BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO. 000075-TP

In the Matter of

INVESTIGATION INTO APPROPRIATE METHODS TO COMPENSATE CARRIERS FOR EXCHANGE OF TRAFFIC SUBJECT TO SECTION 251 OF THE TELECOMMUNICATIONS ACT OF 1996.

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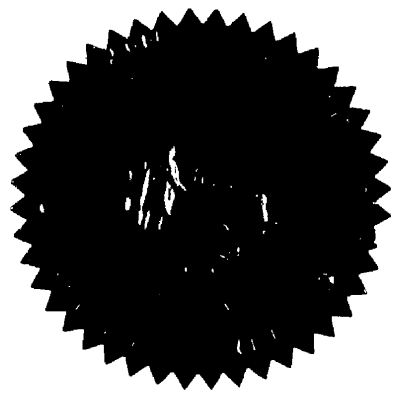

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VOLUME 6
PAGES 761 THROUGH 923

PROCEEDINGS:	HEARING
BEFORE:	CHAIRMAN E. LEON JACOBS, JR. COMMISSIONER J. TERRY DEASON COMMISSIONER LILA A. JABER COMMISSIONER BRAULIO L. BAEZ COMMISSIONER MICHAEL A. PALECKI
DATE:	Thursday, March 8, 2001
TIME:	Commenced at 9:00 a.m. Concluded at 6:05 p.m.
PLACE:	Betty Easley Conference Center Room 148 4075 Esplanade Way Tallahassee, Florida
REPORTED BY:	JANE FAUROT, RPR FPSC Division of Records & Reporting Chief, Bureau of Reporting
APPEARANCES:	(As heretofore noted.)

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WITNESSES

EXHIBITS

PROCEEDINGS

(Transcript follows in sequence from Volume 5.)

CHAIRMAN JACOBS: Go back on the record.

MR. EDENFIELD: Famous last words, but I think we are looking good for finishing relatively close to 5:00 o'clock.

CHAIRMAN JACOBS: Excellent. Now, Mr. Taylor, I'm sorry.

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WILLIAM E. TAYLOR, PH.D

was called as a witness on behalf of BellSouth Telecommunications, Inc. and, having been duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. EDENFIELD:

Q Doctor Taylor, would you confirm that we were previously sworn, please?

A Yes, I was.

Q State your name and employer for the record, please?

A My name is William E. Taylor, I am employed by National Economic Research Associates, Inc.

Q Are you the same William Taylor that caused to be filed in this proceeding 55 pages of rebuttal testimony?

A Yes.

Q Do you have any changes to that testimony?

A No, I don't.

MR. EDENFIELD: At this point, Chairman Jacobs, I would ask that Doctor Taylor's testimony be inserted into the record as if read.

CHAIRMAN JACOBS: Without objection show Mr. Taylor's rebuttal testimony into the record.

BY MR. EDENFIELD:

Q Doctor Taylor, did you have any exhibits?

A Yes, I believe I had -- my vitae was one exhibit.

MR. EDENFIELD: We would at this time ask that Doctor Taylor's exhibit be marked for identification as 26.

CHAIRMAN JACOBS: Yes. Show it marked as Exhibit 26.

(Exhibit 26 marked for identification.)

ON BEHALF OF BELLSOUTH TELECOMMUNICATIONS, INC.

REBUTTAL TESTIMONY OF WILLIAM E. TAYLOR, Ph.D.

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO. 000075-TP

JANUARY 10, 2001

I. INTRODUCTION AND SUMMARY

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND CURRENT POSITION.

A. My name is William E. Taylor. I am Senior Vice President of National Economic Research Associates, Inc. ("NERA"), head of its Communications Practice, and head of its Cambridge office located at One Main Street, Cambridge, Massachusetts 02142.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL, PROFESSIONAL, AND BUSINESS EXPERIENCE.

A. I have been an economist for over twenty-five years. I earned a Bachelor of Arts degree from Harvard College in 1968, a Master of Arts degree in Statistics from the University of California at Berkeley in 1970, and a Ph.D. from Berkeley in 1974, specializing in Industrial Organization and Econometrics. For the past twenty-five years, I have taught and published research in the areas of microeconomics, theoretical and applied econometrics, which is the study of statistical methods applied to economic data, and telecommunications policy at academic and research institutions. Specifically, I have taught at the Economics Departments of Cornell University, the Catholic University of Louvain in Belgium, and the Massachusetts Institute of Technology. I have also conducted research at Bell Laboratories and Bell Communications Research, Inc.

I have participated in telecommunications regulatory proceedings before several state public service commissions, including the Florida Public Service Commission ("Commission") in Docket Nos. 900633-TL, 920260-TL, 920385-TL, 980000-SP, 980696-TP, and 990750-TP. In addition, I have filed testimony before the Federal

Communications Commission ("FCC") and the Canadian Radio-television Telecommunications Commission on matters concerning incentive regulation, price cap regulation, productivity, access charges, local competition, interLATA competition, interconnection and pricing for economic efficiency. Recently, I was chosen by the Mexican Federal Telecommunications Commission and Telefonos de Mexico ("Telmex") to arbitrate the renewal of the Telmex price cap plan in Mexico.

I have also testified on market power and antitrust issues in federal court. In recent work years, I have studied—and testified on—the competitive effects of mergers among major telecommunications firms and of vertical integration and interconnection of telecommunications networks.

Finally, I have appeared as a telecommunications commentator on PBS Radio and on The News Hour with Jim Lehrer. My curriculum vita is attached as Exhibit WET-1.

Q. PLEASE DESCRIBE NERA, YOUR PLACE OF EMPLOYMENT.

A. Founded in 1961, National Economic Research Associates or NERA is an internationally known economic consulting firm. It specializes in devising economic solutions to problems involving competition, regulation, finance, and public policy. Currently, NERA has more than 275 professionals (mostly highly experienced and credentialed economists) with 10 offices in the U.S. and overseas offices in Europe (London and Madrid) and Sydney, Australia. In addition, NERA has on staff several internationally renowned academic economists as Special Consultants who provide their professional expertise and testimony when called upon.

The Communications Practice, of which I am the head, is a major part of NERA. For over 30 years, it has advised a large number of communications firms both within and outside the U.S. Those include several of the regional Bell companies and their subsidiaries, independent telephone companies, cable companies, and telephone operations abroad (e.g., Canada, Mexico, Europe, Japan and East Asia, Australia, and South America). In addition, this practice has supported a large number of legal firms and the clients they represent, and routinely provided testimony or other input to governmental

entities like the FCC, the Department of Justice, the U.S. Congress, several state regulatory commissions, foreign regulatory commissions, and courts of law. Other clients include industry forums like the Unites States Telephone Association.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I have been asked by BellSouth Telecommunications, Inc. ("BellSouth")—an incumbent local exchange carrier ("ILEC")—to address economic issues raised in the testimonies of witnesses representing several alternative local exchange carriers ("ALECs") in this proceeding. To this end, I review and comment on the testimonies of Lee L. Selwyn (representing AT&T Communications of the Southern States, Inc., TCG of South Florida, Global NAPS, Inc., MediaOne Florida Telecommunications, Inc., Time Warner Telecom of Florida, LP, Allegiance Telecom of Florida, Inc., Florida Cable Telecommunications Association, Inc., and Florida Competitive Carriers Association, Michael R. Hunsucker (representing Sprint Corporation or "Sprint"), and James C. Falvey (representing e.spire Communications, Inc. or "e.spire").

Q. PLEASE SUMMARIZE YOUR RESPONSE TO THE POSITIONS TAKEN BY WITNESSES REPRESENTING ALECS IN THIS PROCEEDING.

A. My response to the testimony of ALEC witnesses is summarized as follows:

1. The ALEC witnesses contend that the jurisdictional status of Internet-bound traffic is no different from that of local voice traffic and, therefore, the only form of inter-carrier compensation that should apply to it is reciprocal compensation. This is false. While the FCC's jurisdictional analysis based on the endpoints of the communication inherent in Internet calls is correct, the fundamental economic principle of cost causation reinforces the conclusion that the transmission of Internet-bound calls between local exchange carriers is analogous not so much to the exchange of local voice calls as to the transmission of long distance calls. The ILEC subscriber that calls the Internet does so as a customer of the ISP from which he or she obtains Internet access, not of the ILEC itself. The ALEC witnesses pay lip service to cost causation but fail to correctly apply the principle in their analysis.

2. The ALEC witnesses assert that Internet-bound traffic and local voice traffic are, in effect, functionally or "technically" identical. Therefore, they argue, reciprocal compensation ought to apply to Internet-bound traffic just as it does for local voice traffic. This is false. For determining who should compensate whom, it is irrelevant

how a service is used, what facilities are used to provide the service, or how much cost is generated. What matters only is how cost is generated. The answer to this question comes from the cost causation principle which traces the cost of the Internet-bound call from its source (the economic decision) to its incidence. Also, the costs of transporting and switching traffic are not determined by what network elements are used; rather, they are determined by how the network elements are used. Therefore, although the facilities used to transport and switch an Internet-bound call may be similar to those used to transport and switch local voice calls, there are characteristics of Internet-bound traffic that make its incremental cost of transport and switching (as measured by TELRIC) different from that for local voice traffic.

3. The ALEC witnesses contend that ISPs are no different from any other end-user; therefore, Internet-bound calls are no different from local voice calls and must be eligible for reciprocal compensation. This is false. ISPs are not legitimate end-users but carriers that exist solely to perform the carrier functions that establish a pathway between the Internet user and Internet destinations. The efficient form of inter-carrier compensation for Internet-bound traffic is a usage-based charge (analogous to the carrier access charge) assessed on the ISP by the ALEC serving it. The ALEC and ILEC would then defray their respective costs from ISP payments of that charge. Because of a longstanding FCC exemption from such charges on the class of carriers to which ISPs belong, the second-best cost causative policy is an equitable sharing (between the ALEC and the ILEC) of local exchange revenues earned from ISPs who purchase/lease lines out of local exchange tariffs for the purpose of receiving incoming Internet-bound traffic. Bill-and-keep is the next best option for inter-carrier compensation. Reciprocal compensation at a positive rate (particularly that set for the exchange of local voice traffic) should not be an option at all.

4. The ALEC witnesses insist that inter-carrier compensation for Internet-bound traffic should occur in the form of a reciprocal compensation rate which is (1) symmetric (i.e., the same for both the ILEC and the ALEC) and (2) set at the cost of the ILEC to terminate a local voice call. This recommendation is flawed for several reasons. First, this form of compensation is not based on cost causation. Second, the ILEC's incremental cost to terminate a local voice call may differ significantly from (indeed, be significantly higher than) an ALEC's cost to switch or deliver an Internet-bound call to an ISP, particularly if the ALEC is designed solely to receive (and deliver to ISPs) incoming Internet-bound calls from the ILEC's subscribers. Third, for an ALEC that has a much lower incremental cost to deliver Internet-bound calls to ISPs, a symmetric reciprocal compensation rate set at the level of the ILEC's incremental cost to terminate a local voice call provides a windfall profit margin. Other things being equal, this can further stimulate the ALEC to specialize in call termination services, to the detriment of the overall public policy goal of fostering competition for the full spectrum of local exchange services.

5. The ALEC witnesses provide examples of states that have affirmed reciprocal compensation for Internet-bound traffic. This is a one-sided presentation of the facts.

Almost every state that has retained reciprocal compensation for this purpose has done so by making the determination that an Internet-bound call is jurisdictionally local. At least seven states have ruled that, to the contrary, reciprocal compensation does not apply to Internet-bound traffic. In so doing, they have touched upon various aspects of Internet calls. Without actually deciding whether such calls are local or long distance, some of these states have rejected reciprocal compensation on the basis of detailed economic analyses (of the sort presented in this testimony). Some have opted for bill-and-keep while others are waiting for the expected FCC ruling on a permanent form of inter-carrier compensation for Internet-bound traffic.

6. The ALEC witnesses contend that reciprocal compensation at a symmetric rate for Internet-bound traffic ensures efficient entry and competition and determines the technologies that ALEC entrants adopt and the services they provide. This conveys a misleading picture because such compensation can harm economic efficiency in at least three ways: (1) by inefficient subsidization of Internet users by non-users, (2) by distorting the local exchange market itself and skewing competitive entry towards specialization in call termination services (i.e., serving ISPs), and (3) creating perverse incentives to arbitrage the system at the expense of basic exchange ratepayers, thereby enriching entrants and rewarding rent-seeking behavior.

II. INTER-CARRIER COMPENSATION FOR INTERNET-BOUND CALLS

1. Internet-Bound Traffic: Is it Analogous to Local or Long Distance Traffic? (*Issue 2*)

Q. SOME ALEC WITNESSES [HUNSUCKER, AT 9-10; FALVEY, AT 4; SELWYN, AT 7 AND 18] TAKE THE POSITION THAT INTERNET-BOUND CALLS ARE LOCAL CALLS AND RECIPROCAL COMPENSATION SHOULD BE CONTINUED TO BE PAID FOR SUCH CALLS. DO YOU AGREE?

A. No, for two reasons. First, as the FCC has already correctly determined, calls made to Internet destinations are more likely to be jurisdictionally interstate than local.[1] Second, the cost causation principle implies that the relationship between the end-user and the ISP is analogous to that between the end-user and an inter-exchange carrier ("IXC").

[1] FCC, *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996* and *Inter-Carrier Compensation for ISP-Bound Traffic*, CC Docket Nos. 96-98 and 99-68, Declaratory Ruling in CC Docket No. 96-98 and Notice of Proposed Rulemaking in CC Docket No. 99-68 ("*ISP Declaratory Ruling*"), released February 26, 1999.

Therefore, ideally, the ISP should be required to pay usage-based charges to the ILEC and/or ALEC akin to the access charges currently paid by IXCs to the ILEC for all long distance calls carried.

Q. PLEASE EXPLAIN THE FCC'S FINDING THAT INTERNET-BOUND CALLS ARE JURISDICTIONALLY MORE LIKELY TO BE INTERSTATE.

A. This finding has been discussed in depth by BellSouth witness Beth Shiroishi (Direct Testimony, at 3-7). I note briefly here the FCC's stated view that the jurisdictional nature of communications has traditionally been determined by the *end points* of the communication, not by intermediate points of switching or exchanges between carriers.[2] More importantly, based on this premise, the FCC explained that calls made to the Internet do not terminate at the ISP's local server (in the sense a local voice call terminates at a carrier's switch) but, rather, continue on to Internet destinations that are frequently located in other states.

The FCC also noted that while jurisdiction is determined unambiguously when a call originates and terminates entirely within the circuit-switched network, it is a very different matter when the call crosses over from the circuit-switched network into the packet-switched network (that comprises the Internet's backbone network and Internet web sites) along the way to its destination.[3] This distinction is particularly important because the packet-switched network is a "connectionless" network in which termination, in the sense understood within the circuit-switched network, technically does not happen. For example, before it is over, the same Internet call may reach several destination points on the Internet. Also, calls are switched or, more accurately, "routed" over the packet-switched network in a dynamic manner. This means that the Internet call, rearranged in the form of data packets of given length, are sent in a scrambled manner along different available paths within the backbone network, and the "call" is then reconstituted when all of the packets

[2] *ISP Declaratory Ruling*, ¶10.

[3] *ISP Declaratory Ruling*, ¶18.

reach the intended Internet destination. This method of transport and routing is nothing like the termination that occurs within the circuit-switched network where, for every call originated and terminated, a dedicated call path is established for the duration of the call. These crucial differences make it all the more likely that an Internet call will cross several state boundaries—and in a random manner—before it reaches its destination. At best, such a call would be "jurisdictionally mixed," as the FCC has already correctly determined.

Q. IS IT ACCURATE TO CHARACTERIZE THIS VIEW OF THE INTERNET CALL AS ONE ONLY PROPAGATED BY SELF-INTERESTED ILECS?

A. Not at all. Dr. Selwyn [at 25-26] claims:

> This shows that there is no merit to the ILEC suggestion that an end-user's call to an ISP does not really "terminate" with the ISP, but instead in some mythical sense "continues" on into the Internet. ... Put bluntly, however one might fairly characterize what it is that "continues" on into the Internet, it is certainly not the end-user's "call." That call "terminates" (in the sense of the FCC's rules) at the end office switch serving the ISP, and "terminates" (in a more colloquial sense) at the ISP's CPE...

As is evident from its own consideration of this issue, the FCC (not just ILECs) does not share Dr. Selwyn's fractured analysis. Even following the DC Circuit Court of Appeals' remand of the *ISP Declaratory Ruling* back to the FCC for a better explanation of its conclusions about the nature of Internet-bound traffic, the Chief of the Carrier Common Bureau at the FCC publicly reaffirmed the view of such traffic first articulated in the *ISP Declaratory Ruling*. Ms. Shiroishi's Direct Testimony also documents other instances in which the FCC concluded that the service provided by a local exchange carrier to an ISP is exchange access, rather than local exchange, and that calls to the Internet typically cross state jurisdictional boundaries before terminating at Internet websites.

Q. AMONG THE ALEC WITNESSES, ONLY DR. SELWYN APPEARS TO RAISE [AT 28] THE ISSUE OF COST CAUSATION IN THE ANALYSIS OF INTER-CARRIER COMPENSATION FOR INTERNET-BOUND TRAFFIC. HOW IS IT GERMANE TO THE ISSUE AND DOES DR. SELWYN HAVE IT RIGHT?

A. Cost causation is *the* fundamental economic foundation for devising any mechanism of

inter-carrier compensation under arrangements of network interconnection. Accordingly, my testimony places great emphasis on employing the cost causation principle correctly. It also demonstrates why the form of inter-carrier compensation for Internet-bound traffic being advocated by the ALEC witnesses, namely, reciprocal compensation, violates the cost causation principle.

Dr. Selwyn is correct to say that the end-user that originates an Internet call is the cost-causer. However, he errs in failing to properly and fully consider the carrier's role in the end-user's exercise (in Dr. Selwyn's words) of "free will in deciding to place the call." The ISP that offers Internet access service acts as the cost-causing end-user's *agent* in an economic decision (the Internet call) that gives rise to the cost. As I explain in this testimony, this is exactly analogous to the ILEC's role as the end-user's agent in the decision to make a local voice call and the IXC's role as the agent in the decision to make a long distance call.

Q. PLEASE EXPLAIN HOW COST CAUSATION DETERMINES THAT ISPs ARE ANALOGOUS TO IXCs AND SHOULD, IDEALLY, PAY CHARGES THAT ARE ANALOGOUS TO ACCESS CHARGES.

A. To understand this point, it is first necessary to understand the economic principle of cost causation itself. According to this principle, the cost that arises from any economic decision must be recovered from its source; only by doing so, are resources allocated efficiently (i.e., put to their best uses), consumers pay fully for the value of resources they consume, and suppliers are fully compensated for the cost of resources they expend in order to meet consumption demand.

Next, it is necessary to recapitulate the erroneous view of the network that underlies many ALECs' belief (including those in this proceeding) that an Internet call is jurisdictionally local. Implicit in this erroneous view are two crucial assumptions:

1. The ILEC subscriber that calls the Internet is acting as a *customer* of the originating

ILEC,[4] even when the call goes through the ISP to which he or she pays a monthly access fee.[5]

2. The ISP itself is not a carrier but an end-user of the ALEC that terminates the Internet call for the ISP.

These assumptions are epitomized by the following assertions by Mr. Falvey and Dr. Selwyn, respectively:

> ... when a Verizon end-user places a local call to an end-user served by e.spire, e.spire terminates the call originated by Verizon and provides the same functionality to Verizon, regardless of whether the Verizon end-user dials an ISP or any other e.spire local services end-user. Thus, the compensation mechanism—reciprocal compensation at Commission-approved cost-based rates—for the transport and termination of local traffic, should be the same. Both calls use the same path and the same equipment to reach their ultimate destination.[6]

and

> ... while I'm not an attorney and do not offer a legal opinion, in my view ISPs, unlike IXCs, are distinctly not telecommunications carriers as defined under current law. Rather, ISPs are themselves end-user customers of telecommunications carriers, and are thus entitled to exactly the same treatment as any other end-user customer.[7]

The first statement confirms the predominant ALEC view that the cost of an Internet-bound call made by the ILEC's subscriber must be recovered from the ILEC, just as cost is recovered for a local voice call made by that ILEC subscriber. The second statement reflects the ALEC view that an ISP is just another end-user.

Under these assumptions, the ILEC subscriber that makes the Internet call appears to be an end-user of the originating ILEC (paying local residential rates for line charges) and

[4] I distinguish here between a "subscriber" and a "customer" in order to show cost causation. I subscribe to my local carrier in order to have *access* to the public switched network, but I act as a customer of that local carrier in order to *use* Call Waiting service or as a customer of a long distance carrier in order to *use* interstate long distance service. When I am a customer of the local carrier, I cause usage-based cost for that carrier. Similarly, I cause cost for the long distance carrier when I use *its* long distance service.

[5] The ISP is assumed to have a point of presence in the local calling area of the Internet caller.

[6] Direct testimony of James C. Falvey, at 9.

[7] Direct testimony of Lee L. Selwyn, at 21.

the ISP appears to be an end-user of the terminating ALEC (paying local business rates for line charges). The monthly Internet access charges paid by the ILEC subscriber to the ISP and the leased high-speed line charges paid by the ISP to Internet backbone networks are only incidental to this model and have no further role in determining jurisdiction. In this view of the network, therefore, the portion of the Internet call that lies entirely within the circuit-switched network, i.e., up to the ISP, resembles a local call under an interconnection arrangement between two local carriers. From this it would appear that the ALEC that terminates the Internet-bound call is entitled to reciprocal compensation under the FCC's rules.

This conclusion is fundamentally incorrect because it ignores cost causation, specifically, that the ILEC subscriber that makes the Internet call does so *while acting as a customer of the ISP* to which it pays monthly fees for Internet access and which, in return, markets directly to the customer and provides a point of presence in the customer's local calling area in order to provide easy access. Thus, the same subscriber that acts in the capacity of a customer of the originating ILEC when making a local voice call is seen to act in the capacity of a customer of the ISP when making an Internet call. This situation is not an unfamiliar one; in fact, it is exactly analogous to the subscriber acting in the capacity of a customer of an IXC when making a long distance call.

This analogy—and the proper cost causation view of Internet calling—rests on two different assumptions:

1. The ILEC subscriber that calls the Internet is acting as a customer of the ISP to which he or she pays a monthly access fee, even though the call is facilitated by both the originating ILEC and the ALEC serving the ISP.
2. The ISP is viewed as a carrier—akin to an enhanced service provider ("ESP")—that routes the Internet call through the backbone network to its final destination. The ISP performs standard carrier functions such as transport and routing, as well as maintains leased facilities within the backbone network.

These assumptions appropriately depict the Internet-bound call as being much closer in character to an interstate long distance call than to a local call that is contained entirely within the local calling area. They also dispel the notion (such as that expressed by Dr. Selwyn, at 26) that an Internet-bound call is really two calls: the first call ending at the

ALEC serving the ISP, and the second call routed by the ISP through the backbone network to its Internet destination. Indeed, it is quite evident from Dr. Selwyn's testimony that he regards an Internet-bound *call* as equivalent to Internet *access* through the ISP. These are really two completely different entities.

Q. BUT, FROM A CUSTOMER'S PERSPECTIVE, DON'T LOCAL VOICE CALLS AND INTERNET-BOUND CALLS MADE THROUGH ISPS ACCESSIBLE THROUGH LOCAL NUMBERS BOTH APPEAR TO BE "LOCAL" CALLS?

A. Yes, but that mere appearance is not sufficient grounds—from an economic perspective—to designate them both "local" calls or institute reciprocal compensation for both. It is perfectly possible, indeed commonplace, for Internet access (through an ISP) to occur by dialing "local" or seven-digit numbers; indeed, it would seem, that is what leads Dr. Selwyn to make the following unqualified assertion [at 44]:

> From the consumer's perspective, there is no distinction between a local call placed to an ISP and a local call placed to a neighbor; both are dialed in the same manner, priced in the same manner, and are included or not included in the consumer's local calling area on exactly the same basis. In economic terms, ISP-bound calls—specifically the portion of the call that is carried over the local public switched telephone network from the originating caller to the ISP—are "local" in nature and are fully embraced within the applicable state tariffs covering local exchange service.

That ISPs should provide Internet *access* to their customers through local number dialing is neither surprising nor dispositive of the true status of an Internet-bound call: competition among them inevitably drives ISPs to making Internet access as convenient as possible to their customers. However, that is quite different from the fact that the end-to-end Internet call crosses state and jurisdictional boundaries with a very high likelihood. Dr. Selwyn misses three essential points completely.

1. Local or seven-digit dialing does not automatically make the call jurisdictionally local. Firms may use foreign exchange ("FX") lines to haul traffic from considerable distances while still offering service to their customers for the price of a local call.
2. Internet users do not place calls to the ISP; rather, they call Internet destinations. The ISP merely facilitates *access* to those destinations through the packet-switched network. In every regard, ISPs are carriers that facilitate the completion of end-to-end Internet

calls; the Internet access they provide are not *ends* in themselves. Unfortunately, regarding ISPs as "end-users" for the purpose of the access charge exemption (provided by the FCC in order to support an infant Internet "industry" rather than because Internet calls are local) completely clouds this all-important distinction.

3. The *customer's* perspective, such as it is, cannot possibly serve as the basis for determining the efficient form of inter-carrier compensation for Internet-bound traffic. Rather, what matters is solely how cost is caused. As I explained above, cost is caused differently for an Internet-bound call than for a local voice call.

