier Compensation Regime¹.

I. INTRODUCTION AND SUMMARY

In assessing the optimal approach to intercarrier compensation reform, the Commission must weigh the costs and benefits of the possible approaches. If undertaken pragmatically and honestly, such an assessment yields the conclusion that a central component of reform must be the requirement that, to the extent possible, each carrier charge a single, cost-based rate for the exchange of all types of traffic.

¹ See *Developing a Unified Intercarrier Compensation Regime*, Further Notice of Proposed Rulemaking, FCC 05-33 (rel. Mar. 3, 2005) (“FNPRM”).

The Commission has at least a reasonable chance of ensuring that carriers charge cost-based unified rates. As the Supreme Court held in *AT&T v. Iowa Utils Bd.*, the Commission has the authority to adopt regulations to implement the express terms of the Act, even where those terms address intrastate communications. The language of Section 251(b)(5) would appear to govern the termination of all traffic, interstate and intrastate (the case for Commission preemption on traffic origination is significantly weaker). Accordingly, the Commission arguably has the authority to mandate that states use a cost-based methodology, in particular TELRIC, as the basis for setting all intercarrier termination rates. The states have of course already set reciprocal compensation rates based on TELRIC, and these rates should become the Target Rates for all terminating charges. Rate reductions should be phased in over a multiple year transition. As all of the reform proposals recognize, decreases in intercarrier payments should be accompanied by increases in end user charges.

Ensuring the adoption of unified, cost-based rates for the exchange of traffic can, if properly structured, offer at least as many public policy benefits as bill and keep. Both approaches set a uniform price for the exchange of traffic and therefore eliminate the most obvious and immediate flaw in the current system: different prices for different types of traffic. Proponents of bill and keep argue that the shared benefits (between called and calling parties) of a call make a price of zero the most efficient exchange rate, but this is not so. In fact, the economic literature indicates that a cost-based price is often the efficient price where both parties benefit from a call. Similarly, proponents of bill and keep argue that carriers do not incur significant traffic-sensitive costs, but this is not the case. In fact, next-generation wireline

networks that deploy shared fiber loop feeder facilities incur even more traffic sensitive costs than has been the case in the past, and CMRS carriers, whose network costs are almost entirely shared and therefore traffic sensitive, carry increasingly large volumes of traffic.

Proponents of bill and keep argue further that per minute intercarrier charges prevent the development of flat-monthly end user rate structures and that a price of zero would not have this effect. This is incorrect, however, because flat monthly end user rate plans were developed while carriers paid (often above-cost) per minute exchange rates. Proponents of bill and keep argue that retaining any intercarrier payments perpetuates the terminating monopoly problem and leads to endless disputes regarding the “correct” intercarrier rate. But as the internet backbone providers have proven, intercarrier payments (e.g., transit rates) among interconnected networks that have a monopoly over termination to their customers does not necessarily perpetuate the need for regulation of terminating access. Once the obstacles to competitive pressure on intercarrier payments among telecommunications carriers (such as Section 254(g) geographic averaging) are eliminated, it is not at all clear that the retention of a cost-based exchange rate would cause regulation to be needed any longer than would be the case under bill and keep with its huge increases in end user rates and in universal service subsidies. In sum, when closely examined, the benefits of affirmative cost-based rates are just as powerful as the benefits of bill and keep.

At the same time, unified, cost-based rates carry far fewer costs than bill and keep. Most obviously, the legal basis for preemption is far stronger under a cost-based unified rate regime than under bill and keep. Indeed, the weaknesses in the preemption claims of the advocates of

bill and keep are obvious enough that the Commission should halt further discussion of bill and keep under the current statute. Moreover, bill and keep would require that the Commission undertake a complex and contentious set of proceedings to implement huge increases in end user rates and universal service funding. While a cost-based, unified rate system would require such proceedings, the increases in end user rates and in universal service would be far smaller and thus the difficulty of the undertaking diminished accordingly.

While a national methodology for intercarrier payments is clearly the best approach to reform, any reform plan, regardless of the intercarrier rate, must follow certain basic principles. *First*, the Commission should ensure that intercarrier compensation reform does not undermine the development of efficient competition. For example, it must ensure that incumbent LECs are not able to recover switching and transport costs from end users in a manner that harms consumers or competition. This means that incumbent LECs must be prohibited from recovering any of the intercarrier payments associated with multiline business customers from end user charges imposed upon residential or single line business customers. Moreover, the incumbents should not be granted any further flexibility to discriminate in the manner which they apply end user charges to multiline business customers.

Second, the Commission must ensure that incumbent LECs are not able to use any changes in the rules governing network interconnection as a means of artificially raising competitors' costs. The ICF has proposed the most extensive changes to the current interconnection regime, apparently based on the understanding that bill and keep requires such changes. Cost-based intercarrier rates would eliminate any such concern. Moreover, the existing

network interconnection rules are functioning adequately in the current environment. There is no need to complicate an already complex proceeding with this issue. In all events, there is no basis for allowing incumbent LECs to define multiple “edge” points at tandem offices for CLEC interconnection, as the ICF essentially does. This proposal unjustifiably increases CLEC costs and is flatly inconsistent with Section 251(c)(2). Equally unjustified are the ICF proposals that incumbents should never pay for facilities used to establish interconnection between CLEC and ILEC networks and that the often unreasonably high tandem transit rates should remain in place for two years.

Third, in assessing the optimal approach to intercarrier compensation reform, the Commission must be realistic in assessing the participation of rural incumbent LECs. Any cost-based methodology should allow rural incumbents with high costs to charge intercarrier rates that reflect such costs. But the rural exemption provisions of Section 251(f) may prevent the Commission from even ensuring that rural incumbent termination rates follow a uniform methodology. This is an area in which federal-state collaboration may be more promising than preemption.

Finally, the Commission must ensure that intercarrier compensation reform does not include the creation of additional subsidy funds that threaten either the sustainability of universal service or competition. The current universal service fund is already dangerously large. Any further increases in the size of the fund must be kept as small as possible and be accompanied by an expansion in the base of contributors. Any subsidy fund designed to compensate carriers for the loss of intercarrier compensation revenue must be strictly interim in nature and must

distribute subsidies that are portable to competitors if applicable outside of areas subject to the rural exemption from local competitive under Section 251(f).

II. The Establishment Of Unified, Cost-Based Terminating Rates Would Substantially Increase The Efficiency Of The Current Inter-carrier Compensation System

While bill and keep has received a great deal of attention from both the Commission staff and the industry, even its most ardent proponents would likely concede that it represents an enormously complex undertaking. Yet the most obvious (and probably the most harmful) flaws in the current inter-carrier compensation system could be remedied without the need for a grand scheme to completely transform the manner in which carriers exchange traffic. By simply ensuring, to the extent possible under the current statute, that each carrier charges a single, cost-based price for the exchange of all traffic, the Commission could advance consumer welfare substantially without introducing all of the uncertainties and costs of bill and keep.

Every commentator agrees that the application of different rates for different traffic is inefficient where the switching and transport functions performed are the same. It is clear therefore that the Commission could enhance the efficiency of the current system substantially by ensuring that, to the extent possible, each carrier charges the same cost-based rate for the exchange of all traffic (as explained below, the single rate may vary from one carrier to another). This outcome would be beneficial even if, as discussed below, it can only be adopted for traffic termination (and not traffic origination).

As NARUC suggests, it is both legally permissible and sound policy to establish a unified rate (at least on the terminating end) for inter-carrier compensation based on forward-looking

costs.² Given the existing statutory framework, the appropriate means of achieving this goal is for the Commission to reaffirm TELRIC as the required methodology for all traffic subject to Section 251(b)(5) (and, by extension, the pricing requirements of Section 252(d)(2)). The Commission would then rule (as the ICF has suggested) that Section 251(b)(5) governs the termination of all traffic by local exchange carriers, including intrastate terminating access, interstate terminating access and ISP-bound traffic. Each state's existing reciprocal compensation rates would become the unified terminating rates ("Target Rates") for intrastate access, reciprocal compensation, and ISP-bound traffic (subsequent state adjustments to the rate could obviously be made and accommodated by the plan). The FCC would set the interstate terminating access Target Rate for a particular carrier operating in the state to match the state-set rate.

The Commission should then establish an appropriate transition to the applicable unified Target Rates. For example, the Commission could require reductions in access charges in equal increments over 5 years until each carrier has reached its Target Rate in the fifth year of the plan. If necessary, the transition could be longer, for example 7 years, for rural carriers. At some point in the plan, the rate applicable to the exchange of ISP-bound traffic would need to be increased to the TELRIC level. It may be appropriate for this increase to occur in the last year of the

² See *Ex Parte* presentation of NARUC, App C. at 5 ("*NARUC Plan*"), attached to Letter of Robert B Nelson, Commissioner, Michigan Public Service Commission *et al.*, to Kevin Martin, Chairman, FCC, CC Dkt. No. 01-92 (filed May 18, 2005).

transition. As demand for broadband access to the internet grows during the transition period, the impact of the increase for the exchange of dial-up ISP-bound traffic should be minimal. In addition, as many of the reform proposals contemplate, the reduction in intercarrier payments should be accompanied by corresponding increases in the caps applicable to federal subscriber line charges so that carriers have the opportunity to recover directly from end users the revenues that are eliminated from the intercarrier compensation system.

It is important to emphasize, as NARUC does, that all carriers should remain free to agree voluntarily to exchange traffic on a bill and keep basis (*see NARUC Plan* at 5) and that nothing in any FCC intercarrier compensation reform plan should in any way limit the availability of this option. Indeed, as is discussed more fully below, Section 252(d)(2)(B) expressly preserves the right of carriers to enter into bill and keep arrangements if certain criteria are met.

Carriers should continue to be free to mutually agree to convert per minute intercarrier compensation rates to capacity charges at any time. *See NARUC Plan* at 6. Going forward, the FCC should, as NARUC suggests, initiate a proceeding to address capacity-based charges. *See id.* Any capacity-based rules must ensure that ILECs are prevented from using their market power to raise rivals costs. For example, it would be completely inappropriate for the Commission to import into the local market the intercarrier compensation system used by internet backbones in which smaller networks pay but larger networks do not pay for the exchange of traffic. Moreover, the FCC must determine how carriers would apply capacity

charges to shared trunk facilities. As discussed in detail below, it is generally inappropriate to impose flat-rated charges on shared facilities in an economically efficient manner.

