Before the
Federal Communications Commission
Washington, DC 20554

In the Matter of	
High-Cost Universal Service Support	WC Docket No. 05-337
Federal-State Joint Board on Universal Service	CC Docket No. 96-45
Lifeline and Link Up	WC Docket No. 03-109
Universal Service Contribution Methodology	WC Docket No. 06-122
Numbering Resource Optimization	CC Docket No. 99-200
Implementation of the Local Competition Provisions in the Telecommunications Act of 1996	CC Docket No. 96-98
Developing a Unified Intercarrier Compensation Regime	CC Docket No. 01-92
Intercarrier Compensation for ISP-Bound Traffic	CC Docket No. 99-68
IP-Enabled Services	WC Docket No. 04-36
Establishing Just and Reasonable Rates for Local Exchange Carriers	WC Docket No. 07-135

TELECOM INVESTORS' REPLY COMMENTS

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INTRODUCTION AND SUMMARY

M/C Venture Partners and Columbia Capital (the "Telecom Investors"), through undersigned counsel, submit their Reply Comments on the Commission's comprehensive intercarrier compensation reform proposal. The Telecom Investors, in these reply comments, focus their analysis only on the Commission's proposed additional cost methodology. The Telecom Investors believe that this methodology, if adopted, will have a profound and negative impact on investment in competition and innovation in the nation's telecommunications markets. In their initial comments, the Telecom Investors argued that the Commission's proposal to abandon the TELRIC methodology for determining the rates by which carriers will compensate each other for traffic terminated on each other's networks in favor of an untested and unsound "additional cost" methodology will undermine investor confidence in the telecommunications market and the stability of the Commission's regulatory framework. As recognized in numerous comments filed in this proceeding, the Commission's proposed methodology is results-oriented rulemaking at odds with the fundamental principles of administrative decisionmaking and outside the scope of the Commission's statutory authority. It is a methodology designed to force states to adopt a terminating rate close to zero, at or below .0007 cents per minute, a rate arbitrarily selected by AT&T and Verizon that will benefit AT&T and Verizon to the detriment of the rest of the industry and the public interest. As the Telecom Investors observed in their initial comments, the Commission should retain the TELRIC methodology and not adopt the proposed "additional costs" methodology because it is discriminatory and it is economically unsound. These twin failures will drive away investment and result in decreased innovation; contrary to the purposes of the Communications Act and the Commission's duties set forth in that Act.

Many commenters, including a number of economic experts, also observe that the Commission's proposed additional cost standard is results-oriented, incomplete, internally inconsistent, and riddled with inaccuracies. For example, while the Commission's preferred outcome (a rate "extremely close to zero") might be expected under a short run marginal cost standard, it is inconsistent with the Commission's decision to rely on long run incremental costs. The Commission's desire to set terminating rates around zero cents per minute cannot outweigh sound economic principles. By contrast, the TELRIC standard incorporates sound long run costing principles and has been affirmed as a proper methodology under the Act. TELRIC is time-tested, theoretically sound, and is the same pricing model used for the network functions — such as switching and transport — that LECs' already use to terminate telephone calls. As the Commission considers comprehensive reform to the intercarrier compensation regime, it makes no sense to experiment with a new cost standard that will determine the rate for one of the most significant economic components in the industry. The Commission should therefore reject the proposed additional costs methodology and affirm that states must continue to employ the TELRIC methodology for setting the rates for compensation under Section 251(b)(5) of the Act.

As the Telecom Investors observed in their initial comments, the Commission's proposed cost methodology suffers from several flaws. These flaws are echoed in comments from commenters across the spectrum of the industry. These reply comments highlight a number of the more egregious flaws, which together preclude CLECs from recovering their network investments. For instance, under the Commission's proposed methodology, most costs are treated as fixed and are thus excluded entirely from the incremental cost calculation.[1] In addition, the proposal defines the long run so narrowly that it "virtually eliminates the possibility of any cost

[1] Declaration of Lee L. Selwyn, attached to Letter from Brad E. Mutschelknaus, et al., to Marlene H. Dortch, Secretary, Federal Communications Commission, WC Docket No. 05-337, et al. (filed Nov. 26,2008) ("Selwyn Decl.") at ¶ 8.