Q. HOW DOES THE COST CAUSATION PRINCIPLE LEAD TO AN EFFICIENT INTER-CARRIER COMPENSATION MECHANISM FOR INTERNET-BOUND CALLS THAT IS DIFFERENT FROM THAT ADVOCATED BY THE ALEC WITNESSES?

A. The cost causation principle implies that, *for the purposes of an Internet call*, the subscriber is properly viewed as a customer of the ISP, not of the originating ILEC (or even of the ALEC serving the ISP). The ILEC and the ALEC simply provide access-like functions to help the Internet call on its way, just as they might provide originating or terminating carrier access to help an IXC carry an interstate long distance call. Therefore, with the proper network model being analogous to ILEC-IXC interconnection (access), rather than to ILEC-ALEC interconnection, the proper form of inter-carrier compensation should ideally be usage-based charges analogous (but necessarily equivalent) to carrier access charges for long distance calls, rather than reciprocal compensation.

Q. PLEASE EXPLAIN THE CONTRAST BETWEEN THESE TWO "MODELS" OF INTERCONNECTION IN MORE DETAIL.

A. ***ILEC-ALEC Interconnection Model.*** When a BellSouth subscriber places a local call that terminates to an ALEC subscriber, what functions does BellSouth perform? Obviously, it originates the call, providing dialtone, local switching, and transport to the ALEC's point of interconnection. In addition, BellSouth has marketed the service to its subscriber (and customer of local calls), determining the price and price structure and other terms and conditions under which the customer decides to place the call. BellSouth will determine if the call has been completed, bill the customer for the call (if measured service applies) or

for flat-rate service, answer questions regarding the bill or the service and collect money from the customer or lose the revenue if it is unable to collect from the customer. The story is precisely symmetric if the originating party is an ALEC customer and BellSouth or another ALEC terminates the call.

Thus, under ILEC-ALEC interconnection, the originating subscriber is the cost-causing party and is the customer of the originating ILEC. That originating ILEC charges its cost-causing customer for the entire end-to-end call and compensates the ALEC that terminates the call. The originating ILEC's network costs plus the compensation it pays is—in theory—recovered from the local call charge it levies on its (originating) customer. The terminating ALEC's costs are recovered from the compensation payment it receives from the originating ILEC. In this arrangement, both parties recover their costs, and the cost-causer is (again, in principle) billed for the entire cost he or she causes both carriers to incur. Thus, this arrangement is not an arbitrary regulatory or legal construction: for local interconnection between an ILEC and an ALEC, it makes economic sense. It could arise spontaneously in unregulated competitive markets where the ILEC serving the originating subscriber acts effectively as its agent in making necessary network and financial arrangements with an ALEC to terminate the call, just as General Motors may purchase goods or services from Ford or Bendix to include in an automobile purchased by a General Motors customer.

ILEC-IXC Interconnection Model. In contrast, when a BellSouth subscriber places a long distance call using, e.g., AT&T, BellSouth's function is limited to recognizing the carrier code (or implementing presubscription in its switch) and switching and transporting the call to AT&T's point of presence. While at some level, the functions its network performs are similar to those used to deliver local traffic to an ALEC[8], the *economic* functions are very different. It is AT&T that has marketed the service to its customer, determined the price and price structure and other terms and conditions of the call. AT&T

[8] BellSouth supplies the customer's loop and provides dialtone, local switching, and transport to AT&T's point of presence.

will send, explain, and collect the bill from the customer or lose the revenue if it cannot. Thus, under ILEC-IXC interconnection, the originating subscriber is, from an economic perspective, the customer of the IXC, not the originating ILEC.

When an ILEC (or ALEC) subscriber places long distance calls, he acts as a cost-causing customer of the IXC. The ILEC subscriber, acting as an IXC customer, causes costs at various points in the networks involved: for the ILECs/ALECs that originate and terminate the long distance call, as well as for the IXC that transports it between local exchanges. The IXC receives revenue from the customer which it uses, in turn, to pay originating and terminating access charges to the ILECs/ALECs involved and to cover its own network and administration costs. In effect, the IXC acts as its customer's agent in assembling the necessary local exchange components of the call. The ILECs/ALECs involved recover their costs from access charges. If more than one such carrier is involved in delivering the call from the end-user to the IXC, they typically divide the access charges paid by the IXC in proportion to the costs incurred to provision the access portion of the call. Thus, in principle, the cost-causing customer faces a price that reflects all of the costs the call engenders, and all parties that incur costs to provision the call have a claim on the cost-causer's payment.

Thus, from an economic perspective, ILEC-IXC interconnection and ILEC-ALEC interconnection have fundamentally similar characteristics but the actors play different economic roles. In both cases, the originating ILEC subscriber is the cost-causer, and it pays its supplier (the party with whom it has contracted for service) for the end-to-end service it receives in both regimes. The difference is that in the ILEC-ALEC local interconnection regime, the cost-causer is acting as the customer of the originating ILEC, while in the ILEC-IXC regime, the cost-causer acts as the customer of the IXC. This is a significant conclusion because it properly identifies the customer-supplier relationship in each case.[9]

[9] This contrasts with Dr. Selwyn's conclusion [at 19] that "Under the access charge model, the customer of the ILEC is the IXC, not the originator of a long distance call." In that model, the proper customer-supplier or

(continued...)

Q. WHY DOES ILEC-ALEC-ISP INTERCONNECTION RESEMBLE THAT BETWEEN THE ILEC AND THE IXC BUT NOT THAT BETWEEN THE ILEC AND THE ALEC?

A. The question at issue is when multiple ILECs/ALECs combine to deliver traffic to an ISP, are they interconnecting in an ILEC-ALEC local interconnection regime or something analogous to an ILEC-IXC interstate access charge regime? The FCC has characterized the link from an end-user to an ISP as an *interstate* access service and, absent other considerations, ISPs would be subject to usage-based charges analogous to interstate access charges. However, the FCC concluded as far back as 1983 that ESPs (which, today, would include ISPs) are "among a variety of users of access service" in that they "obtain local exchange services or facilities which are used, in part or in whole, for the purpose of completing interstate calls."[10]

The service provided by an ISP exists to enable the ISP's customers to access information and information-related services stored on special computers or web servers at various locations around the world. The ISP typically facilitates such access by selling a flat-rated monthly or yearly Internet access service that, in most cases, calls for that ISP customer to make only a local call in order to reach the ISP's modems. Besides price, ISPs compete on the extent of geographic coverage, specifically, the number of local calling areas they can offer to ISP customers as possible points of connection ("POCs"), as well as on various components of service quality including provision of specialized information

(...continued)

retail relationship remains that between the originating end-user and the IXC. The fact that an IXC may purchase switched access (a wholesale service) from an ILEC or ALEC is irrelevant to this issue and does not alter the path of cost causation. In fact, that path remains unaltered even when the IXC provides a direct (special access) connection to its long distance customer and bypasses the ILEC's (or ALEC's) switches completely. Similarly, the customer-supplier relationship between the originating end-user and the ISP remains unchanged when there is a direct (digital subscriber line) connection between them that bypasses the ILEC's and ALEC's switches.

[10] FCC, *In Re: MTS and WATS Market Structure*, CC Docket No. 78-72, Memorandum Opinion and Order ("*MTS/WATS Order*"), 1983.

services.[11] The ISP markets directly to the originating ILEC's subscriber, attempting to maximize its number of customers and the amount of traffic *incoming* to it by publishing and advertising as many local calling numbers (at its POCs) as possible, and doing everything within its power to help the potential customer avoid having to incur per-minute or toll charges to have Internet access. If necessary, ISPs may use FX lines to haul Internet traffic from considerable distances while still offering Internet access service for the price of a local call.[12] Some ISPs offer 800 service for their customers to access their network when flat-rate local calling is unavailable, although there are some which impose a per-minute charge on the subscriber for such access. Some ISPs maintain Internet gateways for their customers and earn revenue from advertisers that depend more or less directly on the number of customers and the number of times its customers access advertised sites. The ISP bills its customers for their access and usage, and it is the ISP that loses money if it cannot collect from them. From an economic perspective, then, the party that causes the cost associated with Internet-bound traffic is the originating ILEC's subscriber who acts in the capacity of an ISP customer. In this sense, Internet-bound traffic has the same characteristics as IXC-bound traffic in the ILEC-IXC regime and has characteristics opposite to ALEC-bound traffic in the ILEC-ALEC local interconnection regime.

Q. ARE THERE DIFFERENCES BETWEEN AN IXC-BOUND CALL AND AN INTERNET-BOUND CALL?

A. A theoretical difference is that an ILEC subscriber that places a long distance call does not

[11] The POCs are points at which the carrier serving the ISP (which may be an ALEC) accepts the Internet-bound call and routes it to the ISP.

[12] In that respect, the implicit contract is analogous to that which exists between a party with a toll-free "800" telephone number and other parties that are invited to call that number. The holder of the 800 number causes cost by signaling others to call him or her and accepts that cost by being willing to pay for it. Moreover, the holder of the 800 number may control the number of potential callers by choosing the method for disclosing the number (e.g., directory information, word of mouth, special invitation, etc.). Similarly, ISPs that use FX lines to provide local connectivity to distant customers signal a willingness to accept—and pay for—the generally higher cost of providing Internet access to those customers. They too can control the number of potential ISP customers by choosing both how many points of connection to offer for providing local connectivity and pricing options for its Internet access service.

incur a local usage charge on the originating end, while an ISP customer, in principle, does. As a practical matter, however, this difference is irrelevant. Flat and measured basic local exchange rates have *not* been set to reflect the added cost of serving Internet-bound traffic, and a longstanding public policy concern with the level of basic exchange rates limits the ability of the regulator to recover these costs from all local exchange customers.[13] In addition, ISPs compete, in part, by providing local exchange numbers so that their customers can reach them without incurring per-minute charges from the serving ILEC or ALEC. Because Internet-bound traffic is caused by the ISP's customer, the ISP would generally bear the cost of the local connection, just as the IXC does for long distance traffic. And, as I stated earlier, competitive forces in the ISP market encourage ISPs to incur costs and lease facilities so that their customers do not pay additional local exchange costs. For both of these reasons, it would be naïve to think that the originating ILEC's subscriber fully compensates that ILEC for the end-to-end cost of the Internet-bound call.[14]

All of these are reasons why instead of the ILEC paying reciprocal compensation (or, a terminating charge) to ALECs as in the ILEC-ALEC local interconnection regime, for Internet calls by the ILEC subscriber, ISPs should pay the ILEC (and the ALEC that also serves it) usage-based charges analogous to carrier access charges paid by IXCs. Only such a payment will close the gap between the full cost of the call up to the ISP and the local call charge that is assessed to the end-user by the originating ILEC. In this economically correct view of inter-carrier compensation, the ALEC that switches Internet calls for the ISP is compensated not from reciprocal compensation paid by the originating ILEC but from usage-based charges paid to it by the ISP.

[13] Indeed, if the longer holding times of Internet-bound traffic impose costs different from those for ordinary voice traffic, raising prices for all local exchange customers to recover costs imposed by the ISP's customers would constitute a subsidy to ISP access. ILECs that originate Internet-bound traffic would effectively charge ISP customers less than incremental cost and ordinary voice customers more than otherwise for local exchange usage.

[14] This problem is likely to be even more acute when the ILEC's subscriber pays flat-rated local charges rather than per-call rates for local service.

2. Functional Equivalence and the Cost of Internet-Bound Traffic (*Issues 3 and 4*)

Q. BOTH DR. SELWYN [AT 7 AND 40] AND MR. FALVEY [AT 9] ASSERT THAT INTERNET-BOUND TRAFFIC AND LOCAL VOICE TRAFFIC ARE, IN EFFECT, FUNCTIONALLY OR "TECHNICALLY" IDENTICAL. THEREFORE, THEY ARGUE, RECIPROCAL COMPENSATION OUGHT TO APPLY TO INTERNET-BOUND TRAFFIC JUST AS IT DOES FOR LOCAL VOICE TRAFFIC. DO YOU AGREE?

A. No. First, the basic Selwyn-Falvey premise here is incorrect because it completely ignores cost causation. I explained earlier the cost-causative differences between Internet-bound traffic and other local traffic, whatever the degree of *functional* resemblance between them. Even if it were true that the two types of traffic are functionally or technically identical—which they are not—both Dr. Selwyn and Mr. Falvey miss or ignore the fundamental point: cost recovery necessarily depends on who causes the cost in question, *not* on the level of cost or technical characteristics of the underlying service. Thus, for the purposes of making policy, what matters is not whether two different types of traffic use exactly the same network facilities, or even whether they generate the same level of cost. What only matters for that purpose is determining who gives rise to a cost—and in what circumstances—and should, hence, be held responsible for paying for it. Technical characteristics or the level of cost may be items of interest in themselves, but they are totally irrelevant for determining who should be made to pay for the cost. Even if the two types of traffic were functionally identical and generated the same level of cost, it would still be economically inappropriate to apply reciprocal compensation to both.

Second, if the cost *per minute* to terminate a local voice call were truly the same as that cost for an Internet-bound call, I could still understand (though not accept) Dr. Selwyn's statement [at 7]:

> In fact, *there is no technical difference in the manner by which these two types of traffic are handled in the ILEC's network* and by suggesting otherwise, such ILECs are attempting to introduce a market-driven price discrimination based upon the *use* to which local telephone service is put rather than upon the

processes by which it is produced or the costs incurred in its production.[15] However, the costs per minute for the two types of calls are *not* likely to be the same for several reasons documented below.

Q. WITH REFERENCE TO DR. SELWYN'S CHARGE OF AN ATTEMPT AT "MARKET-DRIVEN PRICE DISCRIMINATION," PLEASE EXPLAIN AGAIN YOUR POINT THAT THE ECONOMICALLY APPROPRIATE FORM OF INTER-CARRIER COMPENSATION SHOULD DEPEND ON COST CAUSATION, NOT ON THE LEVEL OF COST OR ON FUNCTIONAL EQUIVALENCE.

A. Dr. Selwyn charges [at 7] that the sole reason for an ILEC to want a different form of inter-carrier compensation for Internet-bound traffic than for local voice traffic is its desire to price discriminate based on how local telephone service is *used*. The fact of the matter is that use *per se* has nothing to do with the choice of an efficient inter-carrier compensation mechanism. *How* cost is recovered must always depend on cost causation, i.e., the economic decision or transaction that is the source of the cost. *How much* cost should be recovered is of only incidental interest to this issue: it reflects the manner of use and determine the *magnitude* of recovery, but it does not determine the form of compensation or recovery itself. To explain this point, I note, as before, that the cost-causer for both a local voice call and an Internet call is the same entity: the ILEC subscriber that places either type of call. That same subscriber is also the cost-causer when he places a *long distance* call through an IXC. Therefore, in all three cases, cost recovery must start with that subscriber (the source of the economic decision to make a call that gives rise to cost). The question is: how should the payment received from that subscriber be used to compensate various carriers that participate in carrying each type of call?

The answer to that question is provided by cost causation. Following a crucial distinction I made earlier, for a local voice call, the ILEC subscriber is also a *customer* of

[15] Emphasis in original.

the ILEC (the supplier of local voice connections). For a long distance call, the ILEC subscriber is a customer of the IXC (the supplier of long distance connections). And, for an Internet call, the ILEC subscriber is a customer of the ISP (the supplier of Internet connections). This trichotomy indicating how the same ILEC subscriber can be a customer of different carriers for different services is particularly important. Indeed, it determines which supplier has the right to charge (recover cost) from the end-user for each service and helps to understand how cost causation works. By being a subscriber of the ILEC, that individual maintains a link to the public switched network over which all three types of services are delivered. With that link in place, that individual has the *option* to purchase various types of telecommunications services. Without that link, he cannot consume any of the three services. However, without the ILEC, the IXC, and the ISP offering and marketing the three types of services to that subscriber, there wouldn't be any service to consume.

The long practice of the IXC recovering the cost of a long distance call from the ILEC subscriber and then using that payment to compensate all facilitating carriers (e.g., those providing switched access) is economically sensible and efficient, and serves as the proper model for compensation in the other two cases. For a local voice call, the ILEC must recover the cost of that call directly from its subscriber (acting as its customer) and then compensate all other facilitating carriers (e.g., the ALEC that provides interconnection if the local call crosses network boundaries). In the same vein, the ISP must recover the cost of the Internet call directly from the ILEC subscriber (acting as the ISP's customer) and then compensate all other facilitating carriers (e.g., the ILEC, the ALEC, the backbone network providers, etc.).

Q. GIVEN THE CLAIMS OF DR. SELWYN AND MR. FALVEY THAT THE FACILITIES USED TO TRANSPORT AND SWITCH BOTH INTERNET-BOUND AND LOCAL VOICE CALLS ARE SIMILAR, ARE THE COSTS ALSO SIMILAR FOR THE TWO TYPES OF CALLS?

A. No. The costs of transporting and switching traffic are not determined by *what* network

elements are used—they are determined by *how* the network elements are used. Therefore, while the facilities used to transport and switch an Internet-bound call may be similar to those used to transport and switch local voice calls, there are characteristics of Internet-bound traffic that make its *cost* of transport and switching (as measured by TELRIC) different from that for local voice traffic. The major differences are:

1. *Call Duration*: Because Internet-bound calls are generally much longer than local voice calls, the average cost of call setup is much lower for the Internet-bound call than for the typical local voice call.
2. *Call Direction*: Transport and termination costs involve only terminating traffic. Some features and functions impose capacity costs only at the originating end and would not be included in a study of cost to the ALEC of delivering Internet-bound traffic to ISPs.
3. *Use of Network Elements*: Because dedicated circuits are used for Internet-bound traffic, traffic-sensitive switching costs are lower for Internet-bound traffic than they are for voice traffic.
4. *Load Distribution*: The proportion of Internet-bound traffic that arrives at the busy hour of the switch may differ from that of local voice traffic. If the load distribution of Internet-bound traffic is flatter than that of local voice traffic and peaks at a different hour, then the average incremental minute of Internet-bound traffic would cause a smaller increase in the capacity requirements of the switch than an incremental minute of local voice traffic.

Thus, even though similar facilities are used to switch and transport Internet-bound and local voice traffic, the TELRIC of Internet-bound traffic can differ significantly from the TELRIC of average local exchange traffic, which currently determines the reciprocal compensation rate for local voice traffic.

Q. PLEASE EXPLAIN THE IMPACT OF CALL DURATION ON COSTS.

A. For every call, there are broadly two types of cost: a *fixed* cost (invariant to the length of the call) for call setup at both ends of the call, and an incremental or *variable* cost that arises for every minute a call passes through a switch. The full *per minute* cost of that call is the sum of the variable cost of that minute plus the fixed cost averaged over the total length of the call. The latter component would obviously diminish as the fixed cost is averaged over an increasing number of minutes. Thus, if the average Internet-bound call is

about five to thirteen times longer than the average voice call,[16] the *average* fixed cost component for the former would be considerably smaller than that for the latter. *Even if* the variable cost component of both types of calls were the same, the *per minute* cost of the average Internet-bound call would still end up being considerably less than that for the average voice call. A simple numerical example illustrates this fact.

Suppose the variable cost for each minute is 0.5¢ (for ease of exposition, it is assumed to be constant for all minutes). Then, a 3-minute call would have a total variable cost of $3 \times 0.5 = 1.5$¢ and a 20-minute call would have a total variable cost of $20 \times 0.5 = 10$¢. Suppose the fixed cost of call setup—which does not vary with the length of the call—is 2¢. Then the *total* cost of the 3-minute call (inclusive of call setup) would be $1.5+2 = 3.5$¢, and that for the 20-minute call would be $10+2 = 12$¢. To figure what each call costs on a per-minute basis, simply divide the total cost of each by the respective number of minutes. Thus, the 3-minute call would cost $3.5 \div 3 = 1.17$¢ per minute and the 20-minute call would cost $12 \div 20 = 0.6$¢ per minute. That is, as the call duration increases, the cost per minute would fall.

Q. WOULD A BIFURCATED RATE STRUCTURE FOR LOCAL SWITCHING SOLVE THIS PROBLEM, AS SUGGESTED BY MR. HUNSUCKER [AT 17]?

A. Yes, by matching the rate structure to the structure of costs. However, this would only solve a problem that arises from averaging costs for calls of different durations, *assuming* that the per-minute incremental cost is the same for both Internet-bound and local voice calls. Below, I explain why that per-minute incremental cost itself is likely to differ.

Q. PLEASE EXPLAIN HOW THE LOAD DISTRIBUTION OF TRAFFIC AFFECTS COSTS.

A. The cost drivers for transmitting or terminating/switching any type of traffic (e.g., Internet-bound traffic, local traffic, toll) include the number and duration of calls in the busy hour.

[16] See, e.g., Susan Biagi, "A Tale of Two Networks," *Telephony*, August 3, 1998.

Incoming call attempts during the busy hour for the ALEC switch determine the capacity requirements for the switch components involved in call setup, namely, the central and peripheral processors and measurement equipment. Call duration during the busy hour determines the capacity requirements for the line and trunk equipment in the switch that are used to set up a path for the call.

It is likely that the load distribution of ISP traffic—number and duration of calls in the busy hour as a percent of total traffic—differs from that for other types of calls. The peak hour for voice traffic normally occurs some time during the business day. Internet-bound traffic is likely to have a flatter load distribution due to the nature of demand. Whereas the business day is confined approximately to an eight hour period with little evening or weekend activity, consumers frequently use the Internet during the evening and weekends. These usage patterns flatten the load distribution for Internet-bound traffic, in the sense that the fraction of usage falling in the busy hour is smaller for Internet-bound traffic than for local voice traffic. This means that Internet-bound traffic requires less investment and costs per minute to provide capacity to meet peak demand than does local voice traffic.

Q. PLEASE EXPLAIN HOW THE USE OF NETWORK ELEMENTS AFFECTS TRANSPORT AND SWITCHING COSTS DIFFERENTLY FOR INTERNET-BOUND TRAFFIC THAN FOR LOCAL VOICE TRAFFIC.

A. Rates set for inter-carrier compensation of any type of traffic must recover only the costs that are traffic-sensitive, i.e., vary with additional usage. Non-traffic sensitive costs, i.e., costs that do not vary with additional usage, *should not be so recovered.* This follows as a matter of general economic principle and as a requirement of the Telecommunications Act of 1996 which states in Section 252(d)(2) that prices for the "transmission and routing of telephone exchange service and exchange access" be based on incremental costs.

It is important to consider how network elements are used for different types of traffic because differences in such use can affect not only the level of costs but, more importantly, the manner in which the costs should be recovered. The same network element that may appear to be a shared facility in certain uses can turn out to be a dedicated facility in other

uses. In the former case, the cost of the facility would be recovered from all customers using that facility and, in the latter case, it would be recovered from the single cost-causing customer.

Q. PLEASE ELABORATE UPON THIS POINT.

A. An examination of the typical line-to-trunk concentration ratio for different types of traffic shows why it is incorrect to conclude that the costs for different types of traffic are the same merely because identical network elements are used. An important part of switch investment costs is the busy hour line CCS (hundred call seconds) costs. Busy hour line CCS is a measure of the type of concentration required on the line side of the switch and is determined by the number of line circuits sharing a trunk circuit and a circuit path through the switch processor. A concentration ratio of 8:1, for example, means that eight line circuits share one trunk circuit and one circuit path through the switch processor.[17] Using basic engineering guidelines, the switch is sized and engineered, i.e., a concentration ratio is determined, to accommodate a certain level of traffic so that a minimum level of blocking occurs if traffic volume during the busy hour is higher than the volume suggested by the concentration ratio that is chosen. For local voice traffic, busy hour line CCS costs are traffic-sensitive in nature because they arise from a shared facility: namely, one circuit path through the switch processor that is shared by eight customer lines. Because of that sharing, the use of the facility during the peak hour imposes congestion costs on other users in the form of rationing or call-blocking. Since line CCS costs arise from a resource that is shared by various users, a recovery mechanism that apportions cost to those cost-causing users provides proper signals at the margin and increases economic efficiency.

Line CCS costs for Internet-bound traffic, however, need not be traffic-sensitive. For the purposes of such traffic, ALECs rely on ISDN Primary Rate Interfaces ("PRI") to serve ISPs and build switches at a concentration ratio of 1:1. For those carriers, line CCS costs

[17] An ordinary voice loop is generally engineered for 3 CCS at the busy hour, while the interoffice trunks that concentrate those loops are engineered for about 27 busy hour CCS. Thus, for local voice traffic, it is not unusual to observe 8 or 9 loops for every trunk.

are fixed with respect to usage. Each line serving an ISP has a *dedicated* path through the switch processor and increased usage from other lines does not impact the use of the line serving the ISP. No matter what the demand is from other lines, the path serving the ISP will always be available for customers calling the Internet. Since the circuit is dedicated to the ISP line, the use of the facility does not impose congestion costs on other users and no rationing or call blocking is imposed on the network as a result. Although the same network elements are used for local voice traffic, inter-carrier compensation for Internet-bound traffic should not include line CCS costs because those costs do not vary with additional usage and are, therefore, not incremental costs of delivering Internet-bound calls.

Q. HOW DOES THIS DISCUSSION PERTAIN TO DR. SELWYN'S OWN TESTIMONY [AT 60-61] ON THE COSTS OF ILECS AND ALECS?

A. In comparing the costs of ILECs and ALECs, Dr. Selwyn advances the notion that the greater economies of scale and scope allegedly enjoyed by ILECs would seem to give those ILECs a cost advantage over the ALECs. This is clearly an empirical issue on which Dr. Selwyn offers no real evidence. However, Dr. Selwyn also acknowledges that ALECs may be able to offset any cost advantage ILECs enjoy through the economies of *specialization.* While Dr. Selwyn casts such specialization as a natural ALEC response to not having sufficient scale to compete with ILECs in terms of their respective average costs, I believe that any ALEC specialization has a much simpler explanation: the opportunity for arbitrage given the market distortion created by reciprocal compensation for Internet-bound traffic. I explain this point later in my testimony.