A. TELRIC Is An Appropriate Methodology For Setting Inter-carrier Compensation Rates

It is sound policy to rely on TELRIC as the basis for setting inter-carrier compensation rates. TELRIC is of course not perfect, but perfection in ratemaking, whether it be a positive rate or a rate of zero, is impossible. It is clear, however, that TELRIC rates do not significantly under-compensate carriers for the cost of providing switching service. As the Supreme Court held, TELRIC is “just and reasonable”³ and does not inhibit investment. *See id.* at 523. Nor, if the years of RBOC opposition to UNE pricing as unreasonably low are to be believed, do TELRIC rates significantly over-compensate carriers for the cost of performing switching and transport. Thus, because TELRIC produces rates more or less in line with the cost of providing service, it is unlikely that carriers in a TELRIC-based inter-carrier compensation system would attempt to disguise traffic, bypass the network, or engage in gaming or arbitrage tactics to any significant degree.

In the *Local Competition Order*, the Commission held that the traffic-sensitive portion of the TELRIC switching rate constitutes the “additional cost” of transport and termination upon

³ *Verizon Communs., Inc. v. FCC*, 535 U.S. 467, 516 (2002) (“At the end of the day, theory aside, the claim that TELRIC is unreasonable as a matter of law because it simulates but does not produce facilities-based competition founders on fact.”).

which Section 252(d)(2) transport and termination rates must be based.⁴ In the *FNPRM*, the Commission asks if it should reconsider this holding.⁵ The Commission articulates this question in numerous different ways. But regardless of whether the question is posed as a concern that carriers do not incur usage-sensitive costs when providing switching or as an inquiry into whether the Commission should utilize short run incremental costs rather than long run increment or average costs (for these purposes long run incremental and average costs amount to essentially the same thing), the answer is that TELRIC should not be abandoned. In an industry characterized by a large proportion of fixed costs, the only practical way to set prices is by using long run or “average” costs. This was the premise upon which the Commission established TELRIC. Indeed, even competitors that pay TELRIC-based prices have consistently conceded that a forward-looking pricing methodology must use long run, or average, costs.⁶

⁴ See *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, 11 FCC Rcd 15499, ¶ 1057 (1996) (“*Local Competition Order*”) (“We conclude that such non-traffic sensitive costs should not be considered ‘additional costs’ when a LEC terminates a call that originated on the network of a competing carrier. For the purposes of setting rates under section 252(d)(2), only that portion of the forward-looking, economic cost of end-office switching that is recovered on a usage-sensitive basis constitutes an ‘additional cost’ to be recovered through termination charges.”).

⁵ See *FNPRM* ¶ 67 (“In the Commission’s pending TELRIC rulemaking, a number of parties have argued that the substantial majority of switching costs do not vary with minutes of use (MOU) and that switching should be offered on a flat-rated basis rather than a per-minute basis. These arguments are consistent with the decisions of a number of state commissions finding that end-office switching costs are not traffic-sensitive and therefore should be recovered on a flat, per-line basis, and not on a per-MOU basis.”).

⁶ See Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig, attached as Appendix B to AT&T Comments, CC Dkt. No. 96-98 ¶ 3 (filed May 20, 1996). This has been confirmed in similar capacity-based, regulated industries, such as the airline industry. See *Economic Regulation and Incremental Costs*, Consultation Paper for the Civil Aviation Authority, London, UK (rel. February 2001) available at <http://www.caa.co.uk/docs/5/ergdocs/economicregincrecostsfeb01.pdf>. To be sure, pricing based on short-run

The Commission has held that the use of a network component causes a carrier to incur usage-sensitive costs if (1) the component of the network is shared⁷ or (2) there is an additional cost incurred by each increment of use, since capacity must eventually be expanded to accommodate peak load demand.⁸ If either of these criteria is satisfied, the Commission has held and economic theory indicates that it is more economically efficient to recoup costs through

marginal costs (SRMC) can provide an efficient method of capacity allocation. This methodology ultimately results in a “saw tooth” pattern, i.e. the price curve spikes as capacity becomes scarce and then drops precipitously as capacity is added. This is the only way that SRMC-based pricing permits carriers to recover their high proportion of fixed costs. But such SRMC-based prices serve as poor indications of investment opportunities, because market participants, as well as new entrants, must be convinced that such price spikes are forthcoming to offset any new investment in capacity or any loss incurred during the “trench” intervals in the price curve. Volatility is also difficult to accommodate in a regulatory system based on price caps, requiring heavier administrative scrutiny with less information on which to establish norms. Finally, volatile prices generally have highly undesirable consequences for end users because they yield wildly different prices for the same service at different moments in time. While long run pricing might not allocate capacity as efficiently as SRMC, it provides a clearer picture of the investment opportunities and is easier to implement.

⁷ See, e.g., *Access Charge Reform et al.*, First Report and Order, 12 FCC Rcd 15982, ¶ 62 (1997) (“*Access Charge First Report and Order*”) (“Costs of local switching attributable to trunk ports are moved to a separate category with in the traffic-sensitive basket. These costs will be recovered through *flat-rated* monthly charges collected from users of *dedicated* trunk ports and *per-minute*, traffic-sensitive charges assessed on users of *shared* trunk ports.”) (emphasis added).

⁸ See *id.* ¶ 54 (“Because the cost of using the incumbent LEC’s common line does not increase with usage, the costs should be recovered through flat non-traffic-sensitive fees.”). As Sprint explains, “A subscriber can make greater use of a dedicated resource . . . without causing the network supplier to incur additional costs for that dedicated resource. In contrast, shared resources that are placed in a common pool and drawn upon for the duration of a call or during call set-up and call tear-down have very different cost characteristics. For example, in the long run, added minutes of calling handled by a network switch or trunk require that the capacity of that resource be increased in order to maintain service quality for other users. Thus, the costs incurred by the network supplier for a shared resource increase when the volume of calling increases.” See Bridger M. Mitchell and Padmanabhan Srinagesh, *Transport and Termination Costs in PCS Networks: An Economic Analysis* at 11 (Apr. 4, 2000) (“*CRA Paper*”) attached to Letter of Jonathan M. Chambers, Sprint, to Larry Strickland and Thomas J Shugrue, FCC, CC Dkt. Nos. 95-185 *et al.*, (filed Apr. 7, 2000).

usage-sensitive rates.⁹ Indeed, recovering usage-sensitive switching costs through flat-rated prices would create new subsidies because customers with below-average usage levels would necessarily subsidize customers with above-average usage levels.¹⁰

Applying this two-part standard, it is clear that switching still contains substantial usage-sensitive costs. First, notwithstanding the Commission's suggestion to the contrary, it is simply untrue that the capacity of new digital switches is so great that they can essentially absorb any foreseeable increase in traffic volumes over the years to come and therefore do not cause carriers to incur usage-sensitive costs.¹¹ Only three years ago, the Commission in the *Virginia Arbitration Order* rejected this very notion.¹² Moreover, although it acknowledged in its *ISP Remand Order* that "next-generation switching technology" is more efficient, the Commission found no reason to conclude there that the usage-sensitive costs of switching had disappeared. The Commission found that ISP-bound traffic must continue to be compensated on a minutes-of-

⁹ See *Access Charge First Report and Order* ¶ 24 ("Thus, the cost of traffic-sensitive access services should be recovered through corresponding per-minute access rates. Similarly, NTS cost should be recovered through fixed, flat rated fees.").

¹⁰ See *Verizon Comments*, CC Dkt. No. 03-173 at 55 (filed Dec. 16, 2003) ("Verizon Comments").

¹¹ See *FNPRM* ¶ 68 ("We invite comment on the proposition that digital switching costs no longer vary with minutes of use due to increased processor capacity.").

¹² See *Application by Verizon Va. Inc., et al. for Authorization to Provide In-Region, InterLATA Services in Va.*, Memorandum Opinion and Order, 17 FCC Rcd 21880, ¶ 121 (2002) ("The switch processor is a shared facility and our rules explicitly grant states the discretion to recover the costs of shared facilities on a usage-sensitive basis.").

use (“MOU”) basis.¹³ Nor does the argument that the manner in which carriers purchase switches support the conclusion that switching costs are no longer usage-sensitive. For example, incumbent LECs have noted in the TELRIC reform proceeding that switch purchases are “sized” based on future demand and therefore are usage-sensitive.¹⁴ Second, and more importantly, switches, no matter what their capacity, continue to be a shared component of the network, and therefore their costs should continue to be recovered on a usage-sensitive basis.

In fact, there is ample evidence that the usage-sensitive costs of origination, transport and termination of traffic are actually *increasing*. For example, the Commission has in the past treated loop costs as non-usage sensitive because loop facilities were dedicated to a particular customer.¹⁵ However, as SBC (the only remaining BOC member of the ICF) notes, ILEC

¹³ Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Intercarrier Compensation for ISP-Bound Traffic, 16 FCC Rcd 9151, ¶ 84, n.157 (2001) (“ISP Remand Order”)

¹⁴ See, e.g., SBC Reply Comments, CC Dkt. No. 03-173, at 77 (filed Jan. 30, 2004) (“The CLECs claim that switching costs are almost exclusively non-traffic sensitive . . . That is false [T]he amount of capacity the incumbent purchases at the outset is of course dependent on its best estimate of future usage, and all usage the incumbent then serves contributes to the potential exhaust of the switch’s capacity. It is thus entirely sensible, as regulators have concluded for decades, to expect users of the switch to bear some substantial percentage of these total costs in direct proportion to their usage.”); Verizon Comments at 54, n.92 (filed Dec. 16, 2003) (“[S]witch processor and memory costs vary with usage. Switch processing resources are engineered and sized prior to deployment based on the amount of expected future use. When an incumbent purchases a switch processor, the size of the switch processor depends on how much traffic the incumbent expects the switch to carry.”).

¹⁵ Local Competition Order ¶ 1057 (“The costs of local loops and line ports associated with local switches do not vary in proportion to the number of calls terminated over these facilities. We conclude that such non-traffic sensitive costs should not be considered ‘additional costs’ when a LEC terminates a call that originated on the network of a competing carrier.”).

deployment of fiber feeder loop plant is causing loop facilities to be shared by multiple end user customers (and carriers). Thus, the more traffic there is, the more feeder plant is necessary.¹⁶

The use of shared feeder loops is likely to grow as fiber is deployed closer to the customer premises. For example, in an FTTC architecture, each individual home has its own dedicated copper loop running from the customer premises to a remote terminal while the shared fiber feeder runs from the remote terminal back to the central office.¹⁷ Most FTTP networks are deployed using a dedicated fiber running from the customer premises to splitters in the field which in turn are connected to shared feeder plant that runs to the central office.¹⁸

In addition, a very large portion of the costs CMRS carriers (which carry more and more traffic) incur to transport and terminate traffic are usage-sensitive. As Sprint has demonstrated, wireless carriers have a high proportion of usage-sensitive costs because neither their loop facilities (spectrum) nor much of their other network infrastructure is dedicated to one customer; rather it is largely shared among multiple subscribers.¹⁹ In addition, in the long run, spectrum

¹⁶ Application for Review of SBC Communications, CC Dkt. Nos. 95-185, *et al.*, at 4 (filed June 8, 2001).