variability" showing its true colors as a short run, rather than a long run methodology.[2] Further, the proposed cost standard excludes all "joint costs" (i.e., costs that are incurred to support two or more separate products or services). It includes only those cost elements that are product-specific and that would not be incurred at all if call termination service were not offered, thereby improperly shifting recovery of all the shared and common costs to other products. If this methodology were replicated for all products sharing the joint costs, no rational investor would choose to deploy capital where it was unable to receive a return on such investment.[3] In effect, the Commission's cost methodology would turn long standing economic principles on its head, requiring carriers to cross subsidize their regulated services (terminating other carrier's traffic) with revenues from unregulated services (such as broadband). Such a counter-intuitive and uneconomic methodology will deter investment in broadband, the seminal goal of the Commission's policy for the last decade. Finally, the Commission's proposed cost methodology has a disproportionate impact on CLECs, who typically do not offer as broad a set of products as the RBOCs, and thus do not have the same capability to spread the burden of recovering joint and common costs across many products.

Commenters agree that if adopted, this flawed methodology will depress investment and as a result lessen competition and reduce innovation across all telecommunications markets. The costing approach proposed by the RBOCs and reflected in the Commission's proposal, by excluding important components of the costs competitors incur to terminate traffic from the RBOCs, would deprive CLECs the ability to recoup the costs of investments made in their network necessary to terminate RBOC traffic.

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[2] *Id*. at ¶ 10, quoting Chairman's Draft Proposal, at ¶ 244.

[3] *See* Selwyn Decl. ¶ 19.

I. The Commission Should Retain the TELRIC Methodology for Setting Section 251(b)(5) Rates (V.B.4.)

The proposed radical departure from the use of the TELRIC methodology for setting the rate at which all carriers will compensate each other for terminating traffic receives little support except from those parties, such as AT&T and Verizon, that the proposal is designed to benefit. It is evident from the comments that many sectors of the industry have grave doubts regarding the legality and viability of the short run incremental cost methodology set forth in the proposals. The proposal is "arbitrary, discriminatory, will result in noncompensatory prices, [and] is biased in favor of the large RBOCs at the expense of CLECs."[4]

The methodology, for no valid reason, abandons over a decade of experience and jurisprudence regarding the TELRIC standard in favor of an untested methodology that will endure years of litigation. In addition, the standard has serious economic flaws that will raise prices, drive away investment, reduce innovation and limit competition. Finally, the proposal is blatant results-oriented rulemaking that will not pass muster upon judicial review because the methodology is tantamount to setting a rate which exceeds the authority conferred on the Commission under Section 252.

A. Replacing the Tested and Court Approved TELRIC Methodology with a Results Oriented and Radical Methodology Undermines the Regulatory Stability Necessary to Foster Investment

Sound economic principles require that the reciprocal compensation regime provide competitors and their investors with the proper economic signals that will encourage efficient investment choices. Of course, setting a price far below a carrier's actual costs for terminating traffic will create economic distortions and inefficient investment and entry decisions. Further,

[4] Selwyn Decl. ¶ 46.

departing from the existing TELRIC pricing standard that provides the proper economic signals eliminates the regulatory stability investors seek when choosing markets in which to invest.

The Commission has already been warned that its radical reform proposals threaten to further undermine the already fragile state of investor confidence in the telecom sector. The plan proposed so clearly favors AT&T and Verizon at the expense of the rest of the industry, the only signal provided is that the system is not fair. This will retard investment in an economic climate where investors are already reluctant to part with their money.

The proposal to abandon the TELRIC pricing methodology for terminating charges is illogical. The states and carriers have over a decade of experience working with the TELRIC standard and have already adopted cost based compensation rates predicated on this principle.[5] Further, the courts and regulators have developed "a robust record on virtually all aspects of the TELRIC standard."[6] Implementing a new methodology would lead to years of arbitration and litigation of the mechanics of such a standard, thereby delaying the Commission's broader reform objectives.[7] In contrast, the U.S. Supreme Court has affirmed the Commission's use of the TELRIC standard; there are mounds of district court and appellate court opinions reviewing state implementation of TELRIC. To invite years of litigation and resulting instability is a solution in search of a problem.

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[5] Ex Parte Letter from Eric Einhorn, Windstream Communications, filed Dec. 5, 2008, Attachment at p. 2-3. (noting that the current TELRIC standard is "adequate and has been extensively litigated.").