3. Cost Causation-Based Policy (*Issues 2, 3, 4, and 6*)

Q. HOW DO YOU RESPOND TO THE ASSERTION BY ALEC WITNESSES THAT AN ISP IS JUST AS MUCH AN END-USER AS, SAY, A PIZZA PARLOR, AND ANY TRAFFIC DIRECTED TO THE ISP SHOULD THEREFORE BE ENTITLED TO THE SAME TREATMENT AS CALLS MADE TO THE PIZZA PARLOR?

A. Following the D.C. Circuit Court of Appeals' vacation and remand of the FCC's *ISP Declaratory Ruling*, it has become commonplace for proponents of reciprocal compensation for Internet-bound traffic to draw an analogy between legitimate end-users like pizza parlors, taxicab companies, or on-line banks and carriers like ISPs. For example, Dr. Selwyn [at 22] quotes a passage from the DC Circuit Court's Remand Order that appears to uphold such an analogy, and Mr. Falvey [at 6 and 8] asserts that the "functionality provided does not differ based on whether or not the end-user of one LEC called by an end-user of another LEC is a pizza parlor or an ISP."

As explained above, from a cost causation standpoint, the functional equivalence of calls to pizza parlors and calls to ISPs (even if true) has absolutely no relevance for the larger policy question of who must compensate whom. The policy of reciprocal compensation is justified by cost causation as long as the calling is between two legitimate end-users within the same local calling area. It is another matter, however, when the called party is *not* an end-user in the true sense of the term.

The first priority of the cost causation principle is to locate the cost-causer or, in other words, the economic decision that gave rise to the cost. When an Internet user wishes to reach a web site or other destination on the Internet, he or she must first secure the services of the entity that is not only in a position to provide the pathway to the Internet but also actively markets those services through advertising and contractual terms and conditions concerning price, scope, quality, etc. The cost of the Internet-bound call—*wherever it may be generated*—would not arise were it not for the promise by the ISP to deliver Internet destinations to the Internet user and that user's voluntary acceptance of the ISP's terms and conditions for granting such access. In the absence of Internet access (i.e., the ISP's service), there would be no Internet-bound calls, and no cost would be caused for such calls. Therefore, the premise of cost causation *does* require us to look at how cost may arise in any instance and the contractual arrangement that governs the economic decision that gives rise to that cost.

As explained above, the same may be observed to be true for other contractual relationships as well: that between the ILEC's subscriber and the ILEC for local voice

calling or that between the ILEC subscriber and the inter-exchange carrier IXC for long distance calling. Of course, the ILEC subscriber would have to use the ILEC's network to reach a CLEC (for cross-network local calls), an IXC (for long distance calls), and an ISP (for Internet calls). That is exactly how all or part of the cost of making those calls would arise in the first place. But, employing the cost causation principle in the manner suggested to determine how or why cost arises does *not* amount to denying compensation where it is due. Indeed, cost causation helps us to sort through the following questions: (1) why did the cost arise (what economic decision caused the cost)? (2) where did the cost arise (what is the chain of economic activities that followed that decision)? and (3) how should the cost be recovered (how can the cost-causer and his/her agent be made to compensate all parties that incurred cost as a result of those economic activities)? Therefore, the identity of the various parties in the contractual relationship *is* fundamental for determining where compensation is due and from whom.

For these reasons, it is absurd to think that end-users set out to call ISPs in the same sense they would a friend or business, e.g., a pizza parlor.[18] The ISP is only a called party for an Internet-bound call in the same sense that an IXC is a called party for a long distance call. Also, only if we accept that every long distance call is really two calls—the first from the calling end-user to the IXC and the second from the IXC to the called party (and its serving LEC)—can we also regard an Internet-bound call as two calls—the first from the calling end-user to the ISP and the second from the ISP to the Internet destination.[19]

To the question why reciprocal compensation should apply when cross-network local calls are made by end-users to brokerage firms, flower shops, pizza parlors, etc., but not when those end-users place Internet-bound calls through ISPs, the obvious answer is that every such entity—legitimately a called party—is an end-user, but an ISP is not. Like the

[18] Hence, the term "ISP-bound traffic" often has the unfortunate connotation that calls are made to ISPs *as if* they are end-users.

[19] The two-call theory is clearly implied by Dr. Selwyn [at 26] when he draws an analogy between calls to an airline reservation desk and Internet-bound calls routed by ISPs.

ISP, the pizza parlor or the bank offers its services over the telephone (although, unlike the ISP, it also has non-network means for selling its services). However, there are also some important differences. First, the pizza parlor or the bank does not perform the carrier-like functions of an ISP to provide access to some other party (such as a web server or Internet destination). Rather, the pizza parlor and the bank provide internal access into their own operations, in much the same way that *any* end-user may be said to provide "access" to himself or herself when a call comes in.

Second, the relationship between the calling end-user (and ILEC subscriber) and the pizza parlor or bank is truly reciprocal, as it is supposed to be between two end-users. That is, the pizza parlor or bank can independently call the ILEC subscriber, i.e., on a separate call from that made by that subscriber to the pizza parlor or bank. An ISP, in contrast, serves merely as an Internet access-granting agent to the ILEC subscriber and has no commercial interest in returning separately any calls to that subscriber. In both of these respects, the role of the ISP is strikingly similar to that of an IXC. Unlike the pizza parlor or bank, an IXC too performs the functions of a carrier and has no commercial interest in returning separately any calls to the ILEC subscriber. These differences powerfully demonstrate that mere *resemblance* between cross-network local voice calls and Internet-bound calls (up to the ISP) is not enough for both to merit the same compensation mechanism. Without belaboring the point unnecessarily, cost causation *does* matter.

Q. IS COST CAUSATION-BASED COMPENSATION THE ONLY FORM OF INTER-CARRIER COMPENSATION FOR INTERNET-BOUND CALLS THAT THE COMMISSION SHOULD CONSIDER?

A. Yes. From the economic standpoint, any method of inter-carrier compensation for Internet-bound calls should be based on cost causation. Ideally, such compensation should occur in the form of usage-based charges (analogous to carrier access charges) paid by the ISP to the ILEC and the ALEC that transport and switch Internet-bound calls to it. However, because the FCC currently exempts ISPs from paying access charges, the next-best cost-causative form of compensation would be an equitable sharing (between the

ILEC and the ALEC) of revenues earned by the ALEC from the lines and local exchange usage that it sells to the ISP. This form of revenue sharing may not be sufficient for the ILEC and ALEC that jointly provide access service to fully recover their costs, but the degree to which they under-recover those costs (or, equivalently, subsidize Internet service) will be the same proportion of their respective costs and, hence, competitively neutral. The third-best and a reasonable interim form of compensation would be bill-and-keep or, in effect, exchange of Internet-bound traffic between the ILEC and the ALEC at no charge to each other. In fact, it is quite possible that the FCC itself will maintain the ESP exemption from access and analogous charges but settle on bill-and-keep for the exchange of Internet-bound traffic.[20] In my opinion, because it is not based on cost causation, reciprocal compensation for Internet-bound traffic should really not be an option at all.

Q. WOULD ANY COST-CAUSATIVE FORM OF COMPENSATION DENY AN ALEC FAIR PAYMENT FOR USE OF ITS NETWORK BY AN INTERNET-BOUND CALL FROM AN ILEC (BELLSOUTH) SUBSCRIBER?

A. Absolutely not. Adopting a cost-causative form of inter-carrier compensation for *any* kind of traffic (local voice, Internet-bound, or long distance) in no way signifies the denial of fair and proper compensation where such compensation is due. It certainly does not follow that BellSouth intends to deny ALECs in Florida any compensation for their part in carrying Internet-bound calls. Rather, the point at issue here is whether *BellSouth* (or any ILEC) should compensate an ALEC for the cost the latter incurs in carrying Internet-bound calls to the ISPs it serves. As I explained above, while that ALEC is entitled to recover fully the cost it incurs for Internet-bound calls, such recovery (compensation) ought to come—in accordance with cost causation—from the ISP or ISPs it serves, not from BellSouth. To have it otherwise—particularly in current circumstances in which ALECs

[20] Two recent papers by FCC economists may presage the adoption of precisely that policy. These are Patrick DeGraba, "Bill and Keep at the Central Office as the Efficient Interconnection Regime," OPP Working Paper Series No. 33, and Jay M. Atkinson and Christopher C. Barnekov, "A Competitively Neutral Approach to Network Interconnection," OPP Working Paper Series No. 34, both issued in December 2000.

frequently share reciprocal compensation revenues with the ISPs they serve—would only reinforce the perverse incentive to specialize in providing "termination" services for ISPs, to the exclusion of virtually all other local exchange services.[21]

4. Reciprocal Compensation, Usage-Based Charges, and Bill-and-Keep (*Issues 4 and 6*)

Q. DR. SELWYN ARGUES [AT 18] THAT ASKING ISPS TO PAY TO RECEIVE INTERNET-BOUND CALLS AND TO RECOVER THEIR COSTS DIRECTLY FROM THEIR INTERNET ACCESS CUSTOMERS WILL NOT WORK BECAUSE LOCAL CALLING HAS TRADITIONALLY BEEN PROVIDED BY LOCAL EXCHANGE CARRIERS ON A "SENT PAID" BASIS. DO YOU ACCEPT HIS ARGUMENT?

A. No. Dr. Selwyn's historical accounting of sent-paid services in the U.S. may be comprehensive, but it is fundamentally irrelevant to the issue of whether Internet-bound calls are local or whether reciprocal compensation should be paid for those calls. There is a very sound cost-causative basis for the sent-paid arrangement for *local voice* calls. As I explained earlier, for those calls, the ILEC subscriber is also the ILEC's customer. Hence, by the principle of cost causation, the ILEC should recover the cost of the local call directly from that customer and compensate any other carrier involved in completing the call. In contrast, regardless of their alleged *technical* resemblance to local calls, Internet-bound calls are caused by the ISP's customer purchasing Internet access from the ISP. By cost causation, the economically proper form of cost recovery for such calls would be for the ISP to recover the cost of those calls fully from its customer and then to compensate both the ILEC (whose subscriber the ISP customer is) and the ALEC serving the ISP. Naturally, if this form of cost recovery is correctly implemented, Internet-bound calls would not be carried on a sent-paid basis but would resemble the manner in which IXC-

[21] Even though, in my opinion, the ALECs delivering Internet-bound calls to ISPs do not provide actual termination services, those ALECs routinely characterize their role in that respect as "termination."

bound calls are carried and billed. This would get around the problem raised by Dr. Selwyn [at 18] that as long as calls to ISPs are rated as local calls and those ISPs are charged for receiving incoming traffic, the effect would be for the ILEC to recover twice, from the originating end-users and the ISPs. More generally, the fallacy underlying Dr. Selwyn's argument here is that just because certain practices (sent-paid, reciprocal compensation, etc.) have traditionally been followed for local usage (voice) services, the same must automatically be true of Internet-bound calls. Strange as it may seem, this amounts to *inferring* that Internet-bound calls are local simply because they are *assumed* to be so. Unfortunately, this sort of illogic or circular logic appears to permeate Dr. Selwyn's testimony.

Q. BUT, WHAT ABOUT DR. SELWYN'S CLAIM [AT 21] THAT "THE FCC HAS EXPRESSLY EXEMPTED [INTERNET-BOUND] CALLING FROM INTERSTATE SWITCHED ACCESS CHARGES, REQUIRING THAT CALLS TO ISPS BE TREATED AND RATED AS LOCAL CALLS AND THAT ACCESS LINE SERVICES FURNISHED TO ISPS BE PROVIDED AS LOCAL BUSINESS EXCHANGE SERVICE LINES OUT OF THE LOCAL EXCHANGE TARIFF?"

A. This is another example of the illogic in Dr. Selwyn's testimony. He makes this claim in an attempt to portray an Internet-bound call as a local call for purposes of compensation. However, the mere fact that ISPs are allowed to purchase local exchange services from ILECs and ALECs that serve them does not necessarily lead to the conclusion Dr. Selwyn seeks. The FCC's grant of the access charge exemption to ISPs was an attempt to protect the growth of a budding Internet "industry."[22] That grant of exemption was neither a repudiation of the FCC's oft-stated conclusion that Internet-bound calls are mostly

[22] The FCC has traditionally explained that exemption thus:

> to protect certain users of access services, such as ESPs, that had been paying the generally much lower business service rates from the rate shock that would result from immediate imposition of carrier access charges.

Internet Traffic Order, ¶5, and *MTS/WATS Order*, ¶715.

interstate in nature, nor was it an overt acknowledgement that such calls should be treated like local voice calls for purposes of cost recovery and compensation. As the Louisiana Public Service Commission recently recognized, the FCC regards ISPs as "end-users" *only for the purposes of the access charge exemption.*[23] That does not in any way alter the fundamental fact that ISPs are not end-users *per se*; Internet calls do not terminate at the ISPs in the manner voice calls terminate at true end-user customer locations. Rather, ISPs perform several carrier functions which result in Internet calls reaching their destinations through the packet-switched network.

Q. WOULD YOU COMMENT ON DR. SELWYN'S CHARGE [AT 46] THAT IF THE COMMISSION WERE TO TREAT INTERNET-BOUND TRAFFIC ROUTED TRHOUGH ALEC-SERVED ISPS AS NON-LOCAL AND EXEMPT IT FROM RECIPROCAL COMPENSATION, BUT RETAIN LOCAL RATING OF SUCH TRAFFIC ROUTED THROUGH ILEC-SERVED ISPS, THEN AN "ENORMOUS AND UNWARRANTED MARKET ADVANTAGE" WOULD BE GRANTED TO THE ILECS AND THEIR ISP AFFILIATES?

A. This is not a substantive issue at all. The "local rating" of Internet-bound calls that Dr. Selwyn is so concerned about stems directly from the FCC's ESP exemption, the sole purpose of which is to allow ISPs to avoid paying switched access charges. This does *not* mean that the FCC accepts such calls as being local in every other respect (in particular, the all-important customer-supplier relationship implied by cost causation). There is no reason to believe either that the FCC selectively views certain Internet-bound calls (those

[23] In becoming the fourth state regulatory agency to deny the payment of reciprocal compensation for Internet-bound traffic, the Louisiana Commission stated:

> There is no prevailing industry custom of treating ISP traffic as "local" for reciprocal compensation purposes. FCC regulations require that ISPs be treated as end-users *for only one purpose, the access charge exemption.*

Louisiana Public Service Commission, *In re Petition of KMC Telecom, Inc. Against BST to Enforce Reciprocal Compensation Provisions of the Parties' Interconnection Agreement*, Order in Docket No. U23839 ("*Louisiana ISP Order*"), October 13, 1999, at 13.

routed through ALEC-served ISPs) as non-local but regards others (those routed through ILEC-served ISPs) as local. Whether ISPs are served by ALECs or the ILECs themselves, they are all currently allowed to purchase business local exchange lines out of local exchange tariffs.

More importantly, if a cost-causative form of compensation were to be adopted for Internet-bound traffic, then the local/non-local distinction (or whether an ISP is ALEC-served or ILEC-served) would not matter. In all instances, the local exchange carriers involved would recover their costs of originating and delivering Internet-bound traffic from the ISPs or ISP-affiliates which, in turn, would recover those costs directly from their Internet access customers. Naturally, in this scheme of things, Internet calling would not be sent-paid.

Q. DR. SELWYN ASKS [AT 21] WHY THE ACCESS CHARGE MODEL IS "NOT APPLICABLE TO OR APPROPRIATE FOR CALLS DELIVERED BY ILECS TO ISPS," AND THEN ANSWERS HIS QUESTION, IN PART, BY POINTING TO THE FCC'S ESP EXEMPTION FROM ACCESS CHARGES. DO YOU AGREE?

A. No. In responding to his own question, Dr. Selwyn relies solely on his interpretation of legal rulings and regulatory decisions, not on the economic merits of a regime of usage-based charges called for by the cost causation principle. Moreover, I strongly disagree that usage-based charges analogous to carrier access charges are "not appropriate" for Internet-bound calls. While the current FCC exemption may make such charges "not applicable" for now, there is nothing in the FCC's original or subsequent justifications for the ESP exemption to indicate that they are also "not appropriate" on economic grounds. Dr. Selwyn may argue from his reading of the law and various court decisions why access-like charges are not applicable, but he certainly has not argued persuasively why they are not economically appropriate.

Q. BUT, ISN'T THE LIKELY DEMISE OF FLAT-RATE INTERNET ACCESS SERVICE DUE TO ANY ADOPTION OF USAGE-BASED CHARGES (AS ARGUED BY DR. SELWYN, AT 23) SUFFICIENT ECONOMIC REASON FOR

NOT LEVYING USAGE-BASED CHARGES ON ISPS?

A. No. As Dr. Selwyn correctly notes, ISPs today mostly offer flat-rate Internet access service which allows customers unlimited access to the Internet at a fixed monthly charge. Dr. Selwyn suggests, however, that this status quo is inherently desirable, i.e., requiring ISPs to pay usage-based charges instead to receive Internet-bound calls would somehow "fundamentally alter the manner in which the Internet is used." If Dr. Selwyn sees this as a negative or adverse development, then I would disagree. Economic efficiency requires that resources be placed in their most productive uses, where they receive full and proper compensation. This underlies the long tradition, in most markets, of moving prices as close to underlying incremental costs as possible. When prices are out of line with costs, either over-consumption or under-consumption of resources can occur, neither of which is an efficient outcome. Flat-rate Internet access with unlimited usage essentially encourages inefficient over-consumption by making the marginal price zero in circumstances in which the marginal cost is not necessarily zero, even if small. As long as there is a significant likelihood of flat-rate pricing raising consumption to the point that existing facilities for carrying Internet-bound calls are exhausted (or, at least, congested) and need to be relieved, the marginal cost of consumption is not zero. Arguably, flat-rate Internet access in such circumstances is *not* the most desirable or efficient economic outcome, although some, like Dr. Selwyn, may believe otherwise.[24] Regulators presently involved in steering hitherto closed and regulated telecommunications markets in the direction of competitive markets have a special responsibility to adopt policies that promote the public interest in as economically efficient a manner as possible.

Usage-based charges on ISPs would more reliably align prices with underlying costs,

[24] The only time flat-rate pricing of Internet access would be efficient is when the facilities used to transport, switch, and route Internet-bound calls become sufficiently plentiful so that exhaustion or congestion, even in the busy hour peak, does not happen. Such a circumstance may well come about as Internet-bound and data traffic are both transported entirely through packet-switched networks. In the meanwhile, the advent of direct connections to ISPs through high-speed digital subscriber lines represents a move in that direction. Ironically, if reciprocal compensation is adopted for Internet-bound calls, the more direct connections to ISPs become the norm, i.e., the less Internet-bound calls go through the circuit-switched network, the less reciprocal

(continued...)

and ensure that what the consumer pays for the marginal unit accurately reflects the cost he or she imposes on the service provider. Such charges would also likely result in per-use pricing of Internet access and usage. This, however, is not necessarily an adverse outcome for the Internet (although some, like Dr. Selwyn, may not see it that way). In the presence of exhaustible or congestible resources, per-use pricing encourages more efficient use of those resources, minimizes the generation of unwarranted subsidies, and ensures stable and sustainable growth of the market in the long run. While some might view unrestrained growth of Internet usage—spurred on by inefficient flat-rate pricing—as good for the public interest, such growth is not sustainable in the long run and may suppress other incipient technologies and services that could be beneficial to consumers. In short, any policy encouraging that type of Internet usage growth could ultimately prove to be myopic and inimical to the public interest.

Q. EVEN IF THE FCC'S ESP EXEMPTION WERE NOT IN EFFECT, ISN'T IT TRUE (AS DR. SELWYN ARGUES, AT 20) THAT APPLYING CONTRIBUTION-LADEN ACCESS CHARGES TO INTERNET-BOUND TRAFFIC WOULD GREATLY RAISE THE COST TO INTERNET USERS OF REACHING THEIR CHOSEN ISPS?

A. No, this too is not a substantive issue. I completely endorse the principle that any usage-based charges on ISPs—should they become the mode of cost recovery for ILECs and ALECs—be cost-based and, if necessary, even set *at* incremental cost. The contribution presently included in carrier access charges serve a larger social purpose (by providing for a subsidy to residential local exchange service), and would, as such, be an unsuitable set of charges for Internet-bound traffic. However, in my testimony, I have called for charges that are *analogous* to carrier access charges, i.e., that they be usage-based. This is not the same as saying that those usage-based charges be at the same level or have the same

(...continued)

compensation revenue would ALECs be able to earn.

structure as carrier access charges.

As to whether usage-based charges on ISPs would make the Internet more expensive, Dr. Selwyn's prediction that they would do so is simplistic. Under per-use pricing of Internet access (that could likely result from usage-based charges on ISPs), some Internet users would experience an increase, and others a decrease, in their monthly Internet use costs. That monthly cost would depend on the Internet user's actual number of minutes or hours of use which, in turn, would depend at least partly on the marginal price he or she faces. At a zero marginal price (such as with flat-rate pricing of Internet access), even the Internet user with the least need for service would likely over-consume. That over-consumption would, in the present scheme of things, be subsidized by non-Internet users.

Q. DO ISPs PAY USAGE-BASED CHARGES (ANALOGOUS TO CARRIER ACCESS CHARGES) TODAY?

A. No. Even though the FCC has declared that Internet-bound traffic is, at best, jurisdictionally mixed and is, in most instances, interstate, no rulemaking has yet occurred to establish such charges for ISPs, and it remains uncertain as to when rules to this effect will be established. In the meantime, ISPs remain beneficiaries of the long-standing access charge exemption; however, that exemption only applies to payment of access charges to *ILECs*. Thus, *ALECs* could, if they so chose, still assess access-like charges on ISPs that use their network.

Q. YOU SUGGEST ABOVE THAT IN THE ABSENCE OF USAGE-BASED CHARGES OR EQUITABLE SHARING OF REVENUES FROM ISPS, A POLICY OF BILL-AND-KEEP MAY BE BETTER THAN RECIPROCAL COMPENSATION. HAVEN'T (AS DR. SELWYN CHARGES, AT 32) ILECS LIKE BELLSOUTH RESISTED BILL-AND-KEEP BEFORE?

A. It is true that BellSouth and other ILECs once resisted bill-and-keep (or reciprocal compensation at a zero rate) for local voice traffic, particularly for the early stages of local exchange competition when the flow of local traffic between ILECs and ALECs tends to be unbalanced. The reasons for that resistance remain as sound today as it was then.

However, to the best of my knowledge, BellSouth and other ILECs *never* resisted bill-and-keep specifically for Internet-bound traffic. Indeed, the complex issues posed by this form of traffic never arose in the immediate aftermath of the Telecommunications Act of 1996, when the FCC was engaged in rulemaking based on the provisions of that Act. The entire structure of cost causation and efficient inter-carrier compensation is different for Internet-bound traffic, despite some superficial resemblances to local voice traffic. As I have explained in this testimony, the analogy of that traffic to long distance traffic implies a very different form of efficient inter-carrier compensation. Bill-and-keep may not be the first-best form of compensation for this purpose, but it is superior to reciprocal compensation.

Q. DR. SELWYN ALSO ACCUSES [AT 32] BELLSOUTH AND OTHER ILECS OF NOW SUPPOSEDLY REVERSING COURSE ON THEIR ALLEGED RESISTANCE TO BILL-AND-KEEP BECAUSE THE ILECS HAVE FOUND THAT ALECS HAVE RETALIATED BY OPTING TO TERMINATE, RATHER THAN ORIGINATE, LOCAL CALLS. DO YOU AGREE?

A. No. Dr. Selwyn's point is that the ILECs originally resisted bill-and-keep because, as net recipients of local traffic, they expected to earn significant reciprocal compensation revenues from the ALECs, but now the apparent success of those ALECs at turning the tables on the ILECs (by specializing in call termination services) has left the ILECs attempting furiously to revive bill-and-keep. Accordingly, Dr. Selwyn pronounces judgment in the following terms [at 32]:

> In competitive markets, competitors live or die by their own business judgments and decisions, and it is not the role of regulators to backstop these market choices by after-the-fact protective measures. [emphasis removed]

This assertion is false. First, as explained above, the ILECs' present support for bill-and-keep for Internet-bound traffic should not be confused with their earlier resistance to bill-and-keep for local voice traffic. Second, Dr. Selwyn over-reaches greatly in describing the local exchange market as "competitive." Even if more entry were to occur in this market than happening presently, as long as ILECs like BellSouth remain subject to regulation and

price-constraining policies, the local exchange cannot behave like an unfettered competitive market. In competitive markets, symmetric reciprocal compensation rates pegged to ILECs' costs would not exist. Finally, in asking for alternatives to reciprocal compensation, BellSouth and the ILECs are seeking the appropriate and efficient form of inter-carrier compensation for Internet-bound traffic, not for "regulatory backstops" or "after-the-fact protective measures."

Q. WHY DO YOU OBJECT TO THE INSISTENCE BY ALEC WITNESSES [FALVEY, AT 11; SELWYN, AT 34 AND 66] THAT RECIPROCAL COMPENSATION SHOULD APPLY TO INTERNET-BOUND TRAFFIC AT RATES THAT (1) ARE SET AT THE ILEC'S INCREMENTAL COST TO TERMINATE THE LOCAL VOICE CALL AND (2) SYMMETRIC BETWEEN THE ILEC AND THE CLEC?