¹⁷ See Nosa Omuogi *et al.*, *Comparing Integrated Broadband Architectures From an Economic and Public Policy Perspective*, in TELECOMMUNICATIONS AND INTERNET POLICY (Brock, G., ed. 1996), available at <http://www.ini.cmu.edu/~sirbu/pubs/FITL/tpc6.html> (noting the similarities between DLC and FTTC architectures).

¹⁸ See http://www.iec.org/online/tutorials/fiber_home/topic04.html (“The splitter is typically placed approximately 30,000 feet from the central office (CO). The split ratio may range from 2 to 32 users and is done without using any active components in the network. The signal is then delivered another 3,000 feet to the home over a single fiber.”).

¹⁹ See *CRA Paper* at 4 (“Spectrum and capacity in a BTS, a BSC, backhaul links, and MTX(s) are dedicated to a call for its duration. When the call is terminated, those resources are released and can be used to support another call.”); *id.* at 10-11 (“To apply the Commission’s rate standard in a wireless network, we inquire whether each component of a PCS network is shared by several users or whether it is dedicated to a single user. Next, we consider whether

and additional cell sites must be considered to be usage-sensitive substitutes for one another because, as traffic congestion increases, carriers must either acquire more spectrum, split cells or do a combination of both (*CRA Paper* at 13).²⁰

In light of these realities, it is clear that the transport and termination functions performed by wireline and wireless networks include substantial usage-sensitive costs that are only increasing as wireless substitution increases and DLC and fiber-loop architectures become the norm. Even the ICF seems to agree that tandem switching should continue to be paid for on an MOU basis.²¹ In sum, the logic of the *Local Competition Order* still applies. Since there remain substantial usage-sensitive costs, it is appropriate and economically efficient for carriers to recover those charges through per minute rates. *See Local Competition Order* ¶¶ 743-745.

Furthermore, it makes sense to apply a single cost methodology, to the extent the applicable law permits, to the origination and termination of all traffic. This is because carriers

each component's costs are traffic-sensitive. Our analysis find that handsets are resources dedicated to individual users and their costs are not traffic-sensitive, while all of the other components are shared among users of the wireless network and the costs of those elements are traffic-sensitive.”).

²⁰ *See id.* at 15 (“In the long run, when all inputs are variable, wireless providers will use a combination of more spectrum (if suitable spectrum is available) and cell splitting to meet increased demand. In this long-run context, all costs associated with cell sites are appropriately treated as traffic-sensitive costs to be included in computing the additional costs of terminating interconnected calls.”).

²¹ *See* Intercarrier Compensation and Universal Service Reform Plan, CC Dkt. No. 01-92, at 25 (filed Oct. 5, 2004) (“*ICF Plan*”) (“During the first two years of the Plan, rates for Tandem Transit Service shall be no higher than the rates for such service on June 30, 2005, or the day before the first day of the Plan. During the three-year period beginning at the start of Step 3 of the rate transition, rates for this service shall be computed to produce no more than the *Average Revenue Per Minute Limit* calculated using the methodology in Section III.C.3.a, below.”) (emphasis added).

perform the same functions and incur the same costs when originating and terminating traffic.²² Indeed, the Commission has only set one rate for UNE switching regardless of the nature of the traffic that passes through that switch. The Commission also noted that there is no distinction between the cost of terminating reciprocal compensation or ISP-bound traffic.²³ In other words, switching is switching and like services should be subject to the same rates.

B. Local Exchange Carriers Should Continue To Apply Traffic Origination Charges Where Another Carrier Has A Customer Relationship With An End User

There continues to be a sound basis in public policy for originating access charges. Most importantly, the origination function causes local carriers to incur the same usage-sensitive costs as termination. Long haul providers that use this functionality benefit from the origination service provided and in a very real sense “cause” the local exchange carrier to incur the costs of origination. Local exchange carriers cannot continue to provide this service and incur the costs of providing it without just compensation. Accordingly, where two carriers provide service to a customer over the same facilities (e.g., the customer purchases local and long distance service

²² See Ex Parte Brief of the Intercarrier Compensation Forum in Support of the Intercarrier Compensation and Universal Service Reform Plan, CC Dkt. No. 01-92, at 10 (filed Oct. 4, 2005) (“*ICF Brief*”) (“[T]he compensation a carrier receives for termination -- routing a call through the end office switch (or functional equivalent) en route to the called party -- may differ radically depending on whether the call crosses state boundaries Yet in each of these cases, the terminating carrier performs the same transport and termination functions.”).

²³ See *ISP Remand Order* ¶ 92 (“Nor does the record demonstrate that CLECs and ILECs incur different costs in delivering traffic that would justify disparate treatment of ISP-bound traffic and local voice traffic under section 251(b)(5).”).

from different carriers), the two carriers should share the cost of the facilities in the form of originating access.

It is also significant that local exchange carriers, including CLECs, continue to be bound by the equal access requirements to provide originating access service to unaffiliated long distance carriers to which their local customers presubscribe.²⁴ It is unreasonable to impose this duty upon local exchange carriers and then prohibit them from recovering the costs incurred in providing such service.

C. The FCC Likely Has The Authority At Least To Establish TELRIC As The Methodology For Setting All Terminating Rates

TELRIC, unlike bill and keep, can likely withstand legal scrutiny as applied to all types of traffic, at least on the terminating end. In *AT&T v. Iowa Utilities Board*, the Supreme Court held that the Commission has the authority under Section 201(b) to adopt regulations implementing the terms of Act.²⁵ Where a particular statutory provision addresses intrastate as well as interstate communications, the Commission's authority to adopt implementing regulations extends to both the subject intrastate and interstate communications. As the ICF explains, this holding can be logically interpreted to mean that the Commission has the authority to adopt regulations implementing Section 251(b)(5) (which applies to all "telecommunications")

²⁴ See, e.g., 46 C.F.R. § 64.604(b)(3).

²⁵ *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 377 (1999) ("*Iowa Utilities Board*").

to the “transport and termination” of both intrastate and interstate traffic. As the Supreme Court held, this does not mean that the FCC may set specific rates. As explained in greater detail below, that is the responsibility of the states. *Id.* at 385 n. 10. But it does likely mean that the Commission has the authority to require that states set terminating rates for all intrastate traffic (including intrastate terminating access) based on TELRIC. It is also well within the Commission’s authority to use the TELRIC-based rate adopted by a state as the interstate terminating access rate.

As noted above, it would also be desirable to apply the Target Rate to originating access charges. Unfortunately, there is a significantly greater legal risk associated with attempting to establish a unified traffic origination rate than is the case with attempting to establish a unified termination rate. Since Section 251(b)(5) only addresses “the transport and termination of telecommunications,” there is a significant risk that the Commission’s power to preempt under Section 201(b) will not extend to intrastate originating access. In light of this uncertainty, it makes sense for the FCC to focus its attention on ensuring uniform terminating rates and to seek a collaborative dialogue with the states through a Joint Board to transition intrastate originating access (and interstate originating access) to the Target Rate.

In any event, the Commission can rely to a significant degree on market pressures to reduce originating access charges. This is a likely outcome, because long distance calling is increasingly moving towards arrangements in which the local and long distance connections are provided by the same carrier (e.g., in wireline circuit-switched LEC/IXC, CMRS, and VoIP arrangements). Moreover, the largest providers of stand-alone long distance service, in other

words the largest payers of originating access charges, will likely dramatically reduce the volume of originating access they purchase in the near future. AT&T and MCI have announced that they are exiting the mass market long distance market as stand-alone providers of long distance service.²⁶ Moreover, if acquired by SBC and Verizon respectively, AT&T and MCI likely accelerate their exit from the market as providers of stand-alone long distance service. Thus, even if originating access charges were not subject to unified cost-based Target Rates, there are unlikely to be significant harmful consequences in terms of consumer welfare.

III. The Commission Probably May Not And, In All Events, Should Not Impose A Unified Inter-carrier Compensation Rate Of Zero On The Origination And Termination Of Telecommunications Traffic

Although the FCC staff and members of the industry have dedicated enormous resources trying to justify the adoption of bill and keep as legal and policy matter, that effort has been unsuccessful. It is far from clear that a single price of zero for the exchange of traffic is either lawful or sound public policy.

A. There Are Substantial Legal Risks Associated With Mandating Bill And Keep For All Traffic

Bill and keep is beset by legal problems that likely preclude its implementation for most, if not all, classes of traffic. Most fundamentally, there are substantial risks associated with

²⁶ See AT&T Corp. and SBC Communications Inc., Application under the Cable Landing License Act, Description of the Transaction, WC Dkt. No. 05-65, Public Interest Showing and Related Demonstrations, at 7 (filed Feb. 21, 2005); Verizon Communications Inc. and MCI Inc., Application for Transfer of Control, WC Dkt. No. 05-75. Exh. 1 at 47 (filed Mar. 11, 2005).

mandating bill and keep for traffic subject to Section 251(b)(5) when that traffic is out-of-balance or where carriers incur significantly different termination costs.

Since, as demonstrated above, there continues to be an “additional cost” for terminating traffic subject to Section 251(b)(5), bill and keep is impermissible in the absence of payments between carriers to account for those costs.²⁷ Indeed, the Commission has made clear that bill and keep arrangements do not provide for a mutual and reciprocal recovery of costs and are therefore not permitted when traffic is out-of-balance. In such a scenario, the in-kind payments between carriers are not equivalent, and therefore one of the carriers is not fully compensated for the additional costs that the other carrier has placed upon its network.²⁸ Accordingly, the FCC determined that bill and keep arrangements can only be required “if the volume of terminating traffic that originates on one network and terminates on another network is approximately equal to the volume of terminating traffic flowing in the opposite direction, and is expected to remain so.” *Local Competition Order* ¶ 1111. A similar conclusion may even be justified where there is a balance of traffic between carriers that incur different costs of terminating traffic.