[6] Declaration of August Ankum and Oleysa Denney, QSI Consulting, attached to Letter from Tamar Finn, Counsel for PAETEC Communications, filed Nov. 26, 2008 at ¶ 20. ("QSI Decl.").

[7] *See* QSI Decl. ¶ 24.

B. The Additional Costs Methodology is Unsound Economically and Will Drive Away Investment

The Commission, in setting forth its proposed additional costs methodology claims that "the financial viability of carriers will not be undermined."[8] Supporters of the Commission's proposed methodology, however, make clear the impact on carriers: carriers will be forced to raise rates to their end users for the right to receive calls originated by the RBOCs' customers — and thus caused by the RBOCs' and their customers.

As AT&T explains, the standard "forces each terminating carrier to *look first to its own end users*" for recovery of the joint and common costs excluded from the additional costs standard.[9] In addition, the standard will compel "most carriers to rely primarily on their own end users for recovery of their network costs."[10] In other words, the burden of these unrecovered costs will fall on the "shoulders of end user customers who will have to pay higher local service rates."[11] Raising rates on end users, however is not the answer. It may be satisfactory for the RBOCs that have huge bases of customers to whom they can spread the costs. For smaller carriers, and especially CLECs, the consequences would be disastrous. CLECs have a smaller base of customers, thus requiring each customer to bear a higher percent of the CLEC's unrecovered costs. These higher rates, in turn, will accelerate customer churn. The resulting reductions in the firm's competitive position in the market will, of course impact the ability to attract capital investors. Spread across the CLEC sector, the Commission's plan to force CLECs to recover their costs from their end users would be a crippling blow.

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8 Proposal A, ¶ 267.

9 AT&T Comments at p. 10 (emphasis in original).

10 AT&T Comments at p. 11.

11 Frontier Comments at p. 17.

Commenters in this proceeding also recognize the role the Commission's compensation methodology plays in influencing investment decisions. As Frontier explains, "[a]bsent efficient pricing of its services, including terminating access services, a firm will not generate the necessary resources to attract and retain investors' capital in the long run."[12] In a competitive market, a carrier must be able to recover the full price economic cost of its service including a portion of the shared and common costs.[13] In other words, without the ability to obtain compensatory prices, a carrier has no incentive to invest and may have an incentive to "abandon the market altogether."[14]

The Commission should abandon the ill fated and unsound additional cost methodology. Even the RBOCs recognize that such a methodology threatens efficiency and investment.[15] Commenters, including economic experts, have observed the same flaws the Telecom Investors observed in their initial comments. Together these flaws lead to terminating rates far below the cost CLECs incur to terminate traffic, making it unlikely that CLECs will recover their investments in the network.

First, the proposed methodology, although it claims to constitute a long run methodology, looks more like a short run methodology and thus is internally inconsistent. While the draft (Proposal A ¶ 244) pays lip service to the need for a long run costing methodology, the proposal instead improperly categorizes certain costs as fixed and "excludes [certain] fixed investment costs altogether."[16] Economic experts comment that the Commission's overarching assumption

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[12] Frontier Comments at p. 15.

[13] Frontier Comments at p. 16.

[14] Frontier Comments at p. 16.

[15] *See* Comments of Broadview et al. at p. 35 (citing RBOC Comments filed in response to the Commission's TELRIC NPRM in Docket No. 03-173).

[16] Selwyn Decl. ¶ 8.

that the cost of terminating traffic is "close to zero,"[17] is plainly inconsistent with the long run costing principles that the proposal espouses. In other words, while claiming to be a long run methodology, by defining away variable costs as fixed, it is actually a short run methodology. QSI, for example, explains that the proposed methodology is closer to a short run methodology because handling the assumed total volume of terminating traffic would require substantial long-term investments.[18] As Dr. Selwyn finds, the draft proposal "virtually eliminates the possibility of any cost variability," the hallmark of the long run costing principle.[19] Dr. Selwyn explains that carrier investments in fiber optic cable, for example, are not fixed, as the Commission's proposal claims, but are variable over the long run. As demand increases, carriers have to augment network capacity, either by deploying additional fiber cable, or investing in upgrading the optical network gear used to transmit traffic over the fiber cable. These are long run costs and that are excluded from the methodology.[20] As Dr. Selwyn explains, the cost to add new fiber capacity is not close to zero as the proposal posits.[21] Instead, the initial fiber investments are based on projections of demand and additional capacity is deployed based on those projections.[22] While the cost to add additional spare capacity to accommodate growth is cheaper at the time of initial deployment, it is wrong to suggest that the cost of the deployment of that additional capacity is close to zero, as the draft suggests.