A. I object to that recommendation by the ALEC witnesses on three grounds. First, reciprocal compensation for Internet-bound traffic is not a cost causative form of inter-carrier compensation (for reasons I have explained).

Second, the ILEC's incremental cost to terminate a local voice call may differ significantly from (indeed, be significantly higher than) an ALEC's cost to switch or deliver an Internet-bound call to an ISP. This difference is likely to be more striking if the ALEC in question is designed solely to receive (and deliver to ISPs) incoming Internet-bound calls from the ILEC's subscribers.

Third, a symmetric reciprocal compensation rate set at the level of the ILEC's incremental cost to terminate a *local voice* call may, for an ALEC that has a much lower incremental cost to deliver Internet-bound calls to ISPs, provide a windfall profit margin. Other things being equal, this would further stimulate the ALEC to specialize in call termination services (as Dr. Selwyn believes), to the detriment of the overall public policy goal of fostering competition for the full spectrum of local exchange services.

I explore these issues at length in the remainder of my testimony.

5. State Decisions (*Issues 2, 4, and 6*)

Q. THE FCC THUS FAR HAS NOT ACTED TO ESTABLISH PERMANENT INTER-CARRIER COMPENSATION RULES FOR INTERNET-BOUND TRAFFIC. THE ALEC WITNESSES CITE EXAMPLES OF STATES THAT HAVE FAVORED RECIPROCAL COMPENSATION FOR THIS PURPOSE. HAVE ALL STATES ACTED THAT WAY?

A. No. For a period of time until the FCC's *ISP Declaratory Ruling* was issued in early 1999, a number of states pursued their own rulemaking on the issue. Those states chose to adopt the ILEC-ALEC local interconnection view of the world and required that the originating ILEC pay reciprocal compensation to "terminating" ALECs for Internet-bound calls just as they would for local voice calls. After the FCC's *ISP Declaratory Ruling* was issued, regulators in Massachusetts, who had previously also adopted the local interconnection view, reversed themselves and declared the unqualified payment of reciprocal compensation for Internet-bound traffic to be antithetical to real competition in telecommunications.[25] Subsequently, regulators in New Jersey, in reversing an arbitrator's recommendation in October 1998, also ordered that reciprocal compensation not be paid for Internet-bound traffic.[26] More recently, regulators in South Carolina,[27] Louisiana,[28]

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[25] Massachusetts Department of Telecommunications and Energy ("DTE"), *Complaint of MCI WorldCom, Inc., Against New England Telephone and Telegraph Company d/b/a Bell Atlantic-Massachusetts for Breach of Interconnection Terms Entered Into Under Sections 251 and 252 of the Telecommunications Act of 1996*, Docket No. 97-116-C, Order ("*Massachusetts ISP Order*"), May 1999. The DTE ordered that all future reciprocal compensation payments by Bell Atlantic be placed in an escrow fund until final disposition on the matter of inter-carrier compensation. The competitive local exchange carriers serving ISPs in Massachusetts currently do not themselves receive any compensation for Internet-bound traffic.

[26] New Jersey Board of Public Utilities, *In the Matter of the Petition of Global Naps, Inc. for Arbitration of Interconnection Rates, Terms, Conditions and Related Arrangements with Bell Atlantic-New Jersey Pursuant to Section 252(b) of the Telecommunications Act of 1996*, Docket No. T098070426, Order, July 7, 1999.

[27] South Carolina Public Service Commission, *In re Petition for Arbitration of ITC^DeltaCom Communications, Inc. With BellSouth Telecommunications, Inc. Pursuant to the Telecommunications Act of 1996*, Docket No. 1999-259-C, Order No. 1999-690, Order on Arbitration, October 4, 1999.

[28] *Louisiana ISP Order*.

Colorado,[29] Arizona,[30] and Iowa[31] have directed that such compensation not be paid. Significantly, Colorado, Arizona, and Iowa regulators have adopted bill-and-keep as the preferred policy option for Internet-bound traffic in their states. A number of other states have, since the FCC's *ISP Declaratory Ruling*, instituted or retained reciprocal compensation—primarily on the argument that Internet-bound traffic is "local." However, contrary to the states that have ruled against reciprocal compensation, these states have made their rulings almost exclusively on their perceptions of the jurisdictional status of Internet-bound traffic. The all-important economic foundations of an efficient compensation policy, particularly cost causation, were almost always excluded from their deliberations.

Q. WHAT REASONS DID MASSACHUSETTS REGULATORS GIVE FOR THEIR REVERSAL ON THE COMPENSATION POLICY FOR INTERNET-BOUND TRAFFIC?

A. The Massachusetts Department of Telecommunications and Energy explained its reasons for the reversal thus:

> The unqualified payment of reciprocal compensation for ISP-bound traffic, implicit in our October Order's construing of the 1996 Act, does not promote real competition in telecommunications. Rather, it enriches competitive local exchange carriers, Internet service providers, and Internet users at the expense of telephone customers or shareholders. This is done under the guise of what purports to be competition, but is really just an unintended arbitrage opportunity

[29] Colorado Public Utilities Commission, *In the Matter of the Petition of Sprint Communications Company, L.P. for Arbitration Pursuant to U.S. Code § 252(B) of the Telecommunications Act of 1996 to Establish an Interconnection Agreement with U S WEST Communications, Inc.*, Docket No. 00B-011T, Initial Commission Decision ("*Colorado ISP Order*"), adopted May 3, 2000, especially at pages 13-18. Also see Colorado Public Utilities Commission, Decision Denying Application for Rehearing, Reargument, or Reconsideration, Docket No. 00B-011T, adopted June 7, 2000.

[30] Arizona Corporation Commission, *In the Matter of the Petition of Sprint Communications Company, L.P. for Arbitration of Interconnection Terms, Conditions and Related Arrangements with U S WEST Communications, Inc.*, Docket Nos. T-02432B-00-0026 and T-01051B-00-0026, Decision No. 62650, adopted June 13, 2000.

[31] Iowa Utilities Board, *In re Arbitration of Sprint Communications Company L.P., and U S WEST Communications, Inc., n/k/a Qwest Corporation*, Docket No. ARB-00-1, Arbitration Order ("*Iowa ISP Order*"), December 21, 2000.

> derived from regulations that were designed to promote real competition. A loophole, in a word. ... But regulatory policy ... ought not to create such loopholes or, once having recognized their effects, ought not leave them open.
>
> Real competition is more than just shifting dollars from one person's pocket to another's. And it is even more than the mere act of some customers' choosing between contending carriers. Real competition is not an outcome in itself—it is a means to an end. The "end" in this case is *economic efficiency* ... Failure by an economic regulatory agency to insist on true competition and economic efficiency in the use of society's resources is tantamount to countenancing and, to some degree, encouraging waste of those resources. Clearly, continuing to *require* payment of reciprocal compensation ... is not an opportunity to promote the general welfare. It is an opportunity only to promote the welfare of certain CLECs, ISPs, and their customers, at the expense of Bell Atlantic's telephone customers and shareholders.[32]

Q. WHY IS THIS PARTICULAR PASSAGE FROM THE MASSACHUSETTS DECISION SIGNIFICANT?

A. This passage is significant for three reasons. First, to the best of my knowledge, the DTE was the first regulatory authority to present a cogent *economic* analysis of carrier incentives and their eventual outcomes under a regime of reciprocal compensation for Internet-bound traffic.

Second, while some of the ALEC witnesses [Hunsucker, at 10; Falvey, at 4] mention the states that have apparently ordered reciprocal compensation for Internet-bound traffic, none presents the alternative viewpoint on the issue, such as that expressed by Massachusetts regulators. Unfortunately, the ALEC witnesses pass up the opportunity to engage the Massachusetts and other similar decisions—with which they would, no doubt, disagree—on a true *economic* level.

Third, in its recent decision ruling against reciprocal compensation for Internet-bound traffic, the Iowa Utilities Board cited the very passage from the Massachusetts decision reproduced above.[33] It is particularly noteworthy that the Iowa Utilities Board issued this

[32] *Massachusetts ISP Order.* Emphasis added (in part) and in original (in part).

[33] *Iowa ISP Order.*

ruling *without* rendering an opinion about whether such traffic is jurisdictionally local or interstate, i.e., based solely on the economic merits of the issue, as is evident from the following passage.

> Reciprocal compensation for ISP-bound traffic would introduce a series of unwanted distortions into the market: cross-subsidization of CLECs, ISPs, and Internet users by the ILECs (sic) customers who do not use the Internet, excessive use of the Internet, excessive entry into the market by CLECs specializing in ISP traffic mainly for the purpose of receiving compensation from the ILECs, and disincentives for CLECs to offer either residential service or advanced services.[34]

Significantly, Colorado regulators also based their decision to deny reciprocal compensation for Internet-bound traffic on similar economic reasoning, particularly with reference to the cost causation principle.

Q. WHAT WAS THE COLORADO COMMISSION'S REASONS FOR DENYING RECIPROCAL COMPENSATION FOR INTERNET-BOUND CALLS, AND IN WHAT CONTEXT DID THAT COMMISSION REACH THAT DECISION?

A. Arbitrating an interconnection agreement between Qwest (then known as U S WEST Communications) and Sprint, the Colorado Commission reasoned thus:[35]

> The ILEC-IXC interconnection analogy suggests that the ISP should compensate both U S WEST and Sprint for the costs they incur in transmitting this call. Even if that analogy were not employed, applying the principle of cost causation would lead to the same conclusion, namely, that the ISP should pay access charges to both U S WEST and Sprint for the cost caused by the ISP customer. The ISP would recover these charges from that customer. This option, however, is precluded by the FCC's access charge exemption for ISPs. Therefore, both U S WEST and Sprint are in the position of having to recover the costs of carrying this Internet-bound traffic through some means other than access charges.
>
> Sprint recommends that cost recovery be done through the process of reciprocal compensation. In the scenario being considered here, since the end-user originating the Internet-bound call is a local exchange customer of U S WEST,

[34] *Id.*, at 4.

[35] *Colorado ISP Order*, at 15-17. Footnotes omitted, emphasis added.

U S WEST would have to compensate Sprint for the latter's costs incurred in transmitting the call to the ISP. *The Commission rejects the use of reciprocal compensation with a positive rate in this instance.*

While ISP calls appear to be interstate in nature, our conclusion is not necessarily based upon that determination. Even if this traffic were considered to be local in nature, the Commission still would not embrace reciprocal compensation with a positive rate. Such a scheme would, in our view, bestow upon Sprint an unwarranted property right, the exercise of which would result in decidedly one-sided compensation. In addition, we find that reciprocal compensation would introduce a series of unwanted distortions into the market. These include: (1) cross-subsidization of CLECs, ISPs, and Internet users by the ILEC's customers who do not use the Internet; (2) excessive use of the Internet; (3) excessive entry into the market by CLECs specializing in ISP traffic mainly for the purpose of receiving compensation from the ILECs; and (4) disincentives for CLECs to offer either residential service or advanced services themselves. In short, we agree with U S WEST that reciprocal compensation for ISP traffic would not improve overall social welfare; it would simply promote the welfare of some at the expense of others.

Q. DID THE COLORADO COMMISSION SPECIFICALLY ACCEPT THE ANALOGY BETWEEN AN ISP CUSTOMER AND AN IXC CUSTOMER FOR THE PURPOSES OF DETERMINING WHAT HOW COST IS CAUSED FOR AN INTERNET-BOUND CALL?

A. Yes. The Colorado Commission stated:[36]

The Commission finds that U S WEST's analogy [between ISP-bound and IXC-bound calls] is the more reasonable. Given that most Internet calls end at locations out of state, it appears that such calls are primarily interstate in nature. We view the originator of the Internet-bound call as acting primarily as a customer of the ISP, not as a customer of U S WEST. Both U S WEST and Sprint are providing access-like functions to transmit the call to the Internet, similar to what their role would be in providing access to an IXC to transmit an interstate call.

[36] *Id.*, at 14-15.

6. Inefficiencies and Adverse Economic Impacts of Reciprocal Compensation for Internet-Bound Traffic (*Issues 4, 5, and 6*)

Q. DO ANY OF THE ALEC WITNESSES ADDRESS THE REAL ECONOMIC HARMS THAT CAN RESULT FROM A POLICY OF RECIPROCAL COMPENSATION FOR INTERNET-BOUND TRAFFIC?

A. No. Despite the clear statements of concern by regulators from various states who have made the effort to explore the full economic ramifications of such a policy, the ALEC witnesses in this proceeding ignore the real harms that that policy can bring. Instead, they provide superficial or spurious economic justifications for that policy. For example, Mr. Hunsucker [at 9] claims that treating Internet-bound traffic as local and making it subject to reciprocal compensation would "avoid imposing separate or additional regulatory hurdles on CLECs that might make entry more difficult, expensive and time-consuming." Holding Internet-bound traffic routed through ISPs apart from all local voice traffic, Mr. Hunsucker claims, would create incentives "for one party or the other to seek compensation rates that are unduly high or unduly low, depending on which carrier tends to have the largest base of ISP customers." Mr. Hunsucker's analysis does not even begin to scratch the surface. He does not explore how economic incentives are shaped and influenced by the type of compensation policy. He does not ask what form of entry is likely to be encouraged by reciprocal compensation for Internet-bound traffic, or what the resulting balance of traffic could be between the ILEC and the ALEC. Finally, he does not explain why a common reciprocal compensation policy (implying the same compensation *rate* for both local and Internet-bound traffic) would be economically efficient and maximize social welfare.

In a similar vein, Dr. Selwyn [at 8] touts a policy of reciprocal compensation for Internet-bound traffic, based on the same single, symmetric rate for transport and termination—pegged solely to the *ILEC's* cost—that currently applies to cross-network local traffic. Beyond citing one of the FCC's original reasons for such a compensation rate for the exchange of local voice traffic, he does not explain why that reasoning would still

apply for the exchange of Internet-bound traffic.[37] In fact, he virtually acknowledges that transplanting a policy created for local voice traffic to Internet-bound traffic creates incentives for ALECs to (1) compete only for call termination services, i.e., specialize in serving ISPs (or, at least, maximize the ratio of incoming to outgoing calls) and (2) deploy cost-lowering technologies that expand the margins between costs and the allowed ILEC-cost-based compensation rate and generate greater profits for themselves. Beyond claiming that such outcomes "promote competition," Dr. Selwyn avoids any discussion about exactly what form of competition and industry structure are likely to emerge in those circumstances, or why that industry structure would be efficient and in the public interest. Having admitted in his testimony that symmetric reciprocal compensation rates may induce ALECs to specialize in call termination services, Dr. Selwyn also appears to contradict himself by claiming [at 31] that "there is no logical connection between the traffic flow and compensation due in one direction, and the traffic flow and compensation that might occur in the reverse direction."

Q. WHY WOULD THE ILEC-ALEC LOCAL INTERCONNECTION REGIME WITH PAYMENT OF RECIPROCAL COMPENSATION FOR INTERNET-BOUND TRAFFIC HARM ECONOMIC EFFICIENCY AND FAIL TO PROMOTE TRUE COMPETITION?

A. The harm to economic efficiency in an ILEC-ALEC local interconnection regime with payment of reciprocal compensation for Internet-bound traffic occurs for three reasons:

1. Inefficient subsidization of Internet users by non-users.
2. Distortion of the local exchange market.
3. Creation of perverse incentives to arbitrage the system at the expense of basic exchange ratepayers.

[37] The FCC's three principal reasons for that policy were: (1) provide incentives to all carriers, especially ALECs, to lower their costs, (2) prevent ILECs from exploiting their greater bargaining strength vis-à-vis ALECs, and (3) administrative simplicity of a single, symmetric rate based on a regulated carrier's cost. See FCC, *In the Matter of Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98, First Report and Order ("*Local Competition Order*"), released August 19, 1996, ¶¶1085-1088.

Q. PLEASE EXPLAIN HOW TREATING INTERNET-BOUND TRAFFIC AS LOCAL FOR PURPOSES OF INTER-CARRIER COMPENSATION COULD CAUSE INEFFICIENT SUBSIDIZATION OF INTERNET USERS BY NON-USERS.

A. The principle of cost causation requires that the *ISP customer* pay at least the cost his call imposes on the circuit-switched network.[38] Suppose inter-carrier compensation for Internet-bound traffic is based on the assumption that such traffic is local. This regime assumes at the outset that the customer initiating the call has paid the originating ILEC for the end-to-end carriage of the call, typically, the per-call equivalent of the local call charge. Out of what it receives, the ILEC would then pay reciprocal compensation to the ALEC that "terminates" to the ISP. This compensation is a per-minute call "termination" charge which, ideally, should reflect the incremental cost that the ILEC *avoids* by not having to handle the call itself. In this scenario, problems can emerge from two sources.

First, if the local call charge is itself inefficient, e.g., it is below the incremental cost of carrying an end-to-end local voice call, then it cannot be sufficient to allow recovery of both the ILEC's incremental cost to originate the call and the ALEC's incremental cost to handle the call. In other words, once reciprocal compensation has been paid, the ILEC would fail to recover its cost of carrying the Internet-bound call when the local call charge itself is inefficient. If the ILEC breaks even for *all* of its services in these circumstances, that would mean that Internet use (for which the cost exceeds revenue) is being subsidized by non-Internet and, most likely, non-local exchange services.

Second, if the cost to handle an Internet-bound call is *less* than the cost to handle the average local voice call (on which most reciprocal compensation arrangements are based), then the ALEC would recover in excess of its cost. Even if the local per-call charge were compensatory, the ILEC could still end up with a higher cost liability than necessary (the sum of its own originating cost and the ALEC's inflated "termination" charge) and a net revenue deficit from carrying the Internet-bound call. Again, the Internet user would not

[38] It is assumed that the cost imposed by that customer for the packet-switched network portion of the Internet call is recovered through monthly access charges by the ISP serving that customer.

be paying the cost he or she imposes on the originating ILEC (equivalent to receiving a subsidy).

This form of subsidization of Internet use within the circuit-switched network can inefficiently stimulate demand for Internet services and further aggravate the ILEC's tenuous position under the view that Internet-bound traffic is local. Additional negative consequences could be (1) greater congestion at local switches engineered for voice traffic generally and, as a result, poorer quality of voice traffic, and (2) opportunistic specialization by ALECs in only handling (or, as the ALECs would characterize it, "terminating") Internet-bound traffic. I discuss the resulting distortion of the local exchange market below.

Q. HOW WOULD TREATING INTERNET-BOUND TRAFFIC AS ANALOGOUS TO LONG DISTANCE TRAFFIC (WITH THE PAYMENT OF ACCESS-LIKE USAGE-BASED CHARGES) REMEDY THIS PROBLEM?

A. When Internet-bound traffic is treated as analogous to long distance traffic, the ISP customer that initiates the call causes all of the costs that are incurred, and, except for the explicit subsidy to ISP access represented by the access charge exemption, remains responsible for paying costs of originating, transporting, and switching his traffic to the ISP. Because of the access charge exemption, ILECs and ALECs that jointly supply access services to ISPs are not fully compensated for those services but each contributes to the ISP access subsidy no more than their proportion of costs. This arrangement is competitively neutral because all ILECs and ALECs involved contribute to the subsidy rather than just the ILECs that originate Internet-bound traffic. In this regime, an ISP has no particular incentive to become an ALEC itself, nor is the competition among ILECs and ALECs to serve ISPs distorted by incentives to seek compensation for "terminating" calls.

Q. PLEASE EXPLAIN HOW TREATING INTERNET-BOUND TRAFFIC AS LOCAL COULD CAUSE THE LOCAL EXCHANGE MARKET TO BE DISTORTED.

A. When Internet-bound traffic is treated as local for purposes of inter-carrier compensation, the compensation paid to the ALEC evidently exceeds the cost it incurs to handle the

traffic and also exceeds whatever cost the ILEC might save when the ALEC delivers the traffic to the ISP in its place. That the prices do not reflect costs should not be surprising. In Florida, interconnection prices are based on the ILEC's forward-looking TELRIC costs of terminating traffic averaged over a wide range of end-users. In fact, the cost of terminating traffic to particular end-users varies a great deal, depending upon their location and the characteristics of the traffic. When traffic is balanced[39] between the ILEC and the ALEC, the accuracy of the TELRIC study is less material; an ILEC that overpays to terminate traffic on the ALEC's network is compensated when the ALEC overpays to terminate traffic on the ILEC's network. Thus, when traffic is balanced, no individual ILEC or ALEC is helped or handicapped in competing for retail customers in the local exchange market by the requirement that interconnection prices be based on TELRICs averaged over all customers.

However, when traffic between the ILEC and the ALEC is grossly unbalanced, e.g., when the ALEC originates little or no traffic (a fact that Dr. Selwyn repeatedly acknowledges as likely given the FCC rule requiring a symmetric compensation rate), the accuracy of the TELRIC study for the traffic served by that ALEC is critical. If the cost to BellSouth (the ILEC) to deliver Internet-bound traffic to the ISP is the same as to a specialized ALEC collocated with the ISP, then paying reciprocal compensation at an averaged rate would cause BellSouth's total cost of local service to increase. This cost increase would not be offset by a similar increase in revenue from terminating the ALEC's traffic (because the ALEC does not originate any traffic). Thus, local exchange competition would be distorted by applying the averaged TELRIC (for local voice traffic) to Internet-bound traffic; ALECs that primarily serve ISPs (and originate little or no traffic) would receive revenues in excess of cost while ILECs (or even other ALECs) that serve all types of customers would experience an increase in costs without a commensurate increase in revenues.

[39] Traffic is said to be "balanced" when originating and terminating volumes are similar.

Q. DO THE ALEC WITNESSES ACKNOWLEDGE THAT THIS MAY OCCUR?

A. Yes. Dr. Selwyn readily acknowledges that these developments in the local exchange market—which I consider troubling and distortive—are possible when Internet-bound traffic is subjected to reciprocal compensation at a symmetric rate but the cost experienced by the ALEC to handle such traffic is lower than the cost experienced by the ILEC.

Consider first Dr. Selwyn's statements [at 37-38]:

> [I]n a competitive local telecom market, carriers can compete for call termination business and, if one carrier is able to furnish the call termination service more efficiently than the ILEC, the goals of competition are served when customers are induced to switch from the ILEC to a CLEC for this service.

And,

> In fact, if the symmetric reciprocal compensation rate is set at the ILEC's cost, then only those CLECs that are able to provide call termination services more efficiently than the ILEC will elect to engage is (sic) this particular market segment. On the other hand, inasmuch as the *Telecommunications Act* and resulting FCC regulations required that the reciprocal compensation rate be set at the ILEC's cost, CLECs acted reasonably in assuming that the rate confronting them in their respective interconnection agreements did in fact represent the ILEC's cost. If the CLEC found that it was able to furnish high-volume call termination services at a lower cost, then it acted legitimately in making the necessary investment in switching and related equipment and in developing a business plan premised on the reciprocal compensation price that was dictated to it by the ILEC. The volume of traffic that may or may not flow in the reverse direction—i.e., from the CLEC to the ILEC, is irrelevant.

Taken together, a reasonable inference from the two statements is that when the rules of the game are set up to provide an ALEC reciprocal compensation for delivering Internet-bound calls to ISPs at a symmetric rate pegged to the *ILEC's* cost to terminate a local *voice* call, ALEC specialization in serving ISPs (what Dr. Selwyn terms "high-volume call termination services") is only to be expected. On that, I agree with Dr. Selwyn; indeed, with incentives set up that way, it is perfectly rational for unregulated ALECs, who are free to enter and operate in the local market as they will, to respond in that matter. However, I strongly disagree with Dr. Selwyn that this is good local competition or even good *for* local competition. As I explain below, what Dr. Selwyn describes in glowing terms is nothing but arbitrage that occurs in response to a market distortion, here the symmetric reciprocal

compensation rule based on the ILEC's cost to terminate a local voice call despite cost differences among ILECs and ALECs. While arbitrage may be *privately* good, i.e., good for the ALECs specializing in call termination, it is definitely not in the public interest. The Telecommunications Act of 1996 made a particular point of creating the conditions for vigorous and efficient local exchange competition, i.e., for the full gamut of local exchange services including both call origination and termination. It certainly never envisioned the rise of a local exchange market in which only the ILEC (and possibly a handful of other carriers) provide the full spectrum of local exchange services, while the majority of new competitive carriers only enter the market as rent-seekers, i.e., in pursuit of arbitrage profits.

Q. PLEASE EXPLAIN HOW THE ILEC-ALEC INTERCONNECTION REGIME FOR INTERNET-BOUND TRAFFIC COULD CREATE PERVERSE INCENTIVES TO ARBITRAGE THE SYSTEM AT THE EXPENSE OF BASIC EXCHANGE RATEPAYERS.

A. Arbitrage is frequently a response to a market distortion. As the DTE in Massachusetts clearly recognized, unintended arbitrage opportunities can easily emerge when competition in the local exchange market is distorted by basing inter-carrier compensation for Internet-bound traffic on the ILEC-ALEC local interconnection regime. When the compensation available to the ALEC for handling Internet-bound traffic exceeds its actual cost of handling that traffic, the ALEC will have a strong incentive to receive as much Internet-bound traffic as possible. Profit maximization can elicit some very inventive schemes that take advantage of this discrepancy but, in the process, distort market outcomes and reduce the efficiency of the telecommunications network.[40] For example, the ALEC's profits would increase whenever a BellSouth subscriber—or the subscriber's computer—could be induced to call the ISP and remain on the line 24 hours a day. Sensing this pure arbitrage

[40] These problems have also been recognized in the recent OPP Working Paper by Patrick DeGraba [at 24]. See *supra*, fn. 21.

profit opportunity, ALECs would also have a strong incentive—indeed, have as their *raison d'être*—to specialize only in "terminating" Internet-bound traffic (as Dr. Selwyn acknowledges), to the exclusion of offering any other type of local exchange service. In fact, a good example of this in Florida surfaced in a recent proceeding when Mr. William J. Rooney, representing Global NAPs (an ALEC for whom Dr. Selwyn was an expert witness), freely admitted to his company being set up to operate that way.[41] These "ISP-specializing" ALECs can—and do—form a three-way axis whose sole purpose is to generate revenues from reciprocal compensation: the ALECs themselves, the ISPs to which the ALECs deliver Internet-bound traffic and possibly send a share of the reciprocal compensation revenues—the spoils of this arrangement—to insure their loyalty and cooperation, and the ISP customers on the originating ILEC's network that generate the Internet-bound traffic. Also, the ISPs themselves are better off if their customers obtain their non-Internet local telephone service from the ILEC or other ALECs that do not serve ISPs, rather than from the ALECs that deliver Internet-bound traffic to them. This is likely to create a further distortion in the local exchange market, contrary to the vision of competition embodied in the Telecommunications Act of 1996.