The ICF acknowledges the need for a “mutual recovery of costs” for traffic exchanged pursuant to 251(b)(5). *See ICF Brief* at 39. Yet, the ICF blithely asserts that these costs can be

²⁷ As stated above, Section 252(d)(2)(B)(i) does allow carriers to mutually agree to bill and keep arrangements.

²⁸ *See Local Competition Order* ¶ 1112 (“In general, we find that carriers incur costs that are not *de minimis*, and consequently, bill-and-keep arrangements that lack any provisions for compensation do not provide for recovery of costs. In addition, as long as the cost of terminating access is positive, bill-and-keep arrangements are not economically efficient because they distort carriers’ incentives, encouraging them to overuse carriers’ termination facilities by seeking customers that primarily originate traffic.”).

recovered through “end user charges, and, where necessary, universal service.” *Id.* This is most likely a mistaken reading of the Act. Section 252(d)(2)(A) states that an interconnection agreement between LECs cannot be considered just and reasonable unless the agreement “provide[s] for the mutual and reciprocal recovery by each carrier of costs associated with transport and termination on each carrier’s network facilities of calls that originate on the network facilities of the other carrier.” 47 U.S.C. § 252(d)(2)(A)(i). If a carrier is recovering these costs from its end users or universal service, the carrier’s recovery is not “reciprocal” or “mutual.”

Any reasonable understanding of these terms precludes the ICF’s reading of the statute. Merriam-Webster defines “mutual” as “done, felt, etc. by each of two or more or toward the other or others; reciprocal.” WEBSTER’S NEW WORLD DICTIONARY 896 (3d ed. 1988). Similarly, reciprocal means “present or existing on both sides; each to the other; mutual.” *Id.* at 1120. These synonymous terms clearly mean that one carrier must compensate the other for the costs imposed on its network and *vice versa*, not that one carrier may be compensated for its costs from a third party. Simply because costs are in fact recovered though bill and keep does not mean that this recovery is mutual or reciprocal. The Commission has said as much in its previous Intercarrier Compensation NPRM.²⁹ Finally, the ICF’s reference (*see ICF Brief* at 40)

²⁹ *Developing a Unified Intercarrier Compensation Regime*, Notice of Proposed Rulemaking, 16 FCC Rcd 9610, ¶ 75 (2001) (“We note that the statute explicitly identifies bill and keep as one arrangement that affords ‘the mutual recovery of costs through the offsetting of reciprocal obligations’: *one party terminates the other’s calls and vice-versa, thus providing for ‘in-kind’ reciprocal compensation.*”) (emphasis added).

to *dicta* by the D.C. Circuit that the Commission *might* have the authority to impose bill and keep on Section 251(b)(5) traffic should carry no weight.³⁰

It is also fairly certain that this same bar against establishing bill and keep for out-of-balance reciprocal compensation traffic would apply equally to ISP-bound traffic. The FCC has now attempted twice to place ISP traffic outside of the ambit of Section 251(b)(5) and has twice been rebuffed by the courts as exceeding its authority.³¹ It is therefore likely that the Commission will eventually be forced to establish compensation for ISP-bound traffic under Section 251(b)(5). If Section 251(b)(5) applies to ISP-bound traffic, so too does the ban on bill and keep for out-of-balance traffic.

Nor is it likely that the Commission has the authority to forbear from this statutory bar on bill and keep for out-of-balance Section 251(b)(5) traffic. Section 10(d) of the Communications Act prohibits the Commission from exercising its forbearance authority with respect to Section 251(c) until it is fully implemented. *See* 47 U.S.C. § 160(d). The question for purposes of reciprocal compensation is whether Section 251(c) incorporates Section 251(b) obligations to the extent that those obligations apply to ILECs. The answer is clearly yes. Section 251(c) begins by stating that, “[i]n addition to the duties contained in subsection (b), each incumbent local exchange carrier has the following duties” 47 U.S.C. § 251(c). The canons of statutory

³⁰ *See WorldCom, Inc. v. FCC*, 288 F.3d 429, 434 (D.C. Cir. 2002) (“*WorldCom*”).

³¹ *See Bell Atl. Tel. Cos. v. FCC*, 206 F.3d 1 (D.C. Cir. 2000); *WorldCom*.

construction require that this language be given independent meaning and not be construed as mere surplusage.³² The most natural reading of the introductory phrase, “[i]n addition to the duties contained in subsection (b),” is that Congress intended that all Section 251(b) obligations, including reciprocal compensation, be incorporated into Section 251(c) (and therefore made subject to the exclusion from the Commission’s forbearance authority) to the extent the Section 251(b) obligations apply to ILECs. Indeed, it would seem that number portability, reciprocal compensation, and other similar requirements in Section 251(b) are just as worthy of the prohibition against forbearance when applied to ILECs as Section 251(c) requirements. This is precisely the conclusion reached by the Common Carrier Bureau in a letter ruling.³³

It is highly likely therefore that the prohibition on forbearance from the requirements of Section 251(c) includes a similar prohibition on forbearance on Section 251(b)(5) (and by extension Section 252(d)(2)) until the Commission has determined that Section 251(c) is “fully implemented.” But the Commission has made no such determination, and it is not even clear upon what basis it would make such a determination.

³² See *Regions Hosp. v. Shalala*, 522 U.S. 448, 467 (1998) (“We are not at liberty to construe any statute so as to deny effect to any part of its language. It is a cardinal rule of statutory construction that significance and effect shall, if possible, be accorded to every word. As early as in Bacon’s Abridgement, sect. 2, it was said that ‘a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence or word shall be superfluous, void, or insignificant.’ This rule has been repeated innumerable times.”) (quoting *Washington Mkt. Co. v. Hoffman*, 101 U.S. 112, 115-16 (1879)); *Reiter v. Sonotone Corp.*, 442 U.S. 330, 339 (1979) (“In construing a statute, we are obliged to give effect, if possible, to every word Congress used.”).

³³ See Letter from Carol E. Matthey, Deputy Chief of the Common Carrier Bureau, to Michael L. Shor, Bell Atlantic/GTE Merger Order, 16 FCC Rcd 22 (2000).

It is also entirely possible that a court would conclude that the Commission does not under any circumstances have the authority to forbear from applying the requirements of Section 252(d)(2) that are designed to ensure that carriers receive adequate compensation for the exchange of traffic. Unlike the provisions of Section 251 and elsewhere in the Act that define the *duties* of some or all carriers, which are provisions for which forbearance may be exercised, the provisions of Section 252(d)(2) at issue here are designed to *protect* carriers from unreasonable interconnection arrangements. In other words, the terms of Section 252(d)(2) are designed to place limits on the FCC's and states' authority to establish interconnection duties without just compensation. A federal agency only has such power as is granted by Congress. It cannot be that an agency has the authority to affirmatively expand its authority by exercising its forbearance power. Yet this would be precisely the result if the Commission were to forbear from enforcing Section 252(d)(2).

Even if the Commission had the right to *consider* whether it is appropriate to forbear from the requirements of Section 252(d)(2), there is no evidence that the statutory standard for forbearance could be met. While this is not the place for a full treatment of this subject, it should be clear, given the numerous policy and legal problems associated with bill and keep, that its adoption is not in the public interest, as is required under the forbearance standard.

Even if bill and keep were somehow permitted for out-of-balance Section 251(b)(5) traffic, it is unlikely that the FCC has the authority to set intrastate access or reciprocal compensation rates (specifically, set the rates at zero). In arguing otherwise, the ICF substantially misstates the precedent set by *Iowa Utilities Board*. As was noted *supra*, the

holding of *Iowa Utilities Board* permits the FCC to direct states to employ TELRIC to set intrastate rates since the FCC may prescribe intrastate access rate *methodologies*. The ICF agrees, noting that, “[u]nder *Iowa Utilities Board*, the Commission has plenary jurisdiction to make very specific methodological decisions about the implementation of section 251.” *ICF Brief* at 41. However, it is simply incorrect to assert, as the ICF does, that “the choice of bill and keep is precisely such a decision, even though it has the effect of producing *specific outcome*” *Id.* (emphasis added). As the FCC has repeatedly found, moving to bill and keep is equivalent to setting the rate for intercarrier payments at zero.³⁴ A rate of zero, or any rate set by the FCC is a “specific outcome” or, in the words of the court in *Iowa Utilities Board*, a “concrete result” (see *Iowa Utilities Board*, 525 U.S. at 384) that the FCC is not permitted to mandate under the Act.³⁵ As the D.C. Circuit notes, the 1996 Act establishes “a scheme in which Congress has broadly extended its law into the field of intrastate telecommunications, but in a

³⁴ See, e.g., *Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers; Equal Access and Interconnection Obligations Pertaining to Commercial Mobile Radio Service Providers*, Notice of Proposed Rulemaking, 11 FCC Rcd 5020, ¶ 3 (1996) (“We further tentatively conclude that, at least for an interim period, interconnection rates for local switching facilities and connections to end users should be priced on a ‘bill and keep’ basis (i.e., both the LEC and the CMRS provider charge a rate of zero for the termination of traffic)”).

³⁵ The Commission recently noted the limits of federal rate setting power for network elements in its DSL Tying Order: (“[T]he Act, for example, expressly assigns to the states the authority to arbitrate interconnection disputes among carriers, and, subject to the general framework set forth by the Commission, to establish appropriate rates for competitive carrier’s use of unbundled network elements. See generally 47 U.S.C. § 252.”). See *BellSouth Telecommunications, Inc. Request for Declaratory Ruling that State Commissions May Not Regulate Broadband Internet Access Services by Requiring BellSouth to Provide Wholesale or Retail Broadband Services to Competitive LEC UNE Voice Customers*, Memorandum Opinion and Order and Notice of Inquiry, 20 FCC Rcd 6830, n.69 (2005). The Commission’s authority to set reciprocal compensation rates is similarly limited.

few specified areas (*ratemaking*, interconnection agreements, etc) has left the policy implications of that extension to be determined by state commissions, [and those decisions] *are beyond federal control.*” *Id.* at 385 n.10 (emphasis added). Rather, the FCC may only “issue[] rules to guide the state commission judgments.” *Id.* at 385. The FCC is permitted to command the states to use TELRIC, but it is the states that have the ultimate ratemaking authority to achieve “concrete result[s].”³⁶

The logic of *Iowa Utilities Board* would apply with equal, if not greater, force to prevent the Commission from setting specific rates for originating intrastate access. As discussed, the Commission’s authority under 251(b)(5) only covers the “transport and termination of telecommunications.” Therefore, absent the voluntary agreement by 50 state commissions to abandon calling party pays in favor of bill and keep (and a rate of zero) for their intrastate access and reciprocal compensation traffic (a highly unlikely outcome), this traffic will remain under a calling party pays system.