[17] Proposal A, ¶ 257.

[18] QSI Decl. at pp. 5-6.

[19] Selwyn Decl. ¶ 10.

[20] Selwyn Decl. ¶ 13.

[21] *Id.* ¶ 14.

[22] *Id.*

The draft cost methodology further exacerbates the problem by considering all non-traffic sensitive costs as fixed in the long run.[23] In other words, the incremental cost methodology permits carriers to recover only those incremental costs attributed to call termination that it considers traffic sensitive. Again, the economic experts dispute this proposal as “unreasonably static and unrealistic.”[24] Dr. Selwyn notes that the premise is that softswitch technology costs are not traffic sensitive.[25] He explains, however, that “softswitch technology could well exhibit even greater traffic sensitivity than legacy circuit switching.”[26]

Second, the economic experts found that the exclusion of shared and common costs from the methodology will also prohibit carriers, especially smaller carriers, from recovering the full cost of their network investments used to terminate traffic. Essentially, the proposed methodology establishes an economic construct which requires all services, except traffic termination, to share in the joint and common costs required to provide a groups of services. As Dr. Selwyn observes, if this concept were taken to its logical extreme and applied to all services, than the shared and common costs among all services — not just terminating traffic — would never be recovered.[27] This is patently absurd, as no rational investor would ever invest in a company that could recover its costs of providing services — except for those costs that are shared. Further, this principle, taken to an extreme, appears to encourage carriers to create separate networks for the termination of traffic by other carrier’s customers. Of course this concept is absurd, especially given the drive towards convergence of all services on a single network. It is equally

[23] Proposal A, ¶ 273.

[24] Selwyn Decl. ¶ 16.

[25] *Id.*

[26] *Id.*

[27] Selwyn Decl ¶ 19.

absurd, however, to propose a pricing principle that ignores the trend of convergence by treating the common costs as irrelevant to the service a carrier provides when terminating another carrier's traffic.[28]

The result of each of the flaws in the additional cost methodology is that a CLEC is unable to recover the cost of terminating traffic from the cost causer and must raise its end users' prices instead. If CLECs are unable to recover the costs of their investments then such investments are unlikely to occur. This, of course favors the RBOCs because, in firms with fewer products such as CLECs, unrecovered costs will be a proportionately larger part of those smaller firms' overall costs.[29]

The Telecom Investors further agree with those comments that the methodology amounts to a requirement that carriers subsidize their regulated operations with revenues from unregulated services.[30] Here, carriers would not receive full compensation for the cost of providing the regulated service (termination of another carrier's traffic). Under the proposed framework such carriers would be required to recoup those costs from their end users. For carriers providing other services on their network, such as broadband, the carrier's broadband customers would bear all the joint and common costs that are excluded from terminating rates.[31] The Commission has already established that such subsidies are inconsistent with good public policy.[32]

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[28] QSI Decl. p. 18 (observing that some shared and common costs are reasonably attributable to terminating traffic.).

[29] *See e.g.,* Selwyn Decl. ¶¶ 33-35; QSI Decl. ¶ 41.

[30] *See e.g.,* CenturyTel Comments, filed Nov. 26, 2008, at pp. 21-22.

[31] *See e.g.,* Ex Parte Letter from Eric Einhorn, Windstream to Marlene Dortch, Dec. 5, 2008, Attachment at pp. 1-2.

[32] *Federal State Joint Board on Universal Service*, 12 FCC Rcd 8776 ¶ 17 (1997) ("In a competitive market, a carrier that attempts to charge rates significantly above cost to a class of customers will lose many of those customers to a competitor.").