It is not surprising, therefore, that the DTE in Massachusetts felt compelled to opine that *termination* of the obligation for reciprocal compensation payments for ISP-bound traffic (because that traffic is no longer deemed local) removes the incentive for ALECs to use their regulatory status "solely (or predominately)" to funnel traffic to ISPs.[42]

Q. BUT, DOESN'T ARBITRAGE SERVE A USEFUL PURPOSE BY EVENTUALLY ELIMINATING DISTORTIONS IN A COMPETITIVE MARKET?

A. In general, arbitrage serves that purpose, provided that the distortion that creates the arbitrage opportunity is temporary and reversible. That is not the case here. The distortion

[41] Florida Public Service Commission, *In re Complaint of Global NAPS, Inc., Against BellSouth Telecommunications, Inc. for Enforcement of Section VI(B) of its Interconnection Agreement with BellSouth Telecommunications, Inc., and Request for Relief*, Docket No. 991267-TP.

[42] *Massachusetts ISP Order.*

at issue here is an artifact of a regulatory rule—symmetric reciprocal compensation for Internet-bound traffic at a rate pegged to the ILEC's cost to terminate local voice traffic—and is unlikely to be arbitraged away. Quite the contrary, the arbitrage opportunity will persist and the worst fears of Massachusetts and other regulators will continue to be realized as long as that regulatory rule is in place. Only an alternative form of inter-carrier compensation, e.g., usage-based charges or bill-and-keep will prevent the distortion—and the arbitrage opportunity—from arising in the first place.

Q. HAVE REGULATORS TAKEN EXPLICIT NOTE OF THE FACT THAT THESE ARBITRAGE OPPORTUNITIES ARISE BECAUSE PRICES (OR, COMPENSATION RATES) ARE OUT OF LINE WITH TERMINATION COSTS?

A. Yes. Where the cost of terminating traffic to a particular type of customer differs greatly from the average, the FCC has recognized the possibility of arbitrage and has declined to use the ILEC's TELRIC termination costs as a proxy for those of the ALEC:

> Using incumbent LEC's costs for termination of traffic as a proxy for paging providers' costs, when the LECs' costs are likely higher than paging providers' costs, might create uneconomic incentives for paging providers to generate traffic simply in order to receive termination compensation.[43]

Instead, the FCC has required separate cost studies to justify a cost-based termination rate which the FCC explicitly expects would be lower than the wireline ILECs' TELRIC-based rate. Note that the paging case also involves one-way calling; like ISPs, paging companies do not originate traffic.

Echoing this sentiment, the Massachusetts DTE has stated flatly that

> The revenues generated by reciprocal compensation for ... incoming traffic are most likely in excess of the cost of sending such traffic to ISPs. ... Not surprisingly, ISPs view themselves as beneficiaries of this "competition" and argue fervently in favor of maintaining reciprocal compensation for ISP-bound traffic. However, the benefits gained, through this regulatory distortion, by CLECs, ISPs, and their customers do not make society as a whole better off,

[43] *Local Competition Order*, ¶1093.

because they come artificially at the expense of others.[44]

Q. BOTH DR. SELWYN [AT 34] AND MR. FALVEY [AT 11] RECOMMEND A SYMMETRIC RECIPROCAL COMPENSATION RATE AT THE LEVEL OF THE ILEC'S TERMINATION COST FOR PROVIDING THE "RIGHT" INCENTIVES TO ALL CARRIERS. IS THERE EVIDENCE OF OPPORTUNISTIC ARBITRAGE THAT CAN ARISE FROM SETTING SUCH A RATE?

A. Yes, there is evidence that the potential bounty from the FCC's reciprocal compensation rule has inspired some rather inventive, if illegal or unethical schemes. The best example is that of an ALEC called US LEC of North Carolina which manufactured sham traffic solely for the purpose of collecting windfall inter-carrier compensation. In fact, the North Carolina Utilities Commission found:[45]

> US LEC deliberately created a usage imbalance between itself and BellSouth by terminating a greater amount of traffic originating on BellSouth's network than it would be terminating to BellSouth. In furtherance of its plan to create a traffic imbalance and thus large reciprocal compensation revenues for itself, US LEC, among other things, induced MCNC and Metacomm to originate connections on BellSouth's network and terminate them to US LEC telephone numbers by agreeing to pay them 40% of all reciprocal compensation BellSouth paid US LEC for minutes of use for which they were responsible.[46]

And,

> In the fall of 1997, Metacomm and MCNC established networks to generate reciprocal compensation for US LEC and commissions for themselves. They established connections by having routers connected to circuits purchased from BellSouth call routers connected to circuits provided by US LEC. They leased transmission facilities from BellSouth capable of originating up to 672 connections simultaneously. Pursuant to US LEC's instructions, Metacomm and MCNC programmed their routers to disconnect and immediately reconnect each connection every 23 hours and 59 minutes, so that US LEC's switches could create the records US LEC which [sic] needed to bill BellSouth for

[44] *Massachusetts ISP Order*. Emphasis added.

[45] *In the Matter of BellSouth Telecommunications Inc v. US LEC of North Carolina Inc*, Before the North Carolina Utilities Commission, Docket No P-561, SUB 10, March 31, 2000.

[46] *Id.*, at 7.

reciprocal compensation.[47]

In another instance, both the Massachusetts DTE (*Massachusetts ISP Order*, Section IV and fn. 39) and the FCC (*ISP Declaratory Ruling*, ¶24, fn. 78) expressed serious concern after ISG-Telecom Consultants International, a Florida-based company formed in the aftermath of the Telecommunications Act of 1996 ("1996 Act"), posted promises on its web site to turn ISPs into ALECs and IXCs with their own ISP operations. As a rationale for doing so, ISG-Telecom believed that "... as a facility based CLEC, the ISP/CLEC should be able to participate in *reciprocal compensation* with the carriers, providing there is not a negative ruling from the FCC in up and coming months." (emphasis added in part) Clearly, arbitrage opportunities presented by the payment of reciprocal compensation for Internet-bound traffic, not an inherently efficient network arrangement, lay at the heart of this mission statement. Dr. Selwyn's prediction that many ALECs will take advantage of the symmetric reciprocal compensation rule (if applied to Internet-bound traffic) by specializing in call termination services rings distressingly true.

Q. COULD THIS ALSO BE TRUE OF AN ALEC WHICH, UNLIKE ISP-SPECIALIZING ALECs, IS A LARGE FACILITIES-BASED PROVIDER OF LOCAL EXCHANGE SERVICES?

A. Yes. All ALECs face these distorted incentives irrespective of the mix of traffic they actually serve. Whether an ALEC passes through a portion of the reciprocal compensation payments it receives to attract ISP customers is irrelevant, because competition among ALECs to serve ISPs will ensure that reciprocal compensation payments in excess of cost will be passed through to ISPs in the form of lower market prices for the network access (local exchange lines) they buy from those ALECs.

Q. HOW DO YOU RESPOND TO DR. SELWYN'S ARGUMENT [AT 64] THAT THE

[47] *Id.*, at 7. MCNC withdrew its participation in the reciprocal compensation arrangement after its management learned that the "unusual configuration and mix of equipment" making up the network was intended to generate revenue from connections without regard to actual traffic or content traversing the connections, *Id.*, at 7.

FCC NEVER CONTEMPLATED ASKING AN ALEC TO FILE COST STUDIES (IN CONNECTION WITH SETTING A RECIPROCAL COMPENSATION RATE) IN THE EVENT THAT THE ALEC'S COSTS ARE LOWER THAN THE ILEC'S?

A. As the passage reproduced in the previous answer from the *Local Competition Order* clearly demonstrates, the FCC is aware that in circumstances when the alternative carrier's (say, a paging provider's) cost is so much lower than the ILEC's that uneconomic incentives for arbitrage are created, separate cost studies are clearly necessary. There is now evidence from around the country that the ISP-specializing ALEC's incremental cost to carry Internet-bound traffic to the ISP is significantly lower than the ILEC's unit cost to terminate the average local voice call.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

BY MR. EDENFIELD:

Q Doctor Taylor, did you prepare a summary of your testimony?

A Yes, I did.

Q Would you give that now, please, sir?

A Sure. I'm going to be testifying as an economist, not as a lawyer, not as an engineer. The economic issue is an interesting one. It's who pays what to whom. And when you are in that position you don't know whether I should be paying you or you should be paying me. You know there is a fundamental misunderstanding going on. So it's who pays what to whom for carrying dial-up calls from Internet users.

My rebuttal testimony looks at three economic reasons why reciprocal compensation at the local interconnection rate is bad policy for consumers. First, cost causality implies that payments go the other way; that is, the ISP ought to be paying both of the local exchange carriers out of the money that the ISP pays the CLECs that serves it. That is the long distance model, the way things work for long distance.

Second, if you do do reciprocal compensation, you get market distortions. From a consumer's perspective, we don't get local competition, instead we

get ALECs fighting over a subsidy to serve ISPs and avoiding residential customers who can cost them more than the revenue that they would get from serving them.

Third, reciprocal compensation subsidizes dial-up Internet access so that ordinary telecommunications users, not computer people, but people who make POTS calls end up paying for costs incurred to serve ISPs, which gives ALECs, all LECs an incentive to keep Internet users on low bandwidth dial-up services, and it sets up a subsidy which is not good public policy.

Quickly let me go over those in a little detail. First, who pays whom. What is this cost causality stuff. Doctor Selwyn's testimony says that most traffic is always sent paid; that is, if I'm a BellSouth subscriber, I make a call, BellSouth should pay to have that call go through to the termination. That is not quite right. That is quite correct for local traffic, no problem with that. Cost causality makes that make sense. That's not the way we do stuff for long distance. The FCC pointed this out in their original order, and it gets someone to thinking why do we have two different ways of handling intercarrier compensation.

And the answer is to see the answer put yourself in the customer's perspective. Suppose you have your computer, you want to dial-up the Internet. Whose service

are you using? Now, what is this going to cost you? What tariff do you look at to decide whether this call is worthwhile to you? Is it BellSouth local exchange tariff? No, you don't pay that. Either it is flat-rated, as it is most places in Florida, or the ISP has put in a system so that you can call them without incurring local charges.

Now, I make my call to the Internet, my server is AT&T. I look at their deal. My deal is $19 a month, plus I think it is 6-cent a minute if I use their 800 number. That's what I think I'm doing. I am AT&T's customer. From an economic perspective that is exactly the same situation I am in for making a long distance call. When I make a long distance call, again, it is AT&T that serves me.

I don't think about what BellSouth's tariff is because it doesn't come into the situation. I buy 7-cent a minute, I think they charge me 7 bucks a month, 7 cents a minute for AT&T. And that is the decision that I made. When I'm a customer I think that is what I have to pay. I'm acting in both of these cases as the end user customer determining what I'm going to do, hoping to face a price equal to the cost I cause that is set by the long distance company or the ISP.

For local traffic it's not like that at all. When I make a call across town, whose tariff am I using,

what numbers do I look at to decide whether the call is worthwhile? Well, it's BellSouth's tariff; that is, I pay them the money, they get the money, act as my agent, pay anybody that they have to pay to make the call go through, and that's the deal. That way the customer -- that's what distinguishes these two cases. The customer faces the price that covers all of the costs of the call.

That's why I think that the right way to look at the question of intercarrier compensation for ISP traffic is like the long distance model, not like the local exchange model. Also, my second point was reciprocal compensation screws up local competition. It does it in two ways. You have heard this before. It wrecks the market for ISP services.

Put yourself in the position of an ISP looking for service. If you go to the ILEC, you go to BellSouth, roughly 95 percent of your customers, of your calls will not generate reciprocal compensation because they will be from your own end user customers. If you go to an ALEC for service, just the opposite, 95 percent of the calls will receive reciprocal compensation. And that is a distortion in the market to serve ILECs.

The flip side of that is the distortion in the market for dial-up Internet users. Who wants to serve a residential customer when that customer can generate

reciprocal compensation obligations that are large? There are obviously other elements that go into choosing whether to serve residence customers or not, but this is a distortion which causes less residential competition than we would otherwise have.

My third reason was that POTS customers subsidize Internet access under reciprocal compensation, and I don't think that is good public policy. The ILEC doesn't recover its cost from its customers, the cost of local calling plus the cost of reciprocal compensation. So, ordinary POTS users are in the position -- ordinary POTS users generate or cause reciprocal compensation to be generated. But the ALEC position requires that ordinary POTS users end up paying for it. So that is what is wrong with reciprocal compensation from an economic point of view.

My testimony also goes into some little arguments that says if you are going to do it anyway, please get the costs right; that is, treat ISP traffic separately and distinctly. First, because the costs are different; and, second, because the ESP exemption makes recovery different. The costs are different because of duration, which we have discussed. They are different because of the difference in time-of-day distributions, but those are things that can be fixed, if that is what

you want to do.

My testimony concludes that the second best solution, not the first best, is bill and keep. Under bill and keep the ILEC and the CLEC will have the same incentive to serve ISPs, that is going to result in imbalanced traffic. And can you do bill and keep as a legal matter? I don't know, obviously. But I do know from personal experience that other states have ordered bill and keep. Colorado, Arizona, and Iowa have ordered it. So if you can't do it, at least you have company.

And that concludes my testimony.

MR. EDENFIELD: Doctor Taylor is available for cross or questions.

CHAIRMAN JACOBS: Very well. Ms. Caswell. Ms. Masterton.

MS. MASTERTON: No questions.

MR. McDONNELL: No questions.

CHAIRMAN JACOBS: Ms. Kaufman.

MS. KAUFMAN: No questions.

MR. HORTON: None.

Ms. McNULTY: No questions.

MR. MOYLE: Just one.

CROSS EXAMINATION

BY MR. MOYLE:

Q You are an expert economist, is that right?

A Yes, sir.

Q I want to ask you a hypothetical. Assume there was a company that had $2.5 billion in total operating revenues.

A Sure.

Q With a net income of $2.7 billion, okay?

A Sure.

Q In your view as an expert economist is a $300 million contingent liability something that seriously jeopardizes the financial health of this hypothetical company?

A In some ways, yes. First, it jeopardizes it enough to make it a requirement to put it on the 10K. Second, the $300 million liability amounts in some circumstances to pick your number, 2, 3, or $4 a month per line. And so that may not jeopardize the financial health of BellSouth, that's a big public policy issue. Things that cost on the order of 2 or $3 month are things that people have died for in this industry. And so it isn't small from a public policy perspective.

Q Okay. But if I understand, a contingent liability, too, it is something that you may have to pay or you may not have to pay, correct, that's why you book it as contingent?

A That is my understanding.

Q Okay. And if it were a liability for sure, it would have more significance than a contingent liability, correct?

A Yes.

MR. MOYLE: Nothing further.

CHAIRMAN JACOBS: Commissioner Jaber.

COMMISSIONER JABER: Doctor Taylor, if a company was that concerned about earnings and revenues, would it have cashed out some dividends, would it have paid its shareholders' dividends?

THE WITNESS: Sure. In the sense that BellSouth competes in the capital markets for capital to continue to invest in the way it invests, and part of that competition in the capital market is the level of dividends that it pays. The fact or the assumption that it has a $300 million contingent liability which may even be small compared with its annually dividend payment is nonetheless an important consideration. It can't stop paying dividends. If it did, there would be immediate ramifications in what its cost of capital would be. You wouldn't want that.

CHAIRMAN JACOBS: Staff.

CROSS EXAMINATION

BY MS. BANKS:

Q Good afternoon, Doctor Taylor.

A Good afternoon.

Q I'm going to try to be brief. I know the day is dwindling, I think we are all dwindling with it.

I am referring to your statement. In your testimony you refer to the term arbitrage, can you define that term for me in the context of this proceeding?

A Yes, I think so. By arbitrage I generally mean an arrangement, generally one which doesn't last in which somebody gets something for nothing. In which a price -- I mean, the typical arbitrage is, say, in foreign exchange where the price for me to buy British pounds is less than the equivalent price in Britain for them to buy U.S. dollars, and all I have to do is fly dollars to Britain and I can eliminate that difference. It sort of has no economic value created, and market forces always work to remove it.

Q Okay. There is a two-part rate structure that has been proposed by some of the witnesses in this proceeding. Is it your opinion that this rate structure could reduce the opportunity to LECs to arbitrage?

A To reduce it, yes. I think a two-part rate structure with an initial charge which includes the set-up costs and then a subsequent charge, that mitigates, reduces, maybe eliminates the problem that long duration calls are not being correctly charged with a flat-rate

single-priced tariff. But as I said in my summary, there are other reasons why costs for serving ISPs are different other than just the duration question.

Q Sir, if I understand you correctly, you are stating it is your position that this two-part rate structure would not eliminate arbitrage?

A Not entirely, that is correct. It would not eliminate mispricing of Internet -- of calls to serve Internet service providers.

Q And can you explain why not?

A Sure. Because there are some other -- there are a bunch of other cost differences. My testimony talks about differences in time, the time of day distribution. For example, for Internet usage that is -- or dial-up Internet usage, not Internet usage in general, but dial-up Internet usage has much more usage at night and on weekends than does ordinary calling.

So that on average, when you add an Internet call to the load on a switch, there is going to be fewer minutes at the peak of the switch. So if you are going to charge the same rate for every minute of local switching, there is going to be less of a cost to you if you are talking about an Internet minute as opposed to an ordinary voice minute. Not because there is any difference in the minutes, it's a difference in the time of day distribution

in the fraction of them which occur at peak hours. So that is one example.

My testimony also discussed where for serving ISPs, typically the switch concentration is one-to-one, which makes a lot of costs which ordinarily would be traffic sensitive nontraffic sensitive and not part of reciprocal compensation. Those are the three -- duration, time of day, and the nontraffic sensitive issue were the three that I raised in my testimony.

Q Okay. Changing gears just a little bit, and I'm assuming you have a copy of your rebuttal testimony in front of you?

A Yes.

Q And I'm referring to Page 10, beginning with Line 24.

A Yes.

Q You state that the ISP is viewed as a carrier that routes the Internet call through the backbone to the final destination, is that correct?

A Yes.

Q Is it correct to say that you are suggesting that the calls to an ISP does not terminate at the ISP, but instead terminates at a distant website?

A I'm with you until you said terminates at a distant website. I'm trying to be careful with the word

termination because that has a technical definition. I'm not sure -- I don't believe that it actually terminates at a distant destination. From an economist's point of view that doesn't care about the technical meanings of these terms, sure.

When I get on the Internet, you know, I dial-up Amazon.com, that is my destination. It's just the same thing as if I were calling someone who was going to take my order on an 800 number by phone. And from my perspective as an economist, there is really no difference in the termination which takes place at Amazon.com's website and the one which would have taken place at their 800 number.

Q So with that in mind, where does the call to an ISP terminate?

A From an economist's point of view, the call itself has multiple terminations, in quotes, not telephonese terminations, but economist terminations; namely all of the different sites that I will visit when I have dialed up my ISP and gone out on the web. So multiple sites, multiple terminations, if you like.

Q I guess to clarify I'm speaking from a technical point of view, where would it terminate when you have a call, ISP call from a technical standpoint?

A Oh, oh. I think I'm a poor one to testify on

technical termination definitions. But I believe the FCC order which, though vacated, explains a great deal about its view of what happens in a packet switched world, it says, I think, that the call doesn't terminate in a traditional and standard way.

I could probably find that if I looked for it. Give me one second. Yes. It's Paragraph 12 of the declaratory ruling. "Consistent with these precedents, we conclude as explained further below that the communications at issue here do not terminate at the ISP's local server," blah, blah, blah, "but continue to the ultimate destination or destinations, specifically at an Internet website that is often located in another state."

And then they explain that further, and I thought I remembered a good example. I don't think I can find the other example here, but the FCC speaks of non-standard termination and multiple termination, but not termination in telephonese at the ISP's location. And that is the FCC's general view that an end-to-end view of telecommunications calls, the same one they used to determine jurisdictional -- the jurisdiction of a long distance call is the appropriate one to apply here.

Q But didn't the D.C. Circuit state that the FCC didn't effectively explain why the call doesn't terminate at the ISP?

A That is probably a fair paraphrase of what the court's decision was. But they needed a better explanation not so much of the end-to-end, but of how an end-to-end analysis applies in a packet switched world where, unlike in a circuit switched world, there really isn't an end.

I mean, maybe this isn't clear to too many people, but when you have a circuit switched there is an electronic path from my ear to you ear, and so it has an end. And your ear is one end, my ear is the other end. That is well defined.

When we have a packet switch, it doesn't work that way. I am sending out packets down a multiple number of routes that go to a multiple number of places. When I'm trying to get on to Amazon.com, I knock on their figurative door, and they start sending me packets back through a thousand different ways that are then reassembled in my computer. And I look at it and see what is going on.

And it isn't at all clear, then, there isn't any connection directly from my ear to its ear. There is, instead, this multiple connection or termination, if you like. There is a multiple communication between me, Amazon.com, and everybody else on the website that I'm looking at. But it's not the same thing as the

traditional termination that we see in the circuit switched world. And my interpretation of the Bell Atlantic court decision was they would like to see some more explanation.

Whereas the end-to-end story makes a lot of sense in a circuit switched world, you really have to tell a story to see how it applies in a packet switched world. And they didn't agree or didn't think the FCC did a complete job in that application. That's my interpretation.

MS. BANKS: Thank you, Doctor Taylor. That concludes Staff's cross.

CHAIRMAN JACOBS: Picking up on your explanation, it would -- and I guess I'm a little too far into this, but it occurs to me that the strongest case against the end-to-end theory rests with packet switching, because somebody somewhere has to put those packets together before they get to my modem, don't they, or to your modem? And if it were a true end-to-end communication, that wouldn't occur until the modem, wouldn't it?

THE WITNESS: I think that is correct in the sense that if I call up -- dial-up from my computer, it is a circuit switched arrangement, there is a circuit open between me and the ISP modem. And it hits the modem and

everything is broken up into little packets and goes out into the network and stuff comes back. Comes back in packets, so there is no real end to it in the sense of a circuit switch, put together at the modem, and then comes down the circuit that is open between me and the ISP. So, that is, I guess, the problem that the appeals court had is trying to figure out what goes on on the other side of the modem. On the other hand, it's not an economic argument so I'm a poor one to ask.

CHAIRMAN JACOBS: Okay. I accept. Thank you.

COMMISSIONER DEASON: I have a question. Doctor Taylor, I'm looking at the prehearing order. Do you have a copy of that?

THE WITNESS: Of the --

COMMISSIONER DEASON: The prehearing order.

THE WITNESS: Oh. No, I'm sorry, I don't.

COMMISSIONER DEASON: You don't have that. Could you provide that to the witness, please.

THE WITNESS: Okay.

COMMISSIONER DEASON: First of all, before I refer you to that order, I take it that your testimony indicates that ISP traffic really should -- that the costs should be recovered by the ALEC through some type of an access charge mechanism or not?

THE WITNESS: Not really. That is my testimony

doesn't say it ought to be an access charge mechanism, it says it should be recovered from the ALEC and -- I'm sorry, the ALEC should recover it from the ISP. And, of course, the ALEC already does recover or does charge the ISP for its PRI access. That is a market-based rate, and there is money flowing from the ISP to the ALEC.

COMMISSIONER DEASON: So it would be up to the -- that should be the flow, the direction should be cost recovery by the ALEC from the ISP, and the ALEC could structure that however they deem appropriate.

THE WITNESS: However they can, given the market that they serve and given the rules of the ESP exemption that at least binds BellSouth. I don't know who else it binds.

COMMISSIONER DEASON: Okay. Is that the same as bill and keep or is there a difference?

THE WITNESS: It depends. It need not be. I mean, it depends on what the ALEC does with the money. If this were actually access charges and we had two ILECs on the originating end of a long distance call, and you have that in Florida, I think, where you have a little independent telephone company that doesn't have any direct relationship with AT&T, say.

If you are an independent subscriber, you dial long distance, that call goes from the independent

generally to BellSouth, BellSouth carries it to AT&T. BellSouth, like the ALEC here, bills carrier access to AT&T, but then pays to keep some of it itself and gives some to the independent that originated the call. They usually divide that on a meet point billing sort of arrangement. So you could do that, you could think of doing that.

Or if the ALEC simply keeps all the money, then that is bill and keep. It gets what -- it keeps what it gets from the ALEC and BellSouth keeps what it gets from its customer.

CHAIRMAN DEASON: So bill and keep could meet that arrangement that you envisioned?

THE WITNESS: That is correct.

COMMISSIONER DEASON: Okay. Now, looking on Page 20 of the prehearing order, Issue 5.

THE WITNESS: Yes.