Moreover, the ICF argument that it is able to eliminate intrastate access charges because such charges are “at odds with federal universal service” principles, again overstates the extent of the Commission’s preemptive power. If the Commission has no express delegated authority in the Act to preempt the state rule in question (as it arguably has with regard to intrastate

³⁶ See *Iowa Utilities Board*, 525 U.S. at 384 (“It is the States that will apply those [TELRIC] standards and implement that methodology, determining the *concrete result* in particular circumstances. That is enough to constitute the establishment of rates.”) (emphasis added).

terminating access), it may not do so for the purpose of simply furthering a federal goal. For example, in *Louisiana PSC*, the Supreme Court held that Section 152(b)'s limitation of the FCC's jurisdiction over rates "denies the FCC the power to preempt state regulation of depreciation for intrastate ratemaking purposes," even if such denial undermines a unified federal scheme for depreciation. 476 U.S. at 373. Because of this limitation, the FCC may not preempt state rates, even if preemption would further some federal goal.³⁷

In the absence of an express of jurisdiction in the federal statute, the FCC can only preempt state common carrier regulation where it is impossible to separate the interstate and intrastate components³⁸ of the regulated subject matter and the state regulation would "negate" the federal regulatory goal.³⁹ To this end, the ICF alleges that, because state universal service funding must be explicit and since it is impossible to determine to what extent access charges contain implicit subsidies, it is necessary to preempt the intrastate rates and move to bill and keep. In other words, the ICF argues that above-cost intrastate rates "negate" the federal policy

³⁷ *Louisiana Public Serv. Comm'n v. FCC*, 476 U.S. 355, 374-75 (1996) ("Section 152(b) constitutes, as we have explained above, a congressional denial of power to the FCC to require state commissions to follow FCC depreciation practices for intrastate ratemaking purposes. Thus we simply cannot accept an argument that the FCC may nevertheless take action which it thinks will best effectuate a federal policy. An agency may not confer power upon itself. To permit an agency to expand its power in the face of a congressional limitation on its jurisdiction would be to grant to the agency power to override Congress. This we are both unwilling and unable to do.").

³⁸ *Id.* at 375 n.4.

³⁹ For example, the courts have held that the FCC acted within its authority to permit subscribers to use their own telephones and preempted state regulation preventing subscribers from providing their own phones that would be used exclusively for intrastate service since state regulation would negate the federal tariff. *See North Carolina Utils. Comm'n v. FCC*, 537 F.2d 78 (4th Cir. 1976).

of tolerating no implicit universal service subsidies. The problem with this argument is that Section 254 states that federal universal service subsidies should be explicit, but it does not say that state universal service subsidies should be explicit.⁴⁰ Thus, as the Fifth Circuit recently determined, it is simply not true that retention of intrastate implicit subsidies somehow negates an inseverable federal policy: “Qwest and SBC deduce a statutory mandate requiring the states to transition from implicit to explicit support mechanisms. We reject this argument. In drafting the statute, Congress unambiguously imposed an explicit subsidy requirement on federal support mechanisms; no such requirement is expressly imposed upon the states.”⁴¹ Therefore, the Act precludes the very goal which the ICF claims as the basis for preemption.

The ICF also alleges that the implicit subsidies in intrastate access charges violate the Act’s admonition that rates be “sufficient,” “predictable,” and “equitable and non-discriminatory” and therefore the FCC can preempt intrastate rates. Again, the Fifth Circuit explicitly rejected these arguments, holding that the states have substantial discretion over how to establish universal service subsidies.⁴²

⁴⁰ Compare 47 U.S.C. § 254(e) (stating that “Federal universal service support . . . should be explicit and sufficient”), with *id.* § 254(f) (stating that states “may” adopt universal service “mechanisms” and that, if a state does establish such mechanisms, they must be “specific, predictable, and sufficient” (not explicit)).

⁴¹ *Qwest Communications Int’l, Inc. v. FCC*, 398 F.3d 1222, 1232 (10th Cir. 2005).

⁴² *See id.* at 1233 (“We do not find, as urged by the Petitioners, that Congress’s requirement that state and federal funding be ‘specific, predictable and sufficient,’ 47 U.S.C. § 254(b)(5), provides a backdoor to federal manipulation of state support mechanisms. The Petitioners’ argument that implicit subsidies are inherently non-specific, unpredictable, and insufficient is unavailing We agree with the FCC that the plain text of the statute merely imposes an obligation on the carriers to contribute to universal service funds; it does not impose a requirement of parity with respect to the internal functioning and the distribution of funds between and among carriers

Finally, the ICF claims that Section 251(g) permits the FCC to regulate “all telecommunications under Section 251(b)(5), including access traffic.” *ICF Brief* at 32. However, 251(g) is not an independent grant of authority. As the Supreme Court flatly stated in *AT&T v. Iowa Utilities Board*, Section 251(g) “is not [a] grant[] of authority at all.” Similarly, in striking down the Commission’s attempt to rely on Section 251(g) as an affirmative source of authority to regulate ISP-bound traffic, the D.C. Circuit explained that “[251(g)] is worded simply as a transitional device, preserving various LEC duties that antedated the 1996 Act until such time as the Commission should adopt new rules pursuant to the Act.” *WorldCom*, 288 F.3d at 430. It is worth noting that, even in adopting its aggressive (and unlawful) interpretation of Section 251(g) as a grant of jurisdiction over ISP-bound traffic, the Commission did not attempt to rely on Section 251(g) as a basis for expanding Commission’s authority over intrastate communications.⁴³

All of this demonstrates that, if the Commission were to implement a comprehensive bill and keep regime for all traffic, there is a substantial risk that the courts would reverse and remand with respect to intrastate access, reciprocal compensation and ISP-bound traffic. Only interstate access would (possibly) remain subject to bill and keep while other traffic would continue to be billed on a CPNP basis. This dual system would invite substantial arbitrage

Congress intended that the states to retain significant oversight and authority and did not dictate an arbitrary time line for transition from one system of support to another.”).

⁴³ See *ISP Remand Order* ¶ 52 (“Thus, ISP traffic is properly classified as interstate, and it falls under the Commission’s section 201 jurisdiction.”).

activities. Bill and keep therefore presents unacceptable legal risks and should not be implemented.

B. Bill And Keep Is Probably Not More Efficient Than Cost-Based Unified Rates And Will Create Its Own Market Distortions

Proponents of bill and keep offer several arguments in support of their position that a price of zero for the exchange of traffic is more efficient. None of these arguments is persuasive.

First, bill and keep proponents have argued that a price of zero is appropriate since both parties benefit equally from a call and place costs on the network.⁴⁴ Many commenters in the previous Intercarrier NPRM spilled much ink debating the veracity of this premise. It is undoubtedly true that, in some cases, call recipients benefit from a call and can be understood to “cause” the cost of the call. But the proponents of bill and keep are simply mistaken that this fact justifies the adoption of bill and keep.

Indeed, as economists Hermalin and Katz have shown,⁴⁵ zero is often not the efficient price for the exchange of traffic between networks even where the called and calling party benefit from a call. For example, Hermalin and Katz show that, when the benefits between

⁴⁴ See Patrick DeGraba, *Bill and Keep at the Central Office as the Efficient Interconnection Regime*, at 17-19 (Dec. 2000) (“COBAK”); *FNPRM*, Appendix C, *A Bill and Keep Approach to Intercarrier Compensation Reform*, at 99-103 (“Staff Paper”).

⁴⁵ See Benjamin E. Hermalin & Michael L. Katz, Walter A. Haas School of Business, University of California, Berkeley, *Network Interconnection with Two-Sided User Benefits* (July 2001).

calling and calling parties are shared, carriers do not compete with one another⁴⁶ and the carriers have different termination costs,⁴⁷ an affirmative exchange rate is efficient. Even in circumstances where carriers do compete, Hermalin and Katz demonstrate that there are certain situations where bill and keep is not appropriate.

Second, advocates of bill and keep argue that recovering switching and transport costs directly from end users is good policy because it eliminates the so-called terminating access monopoly problem. *See COBAK* at 25. The terminating access monopoly refers to a local exchange carrier's "monopoly" over the delivery to its customers of calls that originate on other carriers' networks. The concern is that this monopoly problem exists even for small CLECs and would seem therefore to be a problem that will not disappear even when a market is fully competitive. It is asserted that retaining intercarrier payments perpetuates the terminating monopoly and therefore the need for regulation even after the market is competitive and regulation of end user rates is no longer necessary. *See id.* at 28.

This argument has a certain facile appeal, but it does not hold up under close scrutiny. In fact, it is not the case that intercarrier payments combined with terminating "monopolies" require the regulation of intercarrier payments among multiple interconnected networks in perpetuity. For example, an internet backbone provider has a "monopoly" over access to customers (e.g.,

⁴⁶ Meaning that they are not competing for the same end-user customer. For example, BellSouth generally does not compete for end users in SBC's territory and *vice-versa*.

⁴⁷ In contrast, DeGraba's COBAK model assumes that carriers would have the same costs. *See COBAK* at 17.

servers) served by the backbone network, and (except where peering applies) internet backbones pay each other for the exchange of traffic. Yet there is currently no apparent need to regulate intercarrier payments among internet backbone providers. Thus, it is not the existence of a terminating monopoly or intercarrier payments *per se* that perpetuates the terminating monopoly problem. On the contrary, it appears that the development of competition can eliminate the need not just for regulation of end user charges, but also for terminating access rates.⁴⁸

It is clear therefore that undertaking the complex and uncertain task of adopting bill and keep is not the only means of reducing or eliminating the terminating monopoly problem. Rather than assume that bill and keep is the best way to address this problem, the Commission must weigh the costs and benefits of other means of addressing this problem. For example, one of the main reasons why CLECs were able, absent rate regulation, to charge unreasonable terminating access charges was that the geographic averaging requirements of Section 251(g) prevented long distance carriers from passing through to their customers the high terminating charges imposed by called parties' LECs. Absent the constraints of Section 254(g), long distance carriers might have passed through high terminating costs to calling parties (as they do the high termination rates charged by some foreign carriers). Calling parties would in turn have complained to the called parties or simply refused to call them. The result may well have been greater discipline on

⁴⁸ This does not mean that it would be appropriate to import the characteristics of internet backbone traffic exchange into the local market. The point is simply that the existence of intercarrier rates does not necessarily perpetuate the need for regulation of traffic termination charges.