More importantly such a regime is not sustainable in competitive markets. As the Commission is aware, prices in competitive markets are set by the market. If a carrier must price its service above the market price in order to recover its joint and common costs, its service simply will not sell. The unregulated service, broadband for example, would not be priced efficiently and would cause the carrier to exit the market for that service. In some cases, depending on what other services shared the joint and common costs, the carrier might be forced to exit the market completely due to an inability to recover its network costs.

The chill on investment has additional negative consequences. It is obvious that CLECs that cannot recover the costs of their investments necessary for the termination of traffic are unlikely to have access to capital to make those investments. But those investments are also necessary for the deployment of broadband service. Thus, mandating a below-cost rate would discourage the facilities investment that is necessary for carriers to bring more advanced broadband services to a wider swath of customers.[33] Moreover, if investors understand that carriers are unable to recover the costs of their investments from the services those investments support, the investors are unlikely to provide the required capital and will inevitably direct their capital to other investments where a return on the full investment is more likely. The resulting economic distortions will impede efficiency, chill investment, and hinder CLECs' ability to compete with the larger more diverse RBOCs.

C. The Additional Costs Standard is Impermissible Results Oriented Rulemaking

The proposed methodology is obviously designed to favor the RBOC goal of reducing intercarrier payments to an amount as close as possible to zero, consistent with the RBOC agenda.

[33] *See e.g.*, Windstream Comments at pp. 33-34 (commenting that when a carrier's available revenues are reduced there is less incentive to devote already scarce capital to new investment intensive projects).

As commenters have noted this is the RBOC goal because the large multi-product RBOCs now "transfer more traffic to CLECs for termination than occurs in the opposite direction."[34] Verizon, for example, continues to insist, despite the overwhelming objections to its proposal, that the Commission simply adopt a uniform, national rate of .0007.[35] The proposal, however, while recognizing the limits on its authority by not clearly establishing a rate, has crossed the boundary between setting a rate methodology and setting a rate.

The draft proposal repeats its belief, without sufficient support, that the rate for terminating traffic should be close to zero. As the Telecom Investors observed in their initial comments, this concept is wrong and is inconsistent with previous Commission decisions. Nonetheless, the proposal forges ahead with a methodology so restrictive it is tantamount to setting a rate, which the Eighth Circuit and Supreme Court have indicated is outside the scope of the Commission's authority.[36]

Even commenters that prefer the additional cost methodology agree that the proposed methodology is more rate setting than a rate methodology. The Ohio Commission, for example, while indicating it supports the additional cost methodology, recognizes the advantages and efficiencies of using TELRIC because it is an "established, well developed method, which had already been approved by the Supreme Court."[37] The Ohio Commission further acknowledges the problems with the obvious attempt to force states to adopt a single rate of .0007. In particular, the Ohio Commission observes that the application of the proposed methodology

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[34] Selwyn Decl. ¶ 4.

[35] Verizon Comments at p. 52.

[36] *See AT&T v. Iowa Utils. Bd.*, 525 U.S. 366, 384 (1999); *Iowa Utils. Bd. v. FCC*, 219 F.3d 744, 756-57 (8th Cir. 2000), *aff'd in part and rev'd in part, Verizon Comm's, Inc. v. FCC,* 535 U.S. 467 (2002), *and vacated in part, Iowa Utils. Bd. v. FCC*, 301 F.3d 957 (8th Cir. 2002).

[37] Ohio Commission Comments at p. 50.

> makes all other proposed principles (i.e. cost-based, incremental cost, statutory requirement of 'additional cost,' numerous state commission proceedings) hollow. It is not clear what would be the goal or the value of holding a costly and time consuming proceeding involving a state commission and all carriers in the state, to develop a cost-based uniform state-wide reciprocal compensation rate, if the outcome is predetermined.[38]

In other words, the proposed additional cost methodology "opportunistically turns proper cost methodology concepts on their head to achieve a desired outcome."[39]

CONCLUSION

For the aforementioned reasons, the Telecom Investors urge the Commission not to adopt any reforms to the intercarrier compensation framework that jeopardize the regulatory stability necessary to encourage further investment in competitive telecommunications networks and to ensure that any such reforms are implemented in a competitively neutral and fair manner. To that end it is critical that the commission retain TELRIC for setting Section 251(b)(5) termination rates and reject the proposed additional costs standard.

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[38] Ohio Commission Comments at p. 52.

[39] QSI Decl. ¶ 13.

Respectfully submitted,

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