COMMISSIONER DEASON: Okay. I'm looking at BellSouth's position. The last sentence of that position states, "In the event that the Commission establishes a compensation mechanism for ISP-bound traffic other than bill and keep, it should be cost-based and premised on the cost actually incurred for the delivery of ISP-bound traffic, not on the cost of terminating a local call."

THE WITNESS: Yes.

COMMISSIONER DEASON: How do we do that?

THE WITNESS: Well, I think the straightforward way is to look at the ILEC's cost, let's keep this within the FCC rules, even though you may not have to. But within the FCC rules, we have heard, it is the ILEC's cost that matters. So what is the ILEC's cost for delivery of ISP type traffic that is long duration with certain characteristics for time of day, and for switch concentration. That is a study which can be done. You know, that is a cost which can -- an ILEC cost which can be calculated. And you can set a rate for ISP traffic based on that cost; that is, the cost that an ILEC would incur to serve ISP-bound traffic.

COMMISSIONER DEASON: Could that be called heavy-handed regulation or regulation in an area where it does not need to be?

THE WITNESS: Well, no, I wouldn't call it that. What I would call it would be disaggregation, I guess; that is, whenever you find in all of your regulatory stuff that there are significant differences in cost between things, between long loops and short loops, for example, or serving dense areas or rural areas, frequently you take it that setting price close to cost is a good thing. And even though it makes the tariff more complicated, you actually disaggregate costs, disaggregate rates, and you

have different rates, say, for UNE loops, for dense areas and for rural areas. At least the FCC urges that you do that. I don't know that do you in Florida.

So disaggregating based on differences in cost is a perfectly good thing to do. And disaggregating for ISP traffic is also a good thing to do. Because irrespective of the differences in cost which we have all gone through here, there is also another difference. And, that is, for ordinary local traffic, you can -- you, the Commission, can concoct cost-recovery mechanisms as you please, you are unrestricted. But for ISP-bound traffic you are not, because of the ESP exemption. So that is a reason above and beyond the fact that the costs are different to segregate that traffic, and calculate costs for serving that kind of traffic separately, and set a different rate for it, given that you have decided to go down the road of reciprocal compensation.

COMMISSIONER DEASON: But in your opinion, obviously, you feel that a superior mechanism to that would be bill and keep.

THE WITNESS: Yes. I think bill and keep is not my favorite by any means, but it is better than reciprocal compensation even at cost-based rates, just because the wrong person is being paid, which was the first point of my summary.

COMMISSIONER DEASON: Okay.

CHAIRMAN JACOBS: Redirect.

COMMISSIONER BAEZ: I just have a couple of questions. Doctor, you either suggested or stated outright that reciprocal compensation for ISP-bound traffic is an arbitrage situation?

THE WITNESS: Yes.

COMMISSIONER BAEZ: And you said that market forces worked to eliminate arbitrage. What kind of -- how would these market forces, can you give me some examples of how the market forces would show themselves?

THE WITNESS: Well, in this case where the event that sets up the arbitrage is a regulatory rule, it doesn't happen. That's the problem. The examples of -- well, I think the foreign exchange arbitrage example is how markets really work, that if there is an advantage to be made in shipping coal from New Castle and sending rum to Pittsburg, then that is what is going to happen. And differences in costs will be eliminated that way. Pure differences in prices get eliminated by trade and that is an elimination of arbitrage.

The problem here is the rule says there shall be -- assuming the rule said there was to be reciprocal compensation, what happens? Well, the ISP market is a pretty competitive market. There are a bunch of ALECs out

there, a bunch of ISPs, lightly regulated as far as the Commission is concerned, all competing for customers. And what happens under reciprocal compensation is that the market price that the ALECs can charge ISPs is affected by that reciprocal compensation. In a perfectly competitive market it would be competed away; that is, you know, when you serve an ISP -- you're an ALEC, you serve an ISP. It costs you something. You have to put in the PRI, but you also get this flow of reciprocal compensation. That is going to get competed away. And the way you see that, you would see that in the competitive market is that the rate that gets charged for that PRI gets lower and lower.

You know, if you eliminate reciprocal compensation, if you go to bill and keep, what's going to happen? That market rate is going to go back up. In fact, it's going to go back up to roughly where BellSouth's rate is today, if you think BellSouth's rate is a good rate for BellSouth, because BellSouth doesn't get reciprocal compensation today.

COMMISSIONER BAEZ: I think you heard Mr. Hunsucker state -- I don't know if you did hear his testimony, anyway, but he mentioned that as a company that wears two hats in this whole debate, besides the fact that he doesn't have any friends in the room, you know, his company seeks to counteract the disadvantage as an ILEC of

having reciprocal compensation for ISP-bound traffic by perhaps spending more time promoting their own DSL service, which would act sort of as a bypass to all of this. Is that an example of a market force outside of the regulatory?

THE WITNESS: Yes, it is. Both BellSouth and the other ILECs have an enhanced incentive to push people onto direct access, a high band with access, which is a good thing in some sense.

On the other hand, CLECs have exactly the opposite incentive, that is -- or ALECs -- to keep people on dial-up. So it isn't the best way. And if you want to encourage modern access to the Internet, high bandwidth access to the Internet, it's not the best way to do it. You are going to have the ILECs of the world desperately trying to get their customers onto direct access so they don't have to pay reciprocal compensation. But you are going to have the ALECs trying to keep their customers, and ISPs trying to keep their customer on dial-up access for the opposite reason.

COMMISSIONER BAEZ: Well, I think -- would you agree that broad band access is perhaps a better -- is more desirable than dial-up access?

THE WITNESS: Well, certainly at the same price it would be. These are two different technologies. And I

think as an amateur technologist that, you know, in five years most people will be on some kind of direct access.

COMMISSIONER BAEZ: And that very fact would cause to drive down the price of broad band service, directs access as you call it?

THE WITNESS: It may. I think technological changes will do that more than --

COMMISSIONER BAEZ: And if that happened, I mean, assuming again that broad band service or direct access is perhaps more desirable than dial-up, wouldn't the market have to follow along? I mean, and say, hey, nobody likes dial-up anymore. I know I don't.

THE WITNESS: Sure. And today, look at the difference in market price. I think where I am in Massachusetts DSL is sort of -- I think I pay $49 a month. I have both, actually. My dial-up access to AT&T is $19. So that's a big difference. And when I say that in five years everyone will be direct access, I'm probably being overly optimistic in the sense that we observe the Internet becoming more pervasive.

But the people, the new people that are coming on, I mean, not like you and me, we have been on it a long time, we are sophisticated. But the new people --

COMMISSIONER BAEZ: Speak for yourself.

THE WITNESS: New people are people who use it

less. So it's my father who is a new Internet user, and he has no use for the broad band stuff. You know, the slow stuff is fine for him. And those are the new people that are coming onto the network. So I don't think it is a problem that is going to solve itself.

COMMISSIONER BAEZ: Thank you.

COMMISSIONER PALECKI: But you might be saying that this gravy retrain that we have heard about isn't so much of a gravy train anyway. Because we are going to see it pretty much dwindle over the years, and within six years be replaced by other technologies.

THE WITNESS: Well, I think it is correct over the years people will move off of dial-up access. And it is a silly combination of circuit switched and packet switched anyway. Engineers hate it. Customers, I think, in the future will hate it. But to say that it is going to go away and therefore over some period of time, I don't know how long, and therefore we can ignore it, I think is bad policy.

Suppose an effect of reciprocal compensation is to delay that. I mean, delay is an important -- has important social costs. And if the costs we are talking about are on the order of 3 or 4 or $5 per line per month, those are very, very large numbers in the telephone social calculus. Now, if you could lower basic rates by $5, you

would be heroes in Florida.

COMMISSIONER PALECKI: We have been hearing that the ALECs that focus on ISP-bound traffic need to start looking at changing their marketing strategies. And basically what you are saying, I think, is that no matter how this Commission rules, that I was something that the ALECs are going to have to start doing anyway, because this traffic is dwindling and is dwindling quite quickly. And it just doesn't seem to be the gravy train that it has been characterized as.

THE WITNESS: Well, let's be careful. I wouldn't characterize the traffic as dwindling. I mean, Internet traffic and even dial-up Internet traffic is growing. Growing by leaps and bounds. As a proportion of Internet traffic, dial-up may be getting smaller, but this whole thing is growing so rapidly that I believe the numbers that I sort of see nationally, and I can't speak to Florida, are that dial-up Internet traffic is a growing phenomenon, not a shrinking one. I agree with your kind of long-run technological view that it can't grow forever, but it's growing now, it's not that it is shrinking yet. It is still getting worse.

COMMISSIONER PALECKI: Well, I kind of view what we are doing today as being a measure that is necessary for now that perhaps six to ten years from now will not --

we will not even be talking about these issues anymore.

THE WITNESS: I think you're right.

CHAIRMAN JACOBS: Redirect.

MR. EDENFIELD: I have no redirect. And I would move in Exhibit 26.

CHAIRMAN JACOBS: Without objection show Exhibit 26 is admitted. Thank you, you are excused, Doctor Taylor.

(Exhibit 26 admitted into evidence.)

MR. EDENFIELD: That concludes BellSouth's presentation.

CHAIRMAN JACOBS: Very well.

MR. EDENFIELD: May Doctor Taylor be excused, Chairman Jacobs?

CHAIRMAN JACOBS: Yes, he may be excused.

THE WITNESS: Thank you.

CHAIRMAN JACOBS: Staff.

MS. BANKS: Staff calls Mr. Fogleman.

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GREGORY D. FOGLEMAN

was called as a witness on behalf of Florida Public Service Commission and, having been duly sworn, testified as follows:

DIRECT EXAMINATION

BY MS. BANKS:

Q Mr. Fogleman, have you been sworn?

A Yes.

Q Did you cause direct testimony to be filed in this proceeding with pages numbered 1 through 20?

A That is correct.

Q Do you have any changes or corrections to your direct testimony that has been filed?

A Yes, I do.

Q If you will go ahead and state those changes?

A Sure. On Page 3, Line 23, the last word "the" should be struck. On Page 4, Line 7, after the word "with," insert the word "the." On Page 8, Line 18, strike "recognized as." Page 11, Line 17, strike the first "the."

MS. BANKS: Okay. At this time staff would like to request that the prefiled testimony of Mr. Fogleman be entered into the record as though read.

CHAIRMAN JACOBS: Without objection show the testimony of Mr. Fogleman entered into the record as though read.

DIRECT TESTIMONY OF GREGORY D. FOGLEMAN

Q. **Please state your name, address, and position with the Florida Public Service Commission.**

A. My name is Gregory D. Fogleman. My business address is 2540 Shumard Oak Boulevard, Tallahassee, Florida 32399. I am employed as an Economic Analyst at the Florida Public Service Commission (FPSC) in the Division of Policy Analysis and Intergovernmental Liaison. My duties include developing positions on selected intergovernmental telecommunications issues, preparing comments on behalf of the FPSC in selected federal proceedings, and monitoring national level activities at the Federal Communications Commission (FCC), Congress, federal courts and the National Association of Regulatory Utility Commissioners (NARUC). I also serve as a staff member on the Federal-State Universal Service Joint Board, Federal-State Joint Conference on Advanced Services, and as Second Vice Chair of Administration at the NARUC Staff Subcommittee on Telecommunications.

Q. **Please describe your background and experience.**

A. I graduated from the University of Central Florida (UCF) in 1992 with a Bachelor of Arts Degree in Business Administration, majoring in economics and minoring in computer science. In 1995, I completed the Master of Arts in Applied Economics from UCF. During this time, I also

completed an internship with the Florida Department of Commerce, and was later employed by Lakeland Electric and Water from January 1995 to May 1996. My responsibilities there included conducting forecasts for service area population, short-term fuel costs, and water and energy demand. I was employed by the FPSC in July 1996 in the Division of Communications as a Regulatory Analyst III. My responsibilities included preparing and presenting recommendations concerning telecommunications issues, researching data regarding the telecommunications market for the 1996 Florida competition report, and calculating statewide average rates for taxation purposes. I was promoted to Regulatory Analyst IV in April 1998. Four months later, I was promoted to my current classification as an Economic Analyst. In July 1999, I was transferred to the Division of Policy Analysis and Intergovernmental Liaison where I perform the functions previously stated.

Q. **Have you previously presented testimony before this Commission?**

A. Yes. I have filed testimony in Docket No. 000731-TP and Docket No. 000828-TP. These dockets were arbitrations of interconnection agreements with BellSouth by AT&T and Sprint, respectively. My testimony focused solely on the issue of reciprocal compensation for ISP-bound traffic to

provide background information to the Commission.

Q. **What is the purpose of your testimony?**

A. The purpose of my testimony is to discuss the regulatory treatment of ISP-bound traffic. In addition, I have summarized this Commission's, the FCC's, and other relevant state decisions relating to reciprocal compensation. I also recommend that the FPSC modify its policy of how reciprocal compensation is structured to more accurately reflect how costs are incurred.

Q. **What is "Reciprocal Compensation"?**

A. Section 251(b)(5) of the Telecommunications Act of 1996 (the Act) obligates all local exchange companies (LECs) to establish reciprocal compensation arrangements whereby LECs compensate each other for the transport and termination of "telecommunications" (i.e., local calls). For purposes of my testimony, I will be using "LEC" to refer to both ILECs and CLECs.

Q. **What is the "Reciprocal Compensation" issue specific to ISP-bound traffic?**

A. When an end user of one LEC (LEC #1) calls an ISP within ~~the~~ their local calling area, that is an end user of another LEC (LEC #2), there is an issue of how the first LEC (LEC #1)

should compensate the second LEC (LEC #2) for the transport and termination of the call to the ISP.

Q. **What is your understanding of the purpose of reciprocal compensation?**

A. The purpose of reciprocal compensation is to compensate one LEC for the cost associated with the transport and termination of a call from another LEC.

Q. **Has reciprocal compensation benefited one category of LEC over another?**

A. Yes. Some CLECs have targeted customers with high inbound call volumes because by terminating more local traffic than they were generating, they could actually use reciprocal compensation as a source of revenue. Customers that had these characteristics include centralized calling centers and Internet Service Providers (ISPs). With the prevalence of ISP services expanding, and ISP traffic terminating on their networks, CLECs began to bill ILECs millions of dollars for reciprocal compensation.

Q. **Why were ISPs so attractive as customers?**

A. Serving ISPs enables CLECs to minimize the compensation they would have to pay to the ILEC because ISP-bound traffic is one-way. It also enables CLECs to maximize the compensation

they would receive because of the volume of traffic and the substantially longer call duration, as compared to other calls.

Q. **What information is available regarding the call duration of ISP-bound traffic?**

A. NARUC's Internet Working Group (Working Group) noted in its March 1998 report, "Pricing and Policies for Internet Traffic on the Public Switched Network," that the average duration of an ISP-bound call is 20 minutes, as opposed to three minutes for voice traffic. This information was referenced from Bellcore's 1996 report, "Impacts of Internet Traffic on LEC Networks and Switching Systems." It is also consistent with data found within the FCC's "Digital Tornado: The Internet and Telecommunications Policy," March 1997 (see figure 9, p. 59).

Q. **Has this Commission heard any discussions regarding the average length of ISP-bound calls?**

A. Yes. Just recently, in Docket No. 991220-TP, Order No. PSC-00-1680-FOF-TP, issued September 19, 2000, the FPSC stated that it was persuaded by BST witness Varner's testimony that the call durations for ISP bound traffic are longer than for typical calls (20 minutes versus three to four minutes). It was also presented as part of John A.

Ruscilli's testimony on behalf of BellSouth in Docket No. 000828-TP. (P. 47, lines 21-22)

Q. **Have the longer call durations of ISP-bound traffic been factored into the rates for reciprocal compensation?**

A. Not typically. The rates were based usually on the average duration for voice traffic.

Q. **What impact would this have regarding the amount of compensation recovered by a CLEC with significantly longer holding times?**

A. Assuming that the CLEC had similar costs as the incumbent, the CLEC would over-recover the costs associated with terminating traffic on its network.

Q. **How has the FPSC addressed reciprocal compensation for ISP traffic in the past?**

A. The FPSC decided in the MediaOne/BellSouth arbitration (Order No. PSC-99-2009-FOF-TP, issued Oct. 14, 1999 in Docket No. 990149-TP), the ICG Telecom/BellSouth arbitration (Order No. PSC-00-0128-FOF-TP, issued January 14, 2000 in Docket No. 990691-TP), the ITC^DeltaCom/BellSouth arbitration (Order No. PSC-00-0537-FOF-TP, issued March 15, 2000 in Docket No. 990750-TP), and the Intermedia/BellSouth arbitration (Order No. PSC-00-1519-FOF-TP, issued August 22,

2000 in Docket No. 991854-TP) that parties should continue to operate under the terms of their current respective agreements regarding ISP-bound traffic until the FCC made a final ruling regarding the nature of ISP-bound traffic.

Q. **Has the FPSC issued an order that specifies the jurisdictional nature of ISP traffic?**

A. No. The Commission has not issued such an order. However, in the most recent arbitration decision concerning the issue, Global NAPs/BellSouth, Order No. PSC-00-1680-FOF-TP issued September 19, 2000 in Docket No. 991220-TP, the FPSC decided that ISP-bound traffic should be treated as local traffic for the purposes of reciprocal compensation. The FPSC stated, "[W]e emphasize that in rendering this decision, we stop short of determining that ISP-bound traffic is, in fact, local traffic. Herein, we find only that this traffic shall be treated like local traffic for purposes of compensation." (Order No. PSC-00-1680-FOF-TP, p. 14)

Q. **Has the FPSC made any decisions regarding reciprocal compensation that treat ISP-bound traffic as interstate?**

A. No.

Q. **Has the FPSC filed comments with the FCC regarding the**

jurisdictional nature of ISP-bound traffic?

A. Yes. The FPSC filed comments in FCC Docket No. 99-69, Inter-Carrier Compensation for ISP-Bound Traffic on April 9, 1999, and again on July 21, 2000.

Q. **In these comments, what was the FPSC's position regarding the jurisdictional nature of ISP-bound traffic?**

A. The FPSC endorsed what is known as the "two-call theory." Under this theory, when an end-user calls an ISP to connect to the Internet, there are two separate services that are being provided. The first service is an intrastate telecommunications service, provided by one or more LECs, that allows the end user to call an ISP. The second service is an interstate information service provided by an ISP which enables customers to access Internet content and services. The access lines purchased by end users are local access lines that are provided through an intrastate tariff. Because ISPs are ~~recognized as~~ Enhanced Service Providers (ESPs) and thus are exempt from paying certain interstate access charges, they are able to purchase access through intrastate business tariffs rather than interstate access tariffs.

Q. **What decision has the FCC made regarding reciprocal compensation and the jurisdiction of this traffic?**

A. In the FCC's Declaratory Ruling, FCC 99-38, in CC Docket No. 96-98, released on February 26, 1999, the FCC declared that ISP-bound traffic is jurisdictionally mixed and appears to be largely interstate in nature. (FCC 99-38, ¶ 1, 19) Its decision, however, preserved the exemption of Internet and other information services from interstate access charges. (FCC 99-38, ¶ 34) The FCC also found that its conclusion regarding the nature of ISP-bound traffic "does not in itself determine whether reciprocal compensation is due in any particular instance." (FCC 99-38, ¶ 1)

Q. **Did the FCC make any decision relating to existing interconnection agreements?**

A. The FCC concluded that, in the absence of federal rules regarding the appropriate intercarrier compensation for ISP-bound traffic, carriers are bound by their existing interconnection agreements, as interpreted by state commissions, and thus are subject to reciprocal compensation obligations to the extent provided by such agreements or as interpreted and enforced by state commissions. (FCC 99-38, ¶ 1, 22)

Q. **What was the theoretical basis of the FCC's decision that ISP-bound calls are primarily interstate in nature?**

A. The FCC used an "end-to-end" analysis of these calls.

Specifically, the FCC concluded that ISP-bound calls do not terminate at the ISP's local server, but instead continue on to one or more Internet websites that are often located in another state. (FCC 99-38, ¶ 10-19)

Q. **Does the FCC have rules relating to intercarrier compensation for ISP-bound traffic?**

A. No. The FCC acknowledged in its Declaratory Ruling in CC Docket No. 96-98 (FCC 99-38, ¶ 1, 9, 19, 21-22), released on February 26, 1999, that there are no federal rules establishing an inter-carrier compensation mechanism for such traffic or governing what amounts, if any, should be paid.

Q. **What action has the FCC taken to establish rules?**

A. As part of the FCC's February 26, 1999, Declaratory Ruling in CC Docket No. 96-98, the FCC issued a Notice of Proposed Rulemaking to develop an adequate record upon which to adopt a rule regarding inter-carrier compensation for ISP-bound traffic. (FCC 99-38, ¶ 28) To date, the FCC has not adopted a rule regarding this issue.

Q. **Did the FCC indicate what should be done until it was able to adopt rules?**

A. Yes. The FCC specifically stated in ¶ 28 of the Declaratory

Ruling that "until adoption of a final rule, state commissions will continue to determine whether reciprocal compensation is due for this traffic."

Q. **Was the FCC's Declaratory Ruling challenged in court?**

A. Yes. As a result of the challenge, on March 24, 2000, the United States Court of Appeals for the D.C. Circuit in Bell Atlantic Telephone Companies v. Federal Communications Commission, 2000 U.S. App. LEXIS 4685 (D.C. Cir. March 24, 2000) vacated certain provisions of the FCC's Declaratory Ruling, and remanded the matter to the FCC.

Q. **What did the court conclude?**

A. In the last paragraph of its opinion, the Court stated that the FCC had not adequately justified the application of its jurisdictional analysis in determining whether ISP-bound traffic is subject to ~~the~~ reciprocal compensation. The Court stated:

> Because the Commission has not provided a satisfactory explanation why LECs that terminate calls to ISPs are not properly seen as "terminating ... local telecommunications traffic," and why such traffic is "exchange access" rather than "telephone exchange service," we vacate the

> ruling and remand the case to the Commission. Id. at 26.

However, the Court further noted that:

> We do not reach the objections of the incumbent LECs--that § 251(b)(5) preempts state commission authority to compel payments to the competitor LECs; at present we have no adequately explained classification of these communications, and in the interim our vacatur of the Commission's ruling leaves the incumbents free to seek relief from state-authorized compensation that they believe to be wrongfully imposed. Id. at 26-27.

Q. **What actions should the FPSC take, if any, with respect to establishing an appropriate compensation mechanism for ISP-bound traffic in light of current decisions and activities of the courts and the FCC?**

A. The Commission should move forward to develop appropriate compensation mechanisms for ISP-bound traffic. Based on past practices, any decision the FCC reaches likely will be challenged in court. If the FCC's decision were vacated again, this Commission would still be without a cohesive policy regarding reciprocal compensation for ISP-bound

traffic. In addition, by moving forward, this Commission would be better positioned to challenge the FCC decision, if needed, based on the evidence in this record.

Q. **What policy considerations should guide the Commission's decision in this docket?**

A. The policy issue that must be resolved initially is who should be responsible for recovering the cost associated with terminating traffic that is originated from another carrier. In general, there are two options. The first option would require the carrier with the originating traffic to compensate the carrier who has to terminate the other carrier's traffic (i.e., reciprocal compensation). An alternative to this would require each carrier to recover its own costs from its customers (i.e., bill-and-keep).

Q. **Please explain the bill-and-keep alternative.**

A. Bill-and-keep would require a carrier to recover its own costs of providing services by billing its own customers. It would not be required to compensate another carrier for the costs associated with terminating its traffic on that carrier's network.

Q. **What are the advantages of a bill-and-keep approach?**

A. It eliminates the need for billing and the costs associated

with monitoring traffic. It also reduces the ability of carriers to target customers solely for expected reciprocal compensation revenues.

Q. **What are the problems of adopting a bill-and-keep approach?**

A. One of the assumptions of the bill-and-keep methodology is that the amount of traffic from the ILEC to the CLEC is more or less equivalent to the amount of traffic from the CLEC to the ILEC. I do not believe that this is currently the case based on the information I have read.

Q. **Assuming that traffic is not roughly balanced, what would happen if a bill-and-keep mechanism were adopted?**

A. Carriers that have to terminate more traffic would be forced to pass these costs on to their own customers, even though their customers did not directly cause these costs to be incurred. This could result in customer erosion for a carrier, and a decline in competition in the industry.

Q. **Have any states excluded ISP-bound traffic from reciprocal compensation payments?**

A. Yes. Eleven state commissions have, but for different reasons. Colorado, Iowa, and Arizona have adopted bill-and-keep. Eight other state commissions either ruled that ISP-bound traffic is interstate, or eliminated reciprocal

compensation based on the FCC Declaratory Ruling and are awaiting anticipated FCC action on the issue.

Q. **How does this compare with the number of states that have required reciprocal compensation payments for ISP-bound traffic?**

A. Most states have required reciprocal compensation payments; however, some states have only reached this conclusion as a matter of contract dispute resolution. Other states have either initiated or completed generic proceedings to investigate the issue more thoroughly.

Q. **Are there any structural differences on how compensation is paid for those states that require reciprocal compensation payments for ISP-bound traffic?**

A. Yes. Most states, like Florida, require that compensation be paid using a per minute rate(s). The longer the call, the more compensation must be paid. Several states have recently changed the payment structure to include a fixed and a variable component or even a traffic imbalance adjustment.

Q. **What states have adopted compensation mechanisms that include a fixed and a variable component?**

A. Both the Public Utility Commission of Texas (Docket No.

21982, July 13, 2000, p. 49) and the Public Service Commission of Wisconsin (Docket No. 05-TI-283, November 8, 2000, p. 13) have adopted fixed and per-minute charges. The fixed component is designed to recover costs associated with setting up the call (e.g., establishing a circuit, and creating a billing record). The variable component is designed only to recover the costs associated with the duration of the call.