CLEC terminating access rates. As this example illustrates, there are likely numerous ways for the Commission to eliminate regulatory impediments (e.g., by forbearing from applying Section 254(g)) to the erosion of the terminating monopolies. Bill and keep is not the only way, and probably not the least costly way, of achieving this goal.

Third, proponents of bill and keep argue that eliminating intercarrier payments is sound policy because it eliminates costly disputes over what the “correct” intercarrier rate is. See *Staff Paper* at 107. But as has been observed in the past, this is essentially an argument for trading one type of regulation for another.⁴⁹ Recovering switching and transport costs from end users requires the regulation of end user rates charged by the incumbents and likely also an increase in the size of the universal service fund. It is hard to see why it is any easier to solve these regulatory problems than to set a reasonable, cost-based intercarrier compensation rate. This is especially true since TELRIC-based intercarrier compensation rates have already been established. Moreover, since, as explained, competition can in fact eliminate the need for regulation of intercarrier payments under the correct circumstances, it is not clear that regulation will become unnecessary for end user charges sooner than for intercarrier charges.

All of this demonstrates that the arguments offered in support of bill and keep are weak even on their own terms. But it is also important to consider the true possible benefits to consumer welfare of the most efficient intercarrier compensation regime possible. The truth is

⁴⁹ See e.g., AT&T Comments, CC Dkt. No. 01-92 at ii (filed Aug. 11, 2001).

that intercarrier payments constitute a smaller and smaller portion of carriers' overall costs. The adoption of TELRIC-based rates for all intercarrier charges (or at least all termination charges) would reduce this level even further. Additional changes to the intercarrier compensation rules, even if they made the system more efficient (and of course that is far from certain), would probably not result in significant increases in consumer welfare.

For example, proponents of bill and keep have claimed that per minute intercarrier compensation rates retard the development of purportedly more efficient flat monthly end user charges. *See COBAK* at 28. But the CMRS industry developed these pricing plans while paying per minute reciprocal compensation and terminating access charges. Further significant reductions in per minute charges will make it even easier for carriers to transition to such pricing plans.

Like most administrative policy decisions, the question of how to proceed with intercarrier compensation reform requires a cost benefit analysis. As demonstrated herein, the costs of bill and keep are very substantial. It would require that the Commission rely on dubious legal arguments that would tie up reform in lengthy, costly and probably unsuccessful litigation. Bill and keep would also require that the Commission establish a new set of regulations addressing the complex and contentious questions of end user recovery and probably result in very large increases in universal service obligations. The adoption of cost-based unified intercarrier compensation rates would be far less costly. It would not implicate most of the legal risks associated with bill and keep, and it would not introduce any new legal risks. It would require increases in end user rates, but those increases would be much more modest and the

transition less difficult than would be the case with bill and keep. Cost-based rates might also require an expansion in the universal service fund, but such expansion would be modest, again making the change must less difficult to administer than would be the case with bill and keep.

On the other hand, the benefits of bill and keep are no greater than cost-based unified rates. Both cost-based, unified rates and bill and keep eliminate the arbitrage problem caused by the application of different rates to different types of traffic. Cost-based unified rates yield intercarrier pricing that is at least as efficient as bill and keep. Bill and keep would eliminate the terminating monopoly, but this could be accomplished under a cost-based unified rate regime. Finally, bill and keep would allow for the elimination of regulation upon the development of competition, but this too is achievable using less costly means while retaining cost-based pricing. It is clear therefore that the cost-benefit analysis weighs heavily against the adoption of bill and keep and in favor of cost-based unified rates.

IV. The Commission Should Prohibit ILECs From Recovering Intercarrier Compensation Revenue Currently Associated With Multi-Line Business Customers In A Manner That Results In Unreasonable End User Charges And That Harms Competition

A critical aspect of any intercarrier compensation reform plan is the manner in which the plan addresses the recovery of revenues removed from the intercarrier compensation regime. The most efficient means of addressing this issue is to offer carriers the opportunity to recover the costs directly from end users to the extent possible (thereby limiting increases in universal

service funding).⁵⁰ It should do so by allowing incumbent LECs to recover foregone intercarrier compensation through increased interstate subscriber line charges. Specifically, the Commission should allow gradual increases in the caps applicable to subscriber line charges, with the eventual elimination of the cap on multi-line business subscriber line charges. In managing the transition to higher end user charges, the FCC must ensure that it places appropriate constraints on the manner in which ILECs can recover these costs. In the absence of regulation or competition, ILECs have the incentive and ability to charge unreasonably high rates to some customers and to engage in strategic pricing to exclude entrants seeking to serve other customers.

It is well-established that incumbent LECs have the incentive to misallocate the costs of competitive services to regulatory cost categories associated with services over which the ILECs have market power. Congress recognized this incentive by enacting Section 254(k), which prohibits a carrier from using “services that are not competitive to subsidize services that are subject to competition.” 47 U.S.C. § 254(k). The Commission has (incorrectly) applied Section 254(k) by focusing entirely on the cross-subsidy of unregulated services by regulated services. But the Commission has elsewhere recognized that the incumbents have powerful incentives to shift the costs of regulated services subject to competition to cost categories associated with

⁵⁰ *Cf. Access Charge Reform, et al.*, Sixth Report and Order in CC Docket Nos 96-262 and 94-1, *et al.*, 15 FCC Red 12962 ¶ 12 (2000) (“*CALLS Order*”).

other regulated services that are not subject to competition.⁵¹ The inelastic nature of the demand for telecommunications services makes this type of cost misallocation highly profitable for the regulated firm since increases in prices do not result in significant reductions in the quantity of service demanded.

The recovery of switching and transport costs directly from end users as part of intercarrier compensation reform poses precisely this threat. It potentially opens the door to allow ILECs to recover costs associated with business services subject to competition from mass market and business services over which the incumbents have market power.

For example, the ILECs hold a position of commanding market power in the provision of mass market telephone service. They face little competition from traditional wireline competitors or from recently emerging technologies. UNE-P-based providers are likely to provide very little competition in the mass market in the future since unbundled switching will soon become unavailable.⁵² The proposed acquisition of AT&T by SBC and of MCI by Verizon will accelerate this trend. Nor can it be said that CMRS or VoIP offers substantial competition. The Commission has made clear that these services are, at most, complements to circuit switched

⁵¹ See *Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*, Report and Order, 11 FCC Rcd 17539, ¶ 74 (1996).

⁵² See *Unbundled Access to Network Elements et al.*, Order on Remand, 20 FCC Rcd 2533, ¶¶ 219-221 (2005) (“TRRO”).

voice service.⁵³ Significant decreases in wireless prices have not induced large numbers of wireline consumers to “cut the cord,” indicating a clear lack of cross-elasticity that further demonstrates that wireless and wireline services are in different product markets. Furthermore, as the Commission stated, VoIP is primarily a complement to, not a substitute for, traditional wireline services.⁵⁴ All of this indicates that the ILECs have the incentive and ability to unilaterally increase prices on mass market telephone service customers, unless regulation prevents this outcome.

The ILECs also appear to retain the ability to raise the price of certain services offered to small and medium-sized business customers. They can do this primarily by raising their rivals’ costs.⁵⁵ For example, in the recent *Triennial Review Remand Order*, the Commission eliminated

⁵³ The Commission has “previously found that consumers tend to use wireless and wireline services in a complementary manner and view the services as distinct because of differences in functionality.” *Applications of AT&T Wireless Services, Inc. and Cingular Wireless Corporation et al.*, Memorandum Opinion and Order, 19 FCC Rcd 21522, ¶ 239 (2004) (“*Cingular-AWS Merger Order*”) (citing *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers; Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, et al.*, Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, 18 FCC Rcd 16978 ¶ 230 (2003) *vacated and remanded in part, affirmed in part, United States Telecom Ass’n v. FCC*, 359 F.3d 554 (D.C. Cir. 2004) *cert. denied*, 125 S.Ct. 313, 316, 345 (2004)). Accordingly, the Commission concluded that, “while there is some evidence of a small, but growing number of consumers that have chosen to cut the cord and use wireless services in lieu of wireline service, this trend is a relatively recent phenomenon.” *Cingular-AWS Merger Order* ¶ 242.

⁵⁴ *TRRO* n.118.

⁵⁵ The Commission has acknowledged that ILECs have powerful incentives to raise rivals’ costs. *See Applications of Ameritech Corp., Transferor, and SBC Communications, Inc., Transferee*, Memorandum Opinion and Order, 14 FCC Rcd 14712, ¶ 107 (1999) (“In addition, incumbent LECs, which are both competitors and suppliers to new entrants, have strong economic incentive, to preserve their traditional monopolies over local telephone service and to resist the introduction of competition that is required by the 1996 Act. More specifically, an incumbent LEC has an incentive to: (1) delay interconnection negotiations and resolution of interconnection disputes; (2) limit both the methods and points of interconnection and the facilities and services to which entrants are provided access; (3) raise

unbundled DS1 loops in Tier One wire centers (those with 60,000 or more business access lines) and unbundled DS3 loops in Tier One and Tier Two wire centers (those with 38,000 or more business access lines). *TRRO* ¶¶ 174-175, 178-179. Given the scarcity of competitive providers of wholesale loops and the inadequacy of current special access regulation, the incumbents have both the incentive and opportunity to increase their rivals' loop costs (and therefore increase the downstream retail price) in the provision of business services in Tier One and Two wire centers. The proposed acquisitions of AT&T by SBC and of MCI by Verizon will, if allowed to take effect, increase further the ILECs' stranglehold ability to raise rivals' costs. Furthermore, in areas outside of the dense urban areas, the incumbents generally face no competition for business customers at all. In those areas, the incumbents likely have the incentive and ability to simply unilaterally increase the price for business services.

entrants' costs by charging high prices for interconnection, network elements and services, and by delaying the provisioning of, and degrading the quality of, the interconnection, services, and elements it provides. An incumbent LEC has similar, and probably greater, incentive to deny special accommodations required by competitive LECs seeking to offer innovative advanced services that the incumbent may not even offer. As noted at the outset, this view of the incumbent LECs' incentives and abilities is the fundamental postulate of the basic cornerstones of modern telecommunications law -- the MFJ and the 1996 Act."); *Application of GTE Corporation, Transferor and Bell Atlantic Corporation, Transferee*, Memorandum Opinion and Order, 15 FCC Rcd 14032, ¶ 188 (2000) ("[G]iven their monopoly control over exchange access services, each Applicant currently has the ability to discriminate against rivals providing interexchange services, in favor of its own interexchange operations, by denying, degrading, or delaying access on the originating and terminating ends."); *Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC Exchange Area; Policy and Rules Concerning the Interstate, Interexchange Marketplace*, Second Report and Order, 12 FCC Rcd 15756, ¶ 111 (1997) ("[t]here are various ways in which a BOC could attempt to discriminate against unaffiliated interLATA carriers, such as through poorer quality interconnection arrangements or unnecessary delays in satisfying its competitors' requests to connect to the BOC's network.") (footnote omitted).

The combination of inelastic demand and market power affords ILECs the incentive and ability to raise prices selectively on captive ratepayers while keeping prices low on customers for whom they face competition. The result is unreasonably high prices charged to consumers purchasing the subsidizing services and harm to competition in the provision of the subsidized services. The Joint Commenters are, not surprisingly, especially concerned about the latter.

The Commission has, in the past, specifically expressed the concern that, given the opportunity, ILECs have the incentive to “engage in exclusionary pricing behavior and thereby thwart the development of competition.”⁵⁶ The Commission has also stated that the rules in Part 64 are insufficient to “protect against improper cost allocations from one regulated activity to another regulated activity,”⁵⁷ requiring the adoption of further regulatory constraints on ILEC pricing flexibility. For example, in granting the incumbents special access pricing flexibility, the Commission adopted several different constraints designed to limit the incumbents’ ability to use pricing flexibility to engage in exclusionary conduct.⁵⁸ While these restrictions have proven insufficient, they nevertheless reflect the appropriate policy concern at issue here. Similarly, in the CALLS order, the Commission sought to limit the consequences of pricing flexibility for

⁵⁶ See *Access Charge Reform*, Fifth Report and Order, 14 FCC Rcd 14221, ¶ 79 (1999) (“*Price Flex Order*”).

⁵⁷ *Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*, Report & Order, 11 FCC Rcd 17539, ¶ 74 (1996).

⁵⁸ See *Price Flex Order* ¶ 21 (discussing density zone pricing constraints); ¶ 134 (limiting the use of growth discount plans); ¶ 169 (noting that certain services removed from price caps will be removed from baskets to prevent pricing distortions).

competition by precluding ILECs from deaveraging their increased end user charges unless a state had geographically deaveraged UNE rates for loops. *CALLS Order ¶ 127.*

Regulations designed to limit the incumbents' ability to act on their incentive to misallocate costs are necessary in the instant case as well. Most fundamentally, the Commission must not allow incumbents to recover intercarrier compensation revenue currently associated with multiline business customers (for whom there are competitive alternatives) from mass market customers (for whom competitive alternatives have disappeared or will soon disappear).

But there is also no basis for granting the incumbents further pricing flexibility to recover end user charges among different multiline business customers. While the ICF has proposed that incumbent LECs would have significant pricing flexibility in charging newly increased end user rates, (*see ICF plan* at 63-68) it has offered no basis for concluding that this is reasonable or even what the consequences of such flexibility would be for consumers. Nor has the ICF demonstrated why the pricing flexibility that was requested by the CALLS participants and granted by the Commission is insufficient. This is likely because no valid basis exists for such flexibility. The incumbents' incentives to engage in exclusionary conduct by shifting costs among differently-situated business customers are even more of a threat today, in light of the reduction in the availability of unbundled loops and the looming threat of the Bell-IXC mergers, than they have been in the recent past. Indeed, if anything, the Commission should focus on whether the incumbents already possess too much pricing flexibility in light of current levels of competition. In any event, under no circumstances should the creation of increased caps for end

user charges as a result of intercarrier compensation reform result in increased pricing flexibility for incumbents.

V. The Commission Should Ensure That Network Interconnection Rules Restrict The ILECs' Ability To Raise Rivals' Costs

It is well-established that incumbent LECs have the incentive to deny competitors efficient interconnection for the exchange of traffic. The basic rule of network effects is that the more users that connect to a network, the greater the value the network has to those that use it. This essentially means that CLECs value interconnection much more than ILECs because ILEC networks serve many more customers than CLEC networks. Indeed, ILECs have powerful incentives to increase the price and decrease the quality of the interconnection they grant to CLECs.⁵⁹ The Commission must therefore ensure that the ILECs do not exploit intercarrier compensation reform as a means of raising CLECs' costs of interconnection.

As a threshold matter, there is no apparent reason for the Commission even to address network interconnection in this proceeding so long as carriers charge each other cost-based rates for the exchange of traffic. The existing interconnection rules function adequately in an environment in which carriers pay each other for the transport and termination functionalities performed. They should function even more effectively if intercarrier compensation rates are brought closer to cost. This proceeding is complex enough without the Commission assuming

⁵⁹ See *Local Competition Order* ¶ 224 (noting that ILECs have the incentive to engage in degradation of quality “in a manner imperceptible to end users.”); *Applications of NYNEX Corporation, Transferor and Bell Atlantic Corporation, Transferee*, Memorandum Opinion and Order, 12 FCC Rcd 19985, ¶ 6 (1997).

the added and unnecessary burden of rewriting a set of rules that are only now, nine years after passage of the 1996 Act, becoming relatively stable and predictable.

In all events, however, the Commission should not adopt the network interconnection changes proposed by the ICF (the only plan to proposed extensive changes in this regard). The ICF interconnection proposal suffers from three basic problems. *First*, the “edge” proposal in the ICF essentially requires CLECs (so-called “non-hierarchical networks”) to bear the financial responsibility for carrying traffic that originates with CLEC customers to a number of ILEC interconnection points in a LATA that is equal to the number of ILEC access tandems in the LATA. *See ICF Plan* at 4, 10. This rule would require CLECs to pay to transport traffic to interconnection points in the ILEC network without any consideration of whether it is efficient or sound engineering practice to do so. The result would be an artificial increase in CLEC costs. The edge proposal has of course been proposed as part of a bill and keep proposal. But it is worth noting that the current single point of interconnection in a LATA rule does not result in significant CLEC “free riding” on ILEC networks (the concern that apparently prompted the ICF proposal). Each of the Joint Commenters (either because of requirements in interconnection agreements or simply because it is sound engineering and business practice) regularly establishes dedicated interconnection points at tandem offices and even in some cases end offices when traffic volumes justify such arrangements. Such arrangements limit free riding on incumbent LEC networks. Any situations where free riding becomes a problem could surely be addressed as they arise and need not be addressed in this proceeding.

Not only is the edge proposal unsound public policy, it is also unlawful. Section 251(c)(2) imposes upon incumbent LECs the duty to interconnect with requesting carriers at any technically feasible point. By granting the ILEC (the “hierarchical network”) the right to designate the location and number of points of interconnection on its network, the ICF proposal is clearly inconsistent with the language of the statute. Section 251(c)(2) “permits the CLEC to choose the points in the network at which to interconnect” subject only the qualification of technical feasibility. *MCI Telecomms. Corp. v. Bell Atl. Pa.*, 271 F.3d 491, 517 (3d Cir. 2001). Moreover, the statute expressly grants CLECs the right to interconnect at a single interconnection “point.” *See US West Comms., Inc. v. Jennings*, 304 F.3d 950, 961 (9th Cir. 2002). The only way that the ICF proposal to allow ILECs to designate the *location and number* of interconnection points could be consistent with Section 251(c)(2) is if such an approach were “technically necessary,” which of course it is not. *See MCI Telecomms. Corp. v. Bell Atl. Pa.*, 271 F.3d at 517. (concluding that Verizon proposal that WorldCom interconnect in all access tandem serving areas within a LATA was inconsistent with Section 251(c)(2)).

Second, where a CLEC interconnects with an ILEC, the *ICF Plan* unreasonably requires that the CLEC bear the financial responsibility for carrying traffic in both directions between carriers, rather than requiring that each carrier bear the burden of carrying traffic originating on its network to the other carrier’s edge. As part of this rule, an ILEC never pays for any portion of the interconnection facility, even if a CLEC has constructed such facility. If the CLEC purchases the facility from the ILEC, it pays 50 percent of the above-cost interstate switched dedicated transport rate for up to 40 miles. *See ICF Plan* at 11.

This is yet another means for ILECs to artificially raise CLECs' interconnection costs without any regard to efficiency. Efficient interconnection would require that carriers split the cost of the least expensive facility for exchanging traffic. Yet the ICF proposal requires that CLECs absorb the entire cost of interconnection facilities they construct, thereby essentially precluding use of CLEC-constructed facilities even if they are the most efficient alternative. This leaves CLECs no choice but to purchase interconnection facilities from the ILECs. Just to add insult to injury, the CLEC must pay 50 percent of the above-cost dedicated access rate, rather than 50 percent of a true cost-based rate (such as one based on TELRIC). It is clear therefore that this aspect of the *ICF Plan* must also be rejected.

Third, there is a significant flaw in the tandem transit regime proposed by the ICF. The ICF plan would not even begin to regulate tandem transit rates until 2007 (*see ICF Plan* at 25), and even then, the rates would continue to be well above-cost. The retention of above-cost tandem transit rates gives CLECs the incentive to bypass the incumbent tandem with direct interconnection facilities to other carriers even where such arrangements are inefficient. By contrast, unifying tandem transit rates at the more reasonable TELRIC-based rate would yield efficient outcomes.

Currently, tandem transit rates vary substantially based on the extent to which the states have actively intervened to prevent the ILECs from abusing their market power over tandem

transit services. For example, Conversent pays tandem transit rates⁶⁰ that range from .095 cents per minute in Massachusetts to 2.3 cents per minute in Connecticut.⁶¹ Where CLECs must pay high tandem transit rates, they often have no choice but to establish direct connections to other carriers where such interconnection is in fact inefficient. For example, because the tandem transit rates in Connecticut are so high, Conversent has bypassed SNET's tandems and trunked directly to several other carriers' networks even though such arrangements are inefficient (and would not be established if SNET charged a cost-based tandem transit rate). While this is an extremely costly and unwieldy network architecture, it still permits Conversent to save money over having to pay substantially above-cost tandem transit rates. To establish these arrangements, Conversent must expend resources paying for the additional trunks and negotiating interconnection agreements to cover what is often very small amounts of traffic. In fact, in many cases, other carriers will refuse to negotiate these agreements because of the high transaction costs and their inability to recover these costs at low traffic volumes. In those situations, Conversent is forced to pay the above-cost tandem transit rates. It is clear therefore

⁶⁰ The rates described herein are blended because the actual rates are tiered for day-evening-night or peak-off-peak.