Q. **What are traffic imbalance adjustments?**

A. Once the amount of traffic that terminates to either the ILEC or the CLEC network reaches a predetermined level, additional reciprocal compensation is still paid, but at a lower rate.

Q. **What states have adopted traffic imbalance adjustments?**

A. New York (Opinion and Order No. 99-10, August 26, 1999), Texas (Docket No. 21982, July 13, 2000), and West Virginia (Case No. 99-0426-T-P, October 19, 1999) have adopted traffic imbalance adjustments.

Q. **Can you provide an example of how this was applied by one of the commissions you noted?**

A. Yes. The New York Public Service Commission established a rebuttable presumption regarding the reciprocal compensation

rate that should be paid to those carriers whose incoming to outgoing traffic ratio is 3:1 or greater. The presumption was that traffic in excess of the ratio costs less to terminate, and therefore should be compensated at a lower rate. Traffic below the ratio would be compensated at a higher rate.

Q. **What recourse do carriers have once they reach this ratio?**

A. In New York, a carrier whose compensation would be adjusted downward may attempt to rebut the presumption with a showing that its costs are higher.

Q. **What factors should the Commission consider in setting the compensation mechanism for delivery of ISP-bound traffic?**

A. Because the purpose of reciprocal compensation is to compensate one LEC for the costs associated with the transport and termination of a call from another LEC, the FPSC should consider structuring compensation in a manner that closely represents how costs are incurred.

Q. **Based on the information you have read in other proceedings, does a flat per minute charge, or a combination of fixed and variable charges more closely resemble how costs are incurred?**

A. A fixed and variable structure appears to more accurately

reflect how costs are incurred. As noted by the Public Service Commission of Wisconsin in its Order (Docket No. 05-TI-283, November 8, 2000, pp 12-13):

> In the first generation agreements, the rate for reciprocal compensation was calculated by combining into a single rate the recovery of two separate cost elements: (1) set-up costs, which are incurred one time per call and do not vary with the duration of the call; and (2) time-sensitive costs that are incurred over the entire duration of the call. The cost for call setup was recovered with an averaged rate based upon an assumed call length of approximately four minutes. That assumption was then applied to the cost for transporting and terminating interconnected local traffic.

Q. **Does a bill-and-keep approach accurately reflect how costs are incurred?**

A. No. The bill-and-keep approach to recovery has nothing to do with how the costs are incurred. It is a form of "in kind" payment that is only equitable when traffic is roughly balanced.

Q. **How would you recommend structuring reciprocal compensation?**

A. In general, I would recommend that the cost associated with setting up a call be recovered in the first minute of the call, and include a duration charge for the first minute as well. During subsequent minutes, the only cost recovered would be that associated with duration, or the cost to maintain the circuit and transmit the content of the call.

Q. **Do you think that imbalance adjustments are necessary?**

A. No. If the rates are established to accurately reflect costs, imbalance adjustments are not necessary because only the costs associated with duration are being recovered after the first minute.

Q. **Should ISP-bound traffic be separated from non-ISP bound traffic for purposes of assessing any reciprocal compensation payments?**

A. No. It is my understanding based on testimony in other dockets and in the NARUC report that separating ISP-bound traffic from voice traffic is problematic at best. In addition, if we simply carve out ISP-bound traffic without addressing the underlying problem of how compensation is determined, we are simply providing an opportunity for CLECs to over-recover by focusing on a different set of customers with large amounts of terminating traffic.

Q. **Does this conclude your testimony?**

A. Yes it does.

BY MS. BANKS:

Q Mr. Fogleman, do you have any prefiled exhibits?

A No, I do not.

Q Do you have a summary prepared?

A Yes, I do.

Q Would you please go ahead and present that at this time?

A Sure. In my testimony I addressed two overarching issues. One relates to how this Commission has treated the jurisdictional nature of this traffic in the past, the other relates to how firms should be compensated for using each other's networks. In my testimony I note that this Commission has filed two sets of comments with the FCC asserting that jurisdictions -- that jurisdiction resides with the states and not with the federal government.

In both sets of comments with the FCC, the Commission distinguished between two types of services being provided, an intrastate telecommunications service provided by one or more local exchange companies, and an information service provided by an Internet service provider.

As part of my testimony I have summarized this Commission's, the FCC's, and other relevant state decisions relating to reciprocal compensation. Based on

my review, I recommend that the Commission establish a two-part pricing structure that more accurately reflects costs. This methodology has been adopted by the Texas and Wisconsin state commissions, and is also supported by Sprint Witness Hunsucker in this proceeding. I also agree with many of the parties that the differences in holding times should be reflected in any rate structure adopted by this Commission. This concludes my summary.

MS. BANKS: Staff's witness is tendered for cross.

CHAIRMAN JACOBS: Let's see, how should we begin? I think it is probably proper to go with the ALECs first.

MR. McDONNELL: Thank you, Mr. Chairman.

CROSS EXAMINATION

BY MR. McDONNELL:

Q Mr. Fogleman, in your prefiled testimony you stated that this Commission does have jurisdiction to address this issue, correct?

A I stated that this -- in comments to the FCC asserted some sort of jurisdiction in that we prescribed to the two-call theory in which the first part of the call is an intrastate telecommunications call. However, in various orders we haven't come out directly and stated that.

Q Okay. I saw from your prefiled testimony that you did significant analysis concerning what other state commissions have done, correct?

A Correct.

Q Do you know how many other state commissions have addressed compensation mechanisms for ISP-bound traffic?

A Not off the top of my head.

Q Approximately?

A The analysis that I did was done in part through NARUC e-mails and meetings at NARUC. And then based on that information I would focus in on specific orders. I have that information in hand, and I could look it up real quick. But I think most of the states have done it -- at one level or another have evaluated this issue.

Q Okay. So as far as the FCC is concerned, though, if one state has jurisdiction to entertain this issue, all states would, would that be fair?

A I would agree with that.

Q And you are familiar with the term bill and keep?

A Yes.

Q And looking at Page 14 of your testimony, the question is at Line 5. One of the assumptions of the bill and keep methodology is that the amount of traffic from

the ILEC to the CLEC is more or less equivalent to the amount of traffic from the CLEC to the ILEC, correct?

A Correct.

Q And it's your belief that this is currently not the case today?

A That is correct.

Q And you go on to state that if a bill and keep mechanism were adopted -- going to Line 17 of Page 14, that this could result in customer erosion for a carrier and a decline in competition in the industry.

A That is correct.

Q Now, would that economic effect, in your opinion, take place irrespective of whether we label this traffic local traffic or interstate traffic? Do you understand my question?

A Yes. I think it could.

Q So it would be a result of employing a bill and keep arrangement simply when there is not roughly balanced traffic, correct?

A Correct. I mean, the carrier would have to go to its own customers. And if there was an imbalance of traffic, that is the only customer base that they would have at that time. Over time they might be able to get different types of customers with different calling characteristics.

Q But it's your testimony that using a bill and keep when traffic is out of balance could cause a decline in competition in the industry?

A Yes.

Q And it is your position that this Commission should adopt a cost-based compensation mechanism with a fixed component and a variable component, correct?

A Yes.

Q And would the purpose of that be so that it would be theoretically economically benign for an ILEC, whether that ILEC terminates the call for X cents or whether that ILEC hands you the call and give you X cents to terminate the call?

A Could you repeat the question?

Q Okay. The purpose of making it cost-based, a cost-based mechanism is so that it is benign to the ILEC whether they terminate it themselves or somebody else terminates it?

A Yes, correct.

Q And what specific rates would you use in your bifurcated rate structure?

A Well, you would have -- the setup costs would be fixed, you know, per instance charge. And then you would have all your variable expenses or costs in your per minute rate or charge.

Q Okay. And are those rates available today, do you know?

A I don't believe they are available today.

Q I'm sorry?

A I don't believe so. I think we would have to have another proceeding to get at that, at that rate.

Q And would it be appropriate to use rates that are available today on an interim basis?

A Possibly subject to true-up, yes.

MR. McDONNELL: Nothing further.

CHAIRMAN JACOBS: Ms. Kaufman.

MS. KAUFMAN: I have no questions.

CHAIRMAN JACOBS: Ms. McNulty.

Ms. McNULTY: No questions.

CHAIRMAN JACOBS: Mr. Moyle.

MR. MOYLE: Just a couple.

CROSS EXAMINATION

BY MR. MOYLE:

Q Is it your understanding that the intent of the Florida Telecommunications Law was to promote competition in the telephone industry?

A Yes.

Q And is it also your understanding that the intent of the federal act was to promote competition in the telephone industry?

A Yes.

Q And it is your testimony that a bill and keep arrangement you think would lead to a decline in competition in the industry?

A At this time, yes.

Q I think you had mentioned that you had looked at a number of states as to how they had -- how they had looked at this issue of reciprocal compensation related to ISP-bound traffic?

A That is correct.

Q And you also looked at how the Florida Commission has handled this issue previously, correct?

A Uh-huh.

Q Let me ask you about the other states. Would it be a fair statement to say that the majority of the other states that you reviewed in looking at how these other states have handled the issue have adopted some form of reciprocal compensation?

A Yes.

Q Okay. And with respect to how the Florida Commission has dealt with this issue, didn't all the Public Service Commission, Florida Public Service Commission orders conclude that ISP traffic should be treated as local traffic for which reciprocal compensation should be due?

A It should be treated as local, yes.
Q All right.
A But in none of those orders did they actually come out and say that specifically it is local.
Q All right. But they ordered that for compensation purposes it would be treated as local, correct?
A That is correct.
Q Okay. And just one other question. On Page 14, Line 5, you talk about some problems of adopting the bill and keep approach. Do you see that?
A Yes.
Q Just so the record is clear, is what you are saying here that the traffic in Florida is not roughly balanced?
A I don't believe that ISP-bound traffic going from CLECs to ILECs are roughly balanced based on the information that I have read.
MR. MOYLE: Thank you. I have nothing further.

CROSS EXAMINATION

BY MR. MEZA:
Q Mr. Fogleman, my name is Jim Meza, and I'm going to keep this as short as possible.
Would you agree with me that some ALECs use reciprocal compensation as a source of revenue?

A Yes.

Q Would you also agree with me that some ALECs target ISPs as customers?

A Yes.

Q And that ALECs have an incentive to serve ISPs, would you agree with that?

A With the rate structure as currently, yes.

Q Okay. And why is that?

A Well, as I indicate in my testimony, the fixed component is recovered on a per minute basis, so if you go beyond the average voice call length, you continue to recover that setup charge for as long as that call lasts.

Q Would it also be because that traffic to an ISP is one way?

A Yes.

Q And that the ALEC would not have the obligation to pay reciprocal compensation back to the ILEC?

A If that ISP is the only customer and that ISP also didn't have any other lines other than the lines serving their phone banks or their modem banks.

Q Would you agree with me that the current rate for reciprocal compensation allows an ALEC to overrecover costs associated with terminating traffic on its network?

A I believe that is the case.

Q And would you also agree with me that reciprocal

compensation benefits ALECs over ILECs under the current rates?

A I would agree with that.

Q Under bill and keep, does each carrier charge its own customer for the cost of terminating a call?

A Can you repeat the question.

Q Under bill and keep, does each carrier charge its own customer for the cost of terminating a call?

A Yes.

Q And in your testimony you state that there are a couple of advantages to bill and keep, is that correct?

A Yes.

Q One of those advantages is that it eliminates the need for billing and costs associated with monitoring traffic, is that correct?

A Yes.

Q Another advantage that you state in your testimony is that it reduces the ability of ALECs to target customers, ISPs as customers, is that correct?

A Yes.

Q And as you previously stated here today, ALECs are, in fact, targeting ISP customers?

A Correct. One way is to, as opposed to simply adopting a bill and keep methodology, is to address the underlying rate.

Q But you did testify that bill and keep would address that?

A Yes, that is correct.

Q Okay. And would you agree with me that other state commissions have adopted bill and keep?

A Yes, I believe 11.

COMMISSIONER JABER: Mr. Meza, excuse me. Let me understand what you just said, Greg. I thought you were testifying that a rate based on duration could be an alternative to bill and keep because that takes into effect other circumstances like duration. For example, I thought bill and keep only required the companies to collect termination costs from their own customers, but it didn't take into account any other circumstance such as length of call.

THE WITNESS: Right, that is correct.

COMMISSIONER JABER: Clarify that for me.

THE WITNESS: If you go to a bill and keep, then the company has to go to their own customers to recover all of their costs, period. It's an in-kind payment structure.

COMMISSIONER JABER: All right. And because you recognize that there might be -- traffic would be roughly --

THE WITNESS: Right.

COMMISSIONER JABER: -- imbalanced, that's why you recommend a different rate for --

THE WITNESS: A two-part rate structure.

COMMISSIONER JABER: Yes, I'm done. Ask your last question again.

MR. MEZA: The one prior to the state commission addressing bill and keep?

COMMISSIONER JABER: Uh-huh, addressing bill and keep.

BY MR. MEZA:

Q In your testimony you stated that one advantage of bill and keep is that it reduces the ability of carriers to target customers solely for expected reciprocal comp revenue?

A Right. Because they would no longer get reciprocal compensation. They would have to recover those costs from their own customers. They wouldn't be able to -- they wouldn't see that revenue.

Q You state in your testimony that bill and keep is only equitable if the traffic is equal, is that correct?

A I believe so. Could you --

Q Look on Page 18, Line 22.

A Repeat the question.

Q You state in your testimony that bill and keep

is only equitable when traffic is equal or roughly balanced?

A Correct.

Q Okay. Is it your opinion that the traffic is currently not roughly in balance because ALECs are targeting ISPs as customers?

A I thought I answered that question before. Yes. I think that there is an imbalance and that -- and that CLECs have targeted ISPs.

Q And as a result of targeting ISPs this results in an imbalance of traffic?

A Yes.

Q Would you agree with me that to the best of your knowledge these ALECs have independently made the decision to target ISPs as customers?

A Yes. Based on the rates and the rules as they provided, yes.

Q Would you agree with me that if you remove the financial incentive to serve ISPs, that traffic would then become balanced?

A Over time, perhaps.

Q Well, if you remove -- well, you previously stated that traffic is only imbalanced because ALECs are serving ISPs. So if you remove that factor --

A Right. I'm just thinking that, you know, if you

are a CLEC, I'm not sure you are going to be able to cut off your customers, you know, at the drop of a hat just because the rules have changed.

COMMISSIONER JABER: Greg, what percentage of ALECs have targeted ISP traffic as their sole source of revenue?

THE WITNESS: I don't know of any statistic where we have that. I am familiar with an ex parte from Verizon that listed, I think, four or five prominent CLECs and how much recip comp that they have, and I think it goes out to the first quarter of this year.

COMMISSIONER JABER: Okay. Are you familiar with any FCC order or any other state commission order that defines what the balance is?

THE WITNESS: No.

COMMISSIONER JABER: So no state has determined what equates to roughly balanced?

THE WITNESS: I think the -- in Iowa, an administrative code that they have stated that they believed that 55 percent over a six-month period, if you meet that criteria then that is roughly balanced.

COMMISSIONER PALECKI: Are the ALECs that have targeted the ISP traffic, they have done it because the opportunity exists to make money at that under the current situation?

THE WITNESS: That is correct.

COMMISSIONER PALECKI: And if we immediately went from the current situation to a situation that would remove their current -- completely remove their current levels of compensation like a bill and keep, we would really be pulling the rug from under those ALECs to the point where it would be very difficult or impossible for them to continue in business, would it not?

THE WITNESS: Depending on how many -- depending on their customer makeup, yes, it could. For a CLEC that only had an ISP as a customer, yes, that definitely would be the case.

COMMISSIONER PALECKI: It would make it very difficult for them to continue on as a competitor. And so we actually would be removing some of the competitors from competition?

THE WITNESS: Correct.

COMMISSIONER PALECKI: All right. Thank you.

BY MR. MEZA:

Q If you go to a bill and keep mechanism, does that, in your opinion, automatically will reduce competition in the State of Florida, would that alone reduce competition?

A It could.

Q Could the ALECs that are primarily targeting

ISPs, could they raise their rates that they are charging ISPs to remain in business?

A Yes.

Q By raising rates, could they offset the loss of revenue?

A It depends. They could.

Q And would you agree with me that not all traffic between BellSouth and every ALEC in Florida is not imbalanced?

A I don't know that to be true.

Q Would you agree with me that that is a possibility?

A It's a possibility.

Q Is it your opinion that traffic has to be balanced immediately in order for bill and keep to be a possible solution?

A Based on -- I think it is a function of whether or not this Commission concludes that the traffic is local. If this Commission determines the traffic is local, the FCC rules require that it has to be balanced. So I think it is a function of what jurisdiction this Commission finally decides that this traffic is.

Q I guess this is a question sort of like what came first the chicken or the egg. Does the traffic have to be balanced before you implement bill and keep, or can

it become balanced over time?

A I think it has to be balanced. Also, looking back, I think it was in a docket that was opened in '95 before the Act, this Commission actually adopted an order requiring bill and keep. And one of the caveats was that, gee, the traffic has to be balanced and we will give the parties a year before, you know, if somebody comes back and says that the traffic is out of balance. So, I think this Commission has always thought that the traffic had to be balanced.

Q And you said that was in 1995?

A Yes. And I think it is an order that we have taken official recognition of.

Q And that was prior to the implementation of the Act, is that correct?

A That is correct. I have the Docket Number 950985. I have the order number, as well.

Q Would you agree with me that the role of this Commission is to set policies that benefit all Florida consumers?

A Yes.

Q Is keeping a form or an incentive that benefits solely one type of customer, in your opinion does that benefit all consumers in Florida?

A In general, no.

COMMISSIONER JABER: Just as a follow-up to a previous question, Mr. Fogleman, if you raised rates to ISPs, what market effect does that have on deployment of advanced technology?

THE WITNESS: For dial-up access, I mean, it would make DSL probably look a little bit more viable as an alternative if you are a customer.

COMMISSIONER JABER: More --

THE WITNESS: Well, I mean, if you are a customer and you are looking at DSL rates of about, you know, 30 or $40, and your dial-up access went from, say, $15 to $25, then, gee, the incremental cost as a consumer to go ahead and kick it up to DSL isn't that much.

COMMISSIONER JABER: Are you familiar with Section 706 of the Act?

THE WITNESS: Yes, I am.

COMMISSIONER JABER: Can you summarize that for me?

THE WITNESS: It basically indicates that the FCC and state commissions should do everything within -- do what it can -- I'm sorry. It basically states that the FCC and state commissions should do what they can to ensure the deployment of advanced telecommunications capabilities.

COMMISSIONER JABER: So if we implemented a bill

and keep mechanism and the companies were forced to raise rates for the ISPs, could we actually incent the companies to deploy DSL faster?

THE WITNESS: I don't know that to be true. I mean, on the other hand, the incumbent LECs have an incentive currently to deploy DSL in order to regain those customers and reduce their reciprocal compensation payments to CLECs. So, I don't know that that is necessarily true.

COMMISSIONER PALECKI: Is there a ceiling that the ALECs could raise the rates to the ISPs? Wouldn't the ceiling be the current ILEC tariffed rate?

THE WITNESS: I would think that that is the case. Perhaps the CLECs could provide some alternative, some other benefit other than price or rates to induce them to stay, but I don't know.

BY MR. MEZA:

Q Mr. Fogleman, is it your opinion that a call to an ISP traffic is not interstate?

A I tried to avoid, you know, the jurisdictional analysis. I tried to just indicate what this Commission has done.

Q Okay. So you are not rendering an opinion on whether or what type of traffic this is or what it is classified as?

A Correct.

Q Okay. Would you agree with the following statement, if the FCC believes that a uniform cost recovery mechanism for ISP-bound traffic is necessary, then the FCC should look at the possibility of encouraging the states to require carriers to recover their costs for the transport and termination of all traffic through bill and keep arrangements?

A Yes, those are comments -- those were included in our first set of comments to the FCC.

Q So this Commission, this staff and this Commission has recommended to the FCC that if the FCC develops a uniform recovery mechanism for ISP traffic that that mechanism be bill and keep, is that correct?

A I think it also said that we requested that the FCC remove the roughly balanced requirement that is currently in its rules.

Q That is true. But if you can answer my first question.

A I'm sorry, repeat the question.

Q That this Commission has requested that the FCC if it will implement a federal mechanism, that that mechanism be bill and keep?

A Correct.

CHAIRMAN JACOBS: Run that by me again, I'm

sorry. What was the question again?

MR. MEZA: That this Commission has previously asked the FCC that if it does set a federal mechanism to recover ISP-bound traffic, that that mechanism be bill and keep. And, Chairman Jacobs, I would like to have this marked and put into evidence.

CHAIRMAN JACOBS: Okay. And that, again, was premised on the idea that the traffic is balanced?

THE WITNESS: Well, actually I believe -- number one, I think this is already in evidence. I think we took official recognition of this, both sets of comments to the FCC.

CHAIRMAN JACOBS: Right.

THE WITNESS: And actually I believe what we were saying is that if the FCC were going to do this that they remove the roughly balanced requirement of the rules.

CHAIRMAN JACOBS: That they remove --

THE WITNESS: That they remove that requirement.

CHAIRMAN JACOBS: Interesting.

BY MR. MEZA:

Q And, Mr. Fogleman, that was for all local traffic, though, correct?

A Let's see what it says. In addition, if the FCC believes that a uniform recovery mechanism for ISP-bound traffic is necessary, then the FCC should look at the

possibility of encouraging the states to require carriers to recover their costs for the transport and termination of all traffic through a bill and keep arrangement.

Q And the date --

COMMISSIONER DEASON: Excuse me. I was going to ask you, this was for all traffic, not just for ISP-bound traffic?

THE WITNESS: That is correct.

BY MR. MEZA:

Q And date of these comments was April 9th of 1999, is that correct?

A That is correct.

COMMISSIONER JABER: Mr. Fogleman, remind me, did we start using the two-tier rate structure for ISP recip comp after we filed these comments?

THE WITNESS: I believe so. You mean for Global NAPS?

COMMISSIONER JABER: Global NAPS was after this?

THE WITNESS: I believe so.

COMMISSIONER JABER: I couldn't remember.

MR. MEZA: Thank you, Mr. Fogleman, that's all the questions we have.

COMMISSIONER PALECKI: Could I jump in, I just have a question about the FCC requirement that we have a roughly balanced situation. Is that because if we did not

have roughly balanced traffic that it would create a noncompetitive situation if we implemented bill and keep?

THE WITNESS: I think the concern was that if you didn't have roughly -- if you had roughly balanced traffic, then you wouldn't have to keep track of the costs and you wouldn't have to recover it from the other carrier, you would just cross cancel.

COMMISSIONER PALECKI: But if we went to a bill and keep and things were not roughly balanced, and the utility that bills keeps all the money and there is no distribution, there might be an unfair distribution of costs based upon where costs are caused?

THE WITNESS: That's correct. You, as a CLEC, if you were the CLEC, and I -- I mean, you wouldn't be able to recover your costs from -- if I am the incumbent LEC, my customers. You have no way to get at them if my customers are calling your customers and causing costs to be incurred.

COMMISSIONER PALECKI: And if you have a balanced situation, everything is about 50/50 anyway, so it works out to be a roughly fair split?

THE WITNESS: Correct.

COMMISSIONER PALECKI: Thank you.

CHAIRMAN JACOBS: Ms. Caswell.

MS. CASWELL: Yes.

CROSS EXAMINATION

BY MS. CASWELL:

Q Mr. Fogleman, good afternoon. Kim Caswell with Verizon.

Mr. Fogleman, do you know if any of the local exchange carriers in Florida can bill for the relevant charges under your two-part pricing structure, do they have the capability today to do that?

A I do not know that to be -- I don't know if they can do that today or not.

Q Would you have any idea how long it would take to develop such a capability?

A No.

Q Or how expensive it would be?

A No.

Q You haven't proposed any specific rates in this case?

A No.

Q Would you contemplate then that there might be a follow-up proceeding to determine implementation issues?

A Yes, I would.

Q And if the Commission chose to adopt a bill and keep structure, would there have to be such a follow-up proceeding?

A I would think so.

Q To determine what? And, Mr. Fogleman, I'm just trying to compare the amount of work that might need to be done under one approach as opposed to the other.

Would you think that bill and keep might entail less follow-up work for the Commission than the two-part pricing structure, that's all I'm asking?

A Well, I'm not sure that you could -- I mean, again, it goes back to the jurisdictional issue, I guess. I don't know that the Commission could adopt a bill and keep --

Q Yes, assuming that they could.

A Yes, I guess you're right, it might not take as much time.

COMMISSIONER JABER: Let's say we could, Greg. Let's say we could implement a bill and keep mechanism.

THE WITNESS: Uh-huh.

COMMISSIONER JABER: How do we determine if traffic is roughly balanced? How do you envision --

THE WITNESS: Well, I mean, the only requirement that requires that the traffic is balanced is based on the fact that it is local. So if you assume that the traffic is not local, then the requirement that the traffic is balanced is not there.

COMMISSIONER JABER: Okay. There are two questions in relation to that. If we don't make a finding

that it is local, then are there jurisdictional concerns with respect to if it is not local, it's interstate, and therefore the FCC has jurisdiction, number one. But, number two, if that is not the case, have other states used bill and keep without making a finding that traffic is local?

THE WITNESS: I believe -- let's see. I believe Colorado had switched from what it originally had, a compensation rate, and they went to a bill and keep. I mentioned the Iowa case.

COMMISSIONER JABER: Okay. Let's take them one at a time. Colorado switched to a bill and keep mechanism, they made a finding that ISP-bound traffic was local?

THE WITNESS: No payment required -- this is what I have down in my notes. Colorado does not require payments, and characterizes this as a bill and keep methodology. In Iowa, Iowa has adopted a bill and keep by rule, Iowa Administrative Code 38.6(1), companies can file cost-based tariffs for compensation at termination of local traffic from another LEC if they can show that the ratio of terminating-to-originating traffic from one to another LEC was at least 55 percent terminating over a six-month period.

COMMISSIONER JABER: So by state rule they have

set forth what the balance percentage should be?

THE WITNESS: Correct.

COMMISSIONER JABER: Do you know how that was reported to them? Does the ALEC --

THE WITNESS: No. I have no idea.

BY MS. CASWELL:

Q Mr. Fogleman, I think you testified earlier that the move toward bill and keep would not necessarily incent an ILEC to deploy any more DSL service than it planned to anyway, is that correct?

A Correct.

Q But what about the ALECs, wouldn't a move toward bill and keep perhaps motivate them to change their business plans to focus more on DSL advanced technologies rather than dial-up?

A It could.

MS. CASWELL: Thank you. That's all I've got.

CHAIRMAN JACOBS: Ms. Masterton.

CROSS EXAMINATION

BY MS. MASTERTON:

Q Good afternoon, Mr. Fogleman. Mr. Fogleman, aren't there cost-based rates currently in place or under development, and by that I mean in the UNE pricing docket, that could be used as a basis for developing the bifurcated rate structure that you recommend in your

testimony?

A Yes, I believe there are some. I believe that is the case.

Q So would that reduce the need that you were referring to of a complicated additional proceeding?

A No. I just believe that is just for BellSouth right now, so -- but for BellSouth, for the case of BellSouth, yes.

Q Okay, thank you. Mr. Fogleman, in your direct testimony on Page 17, Line 17 through 19, you state that the purpose of reciprocal compensation is to compensate the carrier for the cost associated with the transport and termination of a call from another local carrier, correct?

A Correct.

Q And in your opinion, a properly structured reciprocal compensation mechanism, such as a bifurcated rate which takes into account varying call durations is consistent with that purpose of allowing appropriate cost-recovery, is it not?

A Correct.

Q So in that case it would not result in a revenue windfall for the carrier receiving that compensation, would you agree?

A If you get the rates correct for each of those components, yes.

MS. MASTERTON: Okay, thank you. That's all I have.

CHAIRMAN JACOBS: I have a question. Your proposal for a two-part mechanism, cost-recovery mechanism for traffic goes to all local traffic, correct?

THE WITNESS: That's correct.

CHAIRMAN JACOBS: And you don't prescribe a -- what's it called, an imbalance adjustment?

THE WITNESS: That's correct. Because if you get the rate correct, then you minimize any kind of incentive for the CLEC to really target and to try to get a huge imbalance of traffic. So whatever additional traffic that may be larger than they would normally get doesn't matter.

CHAIRMAN JACOBS: And that is based on -- that is based on the line of questioning you gave earlier that the imbalance of traffic that CLECs experience now is primarily because they targeted ISPs?

THE WITNESS: Correct.

CHAIRMAN JACOBS: But that doesn't take away the fact of the characteristics of an ISP's traffic, whoever serves them will be the same?

THE WITNESS: Right, it's going to be one way.

CHAIRMAN JACOBS: And so any carrier that picks up an ISP, that traffic is going to have those

characteristics in it?

THE WITNESS: That's correct.

CHAIRMAN JACOBS: So how would you -- let's say that an ALEC just happens to pick up two ISPs, okay. And you are now trying to make sure that there is equitable trade-off there. You are saying that your rate calculation can address and deal with that?

THE WITNESS: If you get the two rate components correct, yes.

CHAIRMAN JACOBS: Okay. Going to the statement that was given to you, were you a part of drafting these comments?

THE WITNESS: No. Actually the first comments were drafted by Walter Bolter (phonetic). And then I believe the second set of comments were really almost drafted as, you know, looking back at the first set of comments.

CHAIRMAN JACOBS: All right. Thank you.

COMMISSIONER PALECKI: Under your proposal, if you get the price right, an ALEC will neither target nor avoid ISPs, they will be on the same plane as other customers, correct?

THE WITNESS: That is correct.

COMMISSIONER PALECKI: If we go to, take bill and keep, wouldn't it be more likely that an ALEC would

actually avoid ISPs?

THE WITNESS: That is correct. Because now they would have to recover any costs directly from the ISP.

COMMISSIONER PALECKI: And there would be a ceiling as to the amount of costs they would be able to recover before the ISP switches to other options?

THE WITNESS: Correct.

COMMISSIONER PALECKI: Thank you.

CHAIRMAN JACOBS: That kind of goes back to my earlier point. Setting aside the market, the contest between ALECs and ILECs, have we set up some kind of an obstacle course for ISPs now to get a carrier?

THE WITNESS: I don't think so.

CHAIRMAN JACOBS: Okay. Let me not -- I was going to bring in some comments from another proceeding. But I just want to make sure that -- because what I would expect would happen here is that their leverage is significantly decreased in the marketplace under that scenario. Okay.

COMMISSIONER JABER: Mr. Fogleman, is there such a thing as a voluntary bill and keep?

THE WITNESS: Sure.

COMMISSIONER JABER: How does that work?

THE WITNESS: Well, I mean, if two parties get together and they negotiate their interconnection

agreement and they decide well, gee, we are just not going to charge each other for the traffic, so yes.

COMMISSIONER JABER: That assumes that they have figured out that the traffic is roughly balanced, right?

THE WITNESS: Or that they have negotiated for some other, you know, give and take. And so it doesn't necessarily mean that there was a balance of traffic, it just means that they agreed on the whole package of issues in their interconnection agreement.

COMMISSIONER JABER: That Iowa rule that you were referring to earlier, it has the 55 percent threshold for -- and I'm assuming two companies get together, or the Commission, you know, as a facilitator, whatever, figures out that traffic is at 55 percent, and they implement a bill and keep mechanism. What about for the companies where it can be shown that the traffic is not balanced?

THE WITNESS: Then they would have to develop some sort of reciprocal compensation rate.

COMMISSIONER JABER: Can you think of anything that would prohibit Florida from doing that, or anything that you would recommend for us not to do something like that?

THE WITNESS: No, I think that you would be able to do something like that if you -- but, again, how do you -- you know, once you decide what that rate is, what a

reasonable, you know, balance of traffic is, you know, you could do that.

CHAIRMAN JACOBS: Redirect.

MS. BANKS: Staff just has a couple of points to clarify.

REDIRECT EXAMINATION

BY MS. BANKS:

Q The first is, I think earlier Mr. Meza asked if the current rates for reciprocal compensation benefits the ALECs over the ILECs, and I just wanted to clarify your response to that. Doesn't it really benefit the ALECs that target the ISP customers?

A I think so.

Q And who set the rate for reciprocal compensation, the ILEC or the ALEC?

A Well, it's based on, I believe, the incumbent's costs.

MS. BANKS: Okay. That's all staff has.

CHAIRMAN JACOBS: Exhibits. No exhibits, were there? Okay, that's it. You are excused, Mr. Fogleman.

MS. BANKS: Excuse me, Mr. Chairman. I think BellSouth had an exhibit they were going to enter. It turns out it is not, so you can do that.

THE WITNESS: Are both sets of comments then not in the record?

MR. MEZA: I don't think they are. So I would like to mark this as -- have it identified as Exhibit 27.

COMMISSIONER JABER: Mr. Chairman, I would like to make a request that all comments that the PSC has filed be marked as that exhibit. I can't imagine anybody would have an objection to that.

MR. MEZA: That's fine.

CHAIRMAN JACOBS: On the issue of reciprocal comp?

COMMISSIONER JABER: Yes, or comments in this docket.

MS. BANKS: Excuse me, Mr. Chairman. I don't know if this will make a difference or not, the PSC's comments are in the official recognition list. On Page 4 of staff's official recognition list at the very bottom of the page, they are in the official recognition list, also. I don't know if that would determine whether BellSouth wants to --

CHAIRMAN JACOBS: We have already identified it, we will go ahead. Because now it includes all Commission comments in this FCC docket, is that correct?

MR. MEZA: We'll be happy to have Exhibit 27 include all comments. And can the staff let us know what those comments are?

CHAIRMAN JACOBS: Would you provide copies to

all the parties?

MS. BANKS: Yes, we can do that.

MR. MEZA: And I would like to move Exhibit 27 into the record.

CHAIRMAN JACOBS: Without objection show Exhibit 27 is admitted.

(Exhibit 27 marked for identification and admitted into the record.)

CHAIRMAN JACOBS: That takes care of it, doesn't it? A couple of matters we need to take care of. One --

MS. BANKS: Excuse me, Mr. Chairman.

CHAIRMAN JACOBS: Yes.

MS. BANKS: Since we are in the mode of entering exhibits, staff would like to enter one exhibit in that we provided to parties.

CHAIRMAN JACOBS: Right. You want to amend Exhibit 1.

MS. BANKS: Yes, sir.

CHAIRMAN JACOBS: Okay.

MS. BANKS: Staff's official recognition Composite 1, we want to include the Iowa Administrative Code.

CHAIRMAN JACOBS: Okay. No objections? Show that Exhibit 1 is amended to include Chapter 38 of the Iowa Administrative Code.

MS. BANKS: Thank you.

CHAIRMAN JACOBS: Briefs. Before we talk about timing, there were two issues that we had asked for briefing. Do you want to describe yours?

COMMISSIONER JABER: As I recall, it was the last paragraph of the Bell Atlantic decision. The last paragraph of the Bell Atlantic decision made reference to what state commissions were free to do, and upon vacation of an earlier ruling. So my question for the parties was what is the -- what does that mean, basically. Legal analysis on what that language in light of the vacation of the order means.

CHAIRMAN JACOBS: Very well. And the point I would ask for briefing is scope of state commission authority to establish reciprocal compensation policy outside of a specific arbitration proceeding. And I note -- I note a policy, not terms and conditions, but reciprocal compensation policy as opposed to terms and conditions of reciprocal compensation. If you want to address terms and conditions, feel free to. But my specific interest is in establishing reciprocal compensation policy.

Now, schedule.

MR. MOYLE: Excuse me, Mr. Chairman, just on that point of clarification. The scope of the state

commission authority to establish recip comp policy outside of a generic proceeding?

CHAIRMAN JACOBS: No. Outside of an arbitration proceeding. Interconnection arbitration proceeding, I mean. Let me be real clear on that.

MR. MOYLE: So that might include this proceeding, or some kind of rulemaking, or something like that?

CHAIRMAN JACOBS: Right, exactly.

Ms. McNULTY: And, Chairman Jacobs, may I ask for clarification on what you mean, the difference between policy versus terms and conditions?

CHAIRMAN JACOBS: In my mind, if we will be absolutely determining a specific rate that would apply to parties, or particular terms of a reciprocal compensation that would apply to parties as opposed to the generic approach that we would take, i.e., the legal issues. And a great example of the legal issues, our statement of our jurisdiction to address these issues, and perhaps even to some extent the generic findings as to how we view the traffic.

Ms. McNULTY: Thank you.

CHAIRMAN JACOBS: Okay. Clear enough?

MS. BANKS: As it relates to the dates in this proceeding, the transcripts are due on March the 23rd with

briefs due on April the 6th.

CHAIRMAN JACOBS: That's it. And then as a final matter we have pending, I believe, a motion to compel.

MS. BANKS: That is correct, Mr. Chairman.

CHAIRMAN JACOBS: I think you have a recommendation?

MS. BANKS: Yes, sir. Just to recap and very brief, on February the 27th, BellSouth filed a motion to compel ALECs to produce responses to BellSouth's discovery prior to hearing. Staff has received several responses to this motion to compel. And after a preliminary review, staff believes that the ALECs should be compelled to respond to certain interrogatories. And I will actually list those at this time. Interrogatories Number 6, 21, and 23. And also the Request for Production Number 4. And we believe that this information that is sought is likely to lead to discovery of admissible evidence.

CHAIRMAN JACOBS: Okay. Now, let's be careful, because some of the responses indicated that while the motion to compel made the assertion that the requests were identical or similar for all the ALECs, there were specific responses that they were not, and that some ALECs were not served some discovery requests. So what I want to be assured, if we are authorizing discovery, that a

party was indeed served that request.

MR. MEZA: Chairman Jacobs, if I could clarify that for you. From what I understand there was a clerical error that e.spire was only served with interrogatories up to Number 21, is that right, Mr. Horton?

MR. HORTON: That is correct.

MR. MEZA: But I think all the other parties were served and responded to the entire set of interrogatories.

CHAIRMAN JACOBS: So as to Interrogatory 23 that you granted e.spire would not be covered by that?

MS. BANKS: Okay.

CHAIRMAN JACOBS: Very well. I will -- go ahead.

MS. BANKS: As a part of that recommendation in light of the fact that if you do decide that the ALECs would be compelled to provide this information, staff would request that -- or would suggest that the ALECs that have not responded, I'm assuming maybe some of them have responded, I'm not sure, due to the nature of when staff received the responses, some of this information may have already been received.

But staff would make the recommendation that the ALECs be compelled to provide this information to BellSouth by Wednesday, March the 14th. And also that

BellSouth would be given the opportunity to do a late-filed exhibit subject to objections by parties.

CHAIRMAN JACOBS: Okay. Now, one of the responses -- I'm sorry.

MS. BANKS: I was going to add to that if that is the way the Commission decides to rule, then we would also request that BellSouth have to file that late-filed exhibit by March 30th, which would be one week prior to the filing due date for the briefs.

CHAIRMAN JACOBS: One of the responses is styled in terms of a motion for a protective order. That is the FCCA's response. I would take it your recommendation is, in essence, to deny that motion consistent with your recommendation?

MS. BANKS: Yes, Mr. Chairman. Staff's recommendation would be to deny in part and grant in part.

MS. KAUFMAN: I'm sorry, Mr. Chairman, it might not be right for me to interrupt. I'm not clear on what we are talking about in terms of the FCCA.

CHAIRMAN JACOBS: Your motion, response -- was it FCCA?

MS. KAUFMAN: It was both. And I thought Bell had said that due to the fact that we are an organization that our responses as to 6, 21, and 23 were acceptable and they were not moving to compel on those.

CHAIRMAN JACOBS: Okay.

MS. KAUFMAN: That is my understanding.

CHAIRMAN JACOBS: I accept that, if that is the agreement.

MR. MEZA: No, that is not correct.

CHAIRMAN JACOBS: Help me understand that.

MR. MEZA: Excuse me, who is this again?

MS. KAUFMAN: This is the Florida Competitive Carriers Association.

MR. MEZA: That is correct.

CHAIRMAN JACOBS: Okay.

MR. GROSS: Mr. Chairman, excuse me. The FCTA also is in a substantially similar situation to the FCCA. We filed a motion for protective order combined with our response in opposition. And several of our responses --

MR. MEZA: He is also correct.

CHAIRMAN JACOBS: Sorry.

MR. MEZA: He is free to go.

MR. GROSS: Okay. I just wanted to confirm that.

MS. KAUFMAN: I'm sorry if this is not appropriate. So that takes care of the interrogatories. I guess POD Number 4 is still outstanding pending your ruling. I'm just trying to get clear on where we are with that.

CHAIRMAN JACOBS: Now, I think we are clear at least on the status of all the filings. Anything outstanding on that? Now, staff, does that complete your recommendation?

MS. BANKS: If I understand correctly, all parties have responded to those to some extent, the interrogatories that were listed, Number 6, 21, and 23. Is that a correct understanding?

CHAIRMAN JACOBS: I'm not sure. But we don't need to resolve that. Let's go ahead and resolve the motions. And then if there is any need to clarify that we can do that. You can get back together or you can come back if we need further clarification.

MS. BANKS: Okay. That's fine. The other was the Request for Production of Document Number 4, Item Number 4. Staff thought that this was germane to this proceeding and, therefore, that ALECs should be required -- compelled to produce that information.

CHAIRMAN JACOBS: Let me see that one, please. I was looking for it and I couldn't find it in my papers, so let me see that. We can go off the record for a moment.

(Off the record.)

CHAIRMAN JACOBS: My question on this was as to confidentiality. Are we requiring any kind of protective

agreements on this?

MR. MEZA: We would be willing to execute any agreement, protective order that the parties requested.

CHAIRMAN JACOBS: All right.

MR. MOYLE: Mr. Chairman, I don't know when the right time to get into this and argue is, but this one, that Number 4, it requests any and all written agreements or contracts between ISPs and our clients. And if I understand discovery, when I produce it I have an obligation to produce it to the requesting party and all of my friends who have been at the table this week, who are also my competitors. You know, I have a serious concern. And even the offer of confidentiality is how do you unring a bell on something like that.

CHAIRMAN JACOBS: I'm prepared, let's rule. Let me start with this one. I'm not going to go with your recommendation on this one. It is overly broad. And it goes to oral agreements, which would be a tremendously difficult standard and would probably pose more cause for delay than anything else. While it could lead to matters that are germane, I think we can proceed and I think parties can effectively conduct their cases without this particular discovery. I will grant it as to the others, and I suspect we'll have information to follow.

MR. HOFFMAN: Mr. Chairman.

CHAIRMAN JACOBS: Yes.

MR. HOFFMAN: Are you going to allow us to be heard on this motion before you make your ruling, or are you making your ruling without -- because let me just say, I mean, and you are going to do, obviously, what you think is appropriate. I think that you are opening the door to a slope so slippery at this point that it is incredible by the precedent that you are establishing by allowing any discovery under the facts and circumstances that are present here. I would like to take two minutes to talk about that. But if you are not inclined to allow us at this point, I will abide by that.

COMMISSIONER JABER: May I interject?

CHAIRMAN JACOBS: Yes.

COMMISSIONER JABER: It's late, let me offer this. It seems like there is some confusion about what has been responded to and what hasn't anyway. I don't know how quickly staff can give me a written order, but maybe if you would like, you know, I can deal with that tomorrow or the day after.

CHAIRMAN JACOBS: I would be happy to defer it the prehearing officer.

COMMISSIONER JABER: Okay. I would just ask that the parties get together, figure out what has been responded to, what hasn't, get with staff, staff will make

a recommendation to me. And, you know, if we need to have a telephone conference, we can do that.

MR. HOFFMAN: Well, as I understand it, if we are ready to roll here, I understand that, Commissioner.

CHAIRMAN JACOBS: No, I am withdrawing my tentative ruling, and I am deferring to the prehearing officer. And it is at her discretion whether she will allow arguments on the motion. But her request, as I understood it, was for the parties to get together and figure out where we are in terms of what discovery has been provided already.

COMMISSIONER JABER: It would be great if I didn't have anything to rule on.

CHAIRMAN JACOBS: Now, because I don't want to cause any undue confusion, how about appear before you and leave that as pending as well as the one I just denied? Do you want to leave that pending, as well?

COMMISSIONER JABER: I would prefer to deal with it altogether.

CHAIRMAN JACOBS: I think that's fair. Why don't we leave it all subject to the prehearing officer's merit, deliberations, and we can get -- can we avoid notice issues by indicating now a time and place when we can do a telephonic proceeding? Do you guys want to take ten minutes to do that? Because I am persuaded that I

don't want to breach too hastily into this, and it's late and we might -- I don't want to broach something without having the opportunity for full consideration. Do you guys want to take ten minutes and try and come up with a time we can do a telephonic proceeding on this, I will be happy to do that.

COMMISSIONER JABER: We were supposed to have a hearing day tomorrow anyway.

CHAIRMAN JACOBS: Yes, that's my thought.

COMMISSIONER JABER: Can we avoid notice issues if we do it then?

CHAIRMAN JACOBS: Yes. That's my thought is we avoid any noticing issues if we can just do it now, come up with a time now. Do you want to do that?

MR. MEZA: Tomorrow morning is fine with BellSouth.

CHAIRMAN JACOBS: Okay.

COMMISSIONER JABER: With the prehearing officer or --

CHAIRMAN JACOBS: No, I'm sorry, I wanted you to designate that, not me.

COMMISSIONER JABER: Okay. 9:30 tomorrow morning is fine.

CHAIRMAN JACOBS: That works for the parties.

MR. MOYLE: We're going to do it with telephone,

is that right?

CHAIRMAN JACOBS: Unless you want to come. If you want to come, that's fine. But I thought it would be more convenient for the parties to arrange to do it by telephone.

MS. KEATING: Actually, Mr. Chairman, that part might be a problem.

COMMISSIONER JABER: We can't do it by telephone, because the people we would need to establish a telephone line are probably gone by now. Why don't we convene here at 9:30 to take up the motions, all the motions.

CHAIRMAN JACOBS: I will let the --

MR. MEZA: That's fine. I mean, if we can spend five minutes resolving this that would be greatly appreciated.

CHAIRMAN JACOBS: That will be even better. If you guys think five or ten minutes will do the job --

MR. MEZA: We are dealing with three interrogatories now. I mean, that's --

CHAIRMAN JACOBS: If you think five or ten minutes will do the job, I don't have a problem with that, either.

MR. HOFFMAN: That would be great. I don't see a lot of down side.

MR. MOYLE: We can come back and figure out what we have figured out.

CHAIRMAN JACOBS: Let's give you 15, what the heck.

(Recess.)

CHAIRMAN JACOBS: Do you want to explain where we are, Staff?

MS. KEATING: I think we are in a little bit better place than we were about 15 minutes ago. Apparently there is some tentative agreement that BellSouth will be willing to accept responses just to Interrogatory Number 23.

And if I understand it correctly, there has been agreement between a number of the parties. The only two left outstanding are Global NAPS and Time Warner, and there is a possibility that once they have a chance to contact their clients that --

CHAIRMAN JACOBS: Ms. Camechis.

MS. CAMECHIS: Hi, Karen Camechis for Time Warner. I am unable to reach my client today due to a family emergency that she is involved with up in Washington. So I will have to check with her before I can agree to any stipulation.

CHAIRMAN JACOBS: Okay. We can leave that pending. We can leave your agreement pending. However, I

will go ahead and accept this as an offer. And then we can come back -- actually what we said is you can come back to the prehearing officer if you need to deal with any objections or complaints. And will that work also for Global NAPS?

MR. MOYLE: I just want to make clear, because this is something I need to understand, I, too, have not been able to communicate with my client.

CHAIRMAN JACOBS: Right.

MR. MOYLE: But I understand that with respect to that request about all the contracts, you have withdrawn that and ruled that is not --

CHAIRMAN JACOBS: Four stands. Let's go back to where we were. We are going to rule on everything now. And my ruling as to POD 4 stands, okay. So now we are on the remaining issues.

MR. MOYLE: Okay.

CHAIRMAN JACOBS: Okay.

MR. MOYLE: I've got my client, if I can take a minute. I'm sorry.

CHAIRMAN JACOBS: Ah. We may get it down to one.

MR. HORTON: Mr. Chairman.

CHAIRMAN JACOBS: It's amazing what 5:30 will do to a controversy.

MR. HORTON: Mr. Chairman, just so it's clear, BellSouth said they want the answer to Interrogatory Number 23. And they did not serve that on e.spire, so I'm out.

CHAIRMAN JACOBS: Correct. So that does not apply.

MS. KAUFMAN: And, Chairman Jacobs, the FCCA is out, as well.

CHAIRMAN JACOBS: As well as the FCTA. Those rulings also still stand.

MS. CAMECHIS: Excuse me, Chairman Jacobs, may I ask a question?

CHAIRMAN JACOBS: Yes.

MS. CAMECHIS: Probably of BellSouth. Interrogatory Number 23 asks for us to describe in full our relationship with any ISP. Is that with regard to whether we have any kind of reciprocal compensation arrangement with them at all, or is it just generally?

MR. MEZA: It's just a general question as to your relationship with ISPs.

MS. CAMECHIS: For example, AOL.

MR. MEZA: Correct.

MS. CAMECHIS: So you want just a general description of however --

MR. MEZA: Correct.

MS. CAMECHIS: Thank you.

CHAIRMAN JACOBS: Is that okay?

MS. CAMECHIS: I will have to check.

CHAIRMAN JACOBS: All right.

(Pause.)

CHAIRMAN JACOBS: You will have to explain to me, are you in agreement as to that request? I don't need to hear the details. If you have an agreement, you don't need to explain the details to me.

MR. MEZA: Yes. We have an agreement with Global NAPS.

CHAIRMAN JACOBS: Okay.

MR. MOYLE: We have an agreement. We have made a slight change and we are, I think, going to be okay.

CHAIRMAN JACOBS: Okay. If you guys can just communicate --

MR. MEZA: While we have everyone here, will the same deadline apply, I guess, as far as responding?

MS. KEATING: That's what we would recommend, they be provided by next Wednesday. And then if BellSouth is wanting to use it as a late-filed exhibit that it be submitted subject to any objections, of course, the week before briefs.

CHAIRMAN JACOBS: Okay. So to be real clear, as to POD Number 4, the request -- I mean, the motion to

compel is denied. As to all other outstanding discovery, there is an offer of settlement by the parties that I will accept pending final approval from Time Warner, and that should resolve all discovery, outstanding discovery.

MR. EDENFIELD: I don't anticipate having a problem with Time Warner. I mean, everybody else has agreed. I don't see a need really to -- unless you just want to, to set a time for anything or go to the trouble of doing a --

CHAIRMAN JACOBS: No. If you need to get back, just arrange it at your -- actually at the convenience of prehearing officer, she is going to do it.

MR. EDENFIELD: And the last thing I just want to make sure I'm clear on is that the only objections -- as part of this agreement, the only objections that are left would be to the extent -- it was to admissibility. In other words, we are not going to agree to this, leave here, and then have them appeal to the full Commission on the objection itself.