⁶¹ This rate actually comprises both the tandem transit rate and the applicable intercarrier termination rate. This is because SNET collects the reciprocal compensation and intrastate terminating access charges and passes them along to the ultimate terminating carrier when it provides transit service. Because those rates vary, but SNET charges 2.3 cents for all tandem transit traffic, the effective transit rate in Connecticut varies arbitrarily by the type of traffic transited. Moreover, even if the reciprocal compensation and intrastate terminating access charges are subtracted out of the 2.3 cents per minute charge, SBC's tandem transit rate in Connecticut is the highest of all of states that Conversent serves. For example, intrastate terminating access rates (which are considerably higher than reciprocal compensation rates) are capped at 1.5 cents per minute in Connecticut, yielding an effective rate of .8 cents per minute for tandem transit service for such traffic. That rate is higher than any other tandem transit rate Conversent pays. The effective rate for reciprocal tandem transit is much higher.

that the Commission should, to the extent possible, begin the transition to cost-based transit prices immediately.

VI. It May Be Appropriate To Apply Different Intercarrier Compensation Rates To Rural ILECs

Several of the intercarrier compensation reform proposals treat carriers serving rural areas (or some proxy for identifying rural areas) more favorably than other carriers. For example, several of the plans allow carriers serving rural areas to charge higher intercarrier compensation rates than other carriers may charge. Unfortunately, none of the plans addresses the fact that there are significant limitations on the Commission's authority to adopt regulations governing intercarrier compensation for rural ILECs. Nevertheless, to the extent that the Commission does retain such authority, differential treatment of rural ILECs is probably lawful and acceptable public policy.

To begin with, the Commission seems to have the authority to set intercarrier rates charged by rural carriers at a higher level than those charged by other carriers. As mentioned, the "additional cost" standard in Section 252(d)(2) seems to require that carriers with higher costs be allowed to charge rates to reflect those costs. This is also of course consistent with the TELRIC methodology, under which higher forward-looking costs of a particular carrier would be reflected in higher rates.

The application of rates set under Section 252(d)(2) to rural carriers is not without its legal complications, however. Section 252(d)(2) applies to traffic exchanged pursuant to Section 251(b)(5). But Section 251(f)(2) creates the risk that the Commission lacks the authority to

ensure that Section 251(b)(5), and by extension Section 252(d)(2), applies to rural carriers. Section 251(f)(2) grants incumbent LECs with fewer than 2 percent of the nation's total subscriber lines the right to petition a state commission to suspend application of Section 251(b) to the rural incumbent. 47 U.S.C. § 251(f)(2). A state "shall" grant such a petition if it determines that it is (1) necessary to avoid "a significant adverse economic impact on users of telecommunications services generally," *or* to avoid an "unduly economically burdensome" *or* "technically infeasible" requirement; and (2) is in the public interest. *See id.*

The provisions of Section 251(f)(2) have potentially broad implications for any attempt to establish a unified, national intercarrier compensation system. As the Commission has observed, every incumbent LEC in the country other than the BOCs and Sprint has fewer than 2 percent of the nation's total subscriber lines and therefore is eligible to file a petition under Section 251(f)(2). Moreover, the Eighth Circuit has held that a state may grant a Section 251(f)(2) petition based merely on the fact that an ILEC experiences the normal economic harm caused by competitive entry and the reasoned conclusion that granting the petition is in the public interest. *See Iowa Utils Bd. v. FCC*, 219 F.3d 744, 759-62 (8th Cir. 2000). The Commission has also ruled that it will leave it to the states to "interpret the provisions of section 251(f) through rulemaking and adjudicative proceedings" and that states "will be responsible for determining whether a LEC in a particular instance" has met the Section 251(f)(2) standard. *Local Competition Order* ¶ 38. All of this indicates that the states have substantial discretion to determine whether Section 251(b)(5) and the "additional cost" standard in Section 252(d)(2) will apply in the future to all ILECs except for the BOCs and Sprint.

To the extent that the Commission does retain authority over intercarrier compensation rates charged by rural incumbent LECs, it should seek to ensure that there is a reasonable basis in cost for any differential between rural ILEC rates and rates charged by other carriers. As is the case with rates charged by other carriers, the Commission should ensure that rural ILECs at the very least charge a unified rate for the termination of all traffic. The most appropriate means of achieving this goal would be for the Commission to require the states to utilize TELRIC methodology (or possibly a similar methodology that includes a greater portion of embedded costs than TELRIC)⁶² to set reciprocal compensation and terminating intrastate access rates applicable to rural carriers. The Commission would then adopt the state-set rate as the interstate terminating access rate. It would be optimal to apply this same rate to originating access. Nevertheless, as explained above, the heightened legal risks associated with the exercise of Commission jurisdiction over the methodology states use to set originating access rates counsels in favor of focusing on ensuring unified rates for termination.

It appears to be sound policy to allow rural ILECs to charge higher intercarrier compensation rates. As mentioned, the efficiency analysis indicates that traffic exchanged between carriers that do not compete (which is normally the case with rural carriers) should reflect the cost differentials among the carriers even where calling and called parties “cause” the

⁶² The Commission is currently considering the extent to which it should adopt a modified forward-looking cost model for determining the level of universal service funding for rural ILECs. *See Federal-State Joint Board on Universal Service*, Fourteenth Report and Order, 16 FCC Rcd 11244, ¶ 8 (2001) (continuing the use of embedded cost to determine rural ILEC universal service subsidies for five years while the Commission studies the manner in which a modified forward-looking model can be developed for rural ILECs).

costs of the call to be incurred. If the rural ILEC charges the same rate for all traffic and that single rate is brought closer to a reasonable estimation of cost, increased consumer welfare should result.

Moreover, arguments raised by proponents of bill and keep are the least persuasive with regard to rural carriers. Rural carriers are the least likely to face significant competition anytime in the foreseeable future, so it is hard to argue that placing all of the costs of intercarrier compensation on end users will expose those end-user rates to competition and gradually eliminate the need for regulation. Rural ILEC end user rates will likely require regulatory oversight even longer than ILEC rates elsewhere in the country. Eliminating rural ILEC intercarrier payments would unquestionably trade one form of regulation for another for the foreseeable future. Thus, retaining lower (but still relatively high) rates for rural ILECs would probably have minimal impact on end user pricing efficiency.

VII. The FCC Must Ensure That Intercarrier Compensation Reform Does Not Threaten To Undermine The Sustainability Of The Universal Service Fund Or Result In The Establishment Of Subsidy Funds That Skew Competitive Outcomes

In assessing the various subsidy funds included in intercarrier compensation reform proposals, the Commission should be guided by three basic principles. The Commission must (1) limit further increases in the universal service fund to the extent possible, (2) ensure that any increase in the size of the universal service subsidy pool is accompanied by an expansion in the pool of contributors, and (3) limit the scope and duration of any interim fund designed to compensate carriers for the loss of intercarrier payments during the transition to higher end user rates.

First, it is clear that the federal universal fund is already dangerously large. The most recent federal universal service contribution factor (applicable to interstate and international end user telecommunications service and, with some exceptions, end user telecommunications revenues) is 11.1 percent.⁶³ This level may already be close to the point at which the pass-through to end users threatens (ironically) the statutory goals of universal service. As the Fifth Circuit has explained, “excessive funding may itself violate the sufficiency requirements of the Act.” This is because “universal service is funded by a general pool subsidized by all telecommunications providers -- and thus indirectly by the customers -- excess subsidization in some cases may detract from universal service by causing rates unnecessarily to rise, thereby pricing some consumers out the market.” *Alenco Communications, Inc. v. FCC*, 201 F.3d 608, 620 (5th Cir. 2001).

As explained above, retaining cost-based intercarrier compensation rates is the correct legal and policy outcome regardless of the implications for universal service. But a collateral benefit of retaining cost-based intercarrier compensation rates is that, by limiting the extent to which switching and transport costs are recovered directly from end users, a unified rate limits the extent to which intercarrier compensation reform will result in a larger universal service fund. This is extremely important in terms of advancing the goals of universal service themselves (as the Fifth Circuit explained), but also to advance the basic policy objective of

⁶³ See *Proposed Second Quarter 2005 Universal Service Contribution Factor*, Public Notice, 20 FCC Rcd 5239 (2005).

efficient pricing. The efficiency concerns are of course that artificially increasing the price of service through universal service pass-throughs to end users can cause customers that are demand elastic to purchase less of the service than would be the case in the absence of the price increase. The resulting dead weight loss is the very essence of harm to consumer welfare.

Second, in all events, the Commission must accompany any increase in the size of the universal service fund with the adoption of a new system for carrier contributions to the fund that broadens the base of contributors. The need for broadening the contribution base has been addressed exhaustively in other contexts, and there is no reason to reiterate the arguments in favor of reform at this time. It is sufficient to emphasize, as do NARUC and the ICF, that any further increase in the size of the universal service fund cannot be sustained without including new categories of service providers in the class of contributors to federal universal service contributors.

Third, several of the plans propose interim subsidy schemes designed to make carriers whole during the transition to higher end user charges. The Commission should approach these subsidy schemes with a high degree of caution. It seems likely that any significant revenue shortfall during the transition to higher end user revenues could be eliminated (or at least reduced enough to obviate the need for an interim subsidy) by reducing the annual reductions in intercarrier compensation rates or increasing the annual increases in end user rates. If for some reason neither of these alternatives is deemed viable, however, it may be appropriate to adopt a strictly interim subsidy mechanism designed to prevent dramatic reductions in revenue. It is important to emphasize that, outside of areas where competitive entry is precluded by the

protections of Section 251(f), any compensatory subsidy must be portable to competitors.

Competitors such as the Joint Commenters will experience revenue loss as a result of intercarrier compensation reform that is likely to be at least as significant (in relative terms) as the shortfalls experienced by incumbent LECs. If competitors are required to contribute to a subsidy fund that benefits their incumbent LEC competitors but competitors are not able to receive compensation from the fund, competitors will be placed in an untenable regulatory price squeeze.

In addition, under no circumstances should any such compensatory subsidy be adopted as a long-term solution to reductions in intercarrier compensation for particular classes of carriers. As the Fifth Circuit has explained, the “Act does *not* guarantee all local telephone service providers a sufficient return on investment; quite to the contrary, it is intended to introduce competition in the market.” *Alenco*, 201 F.3d at 620 (emphasis in original). Accordingly, “[s]o long as there is sufficient and competitively-neutral funding to enable all customers to receive basic telecommunications services, the FCC has satisfied the Act and is not further required to ensure sufficient funding of every local telephone provider as well.” *Id.*

VIII. CONCLUSION

The Commission should approach the reform of intercarrier compensation in a manner that is consistent with these comments.

Respectfully submitted,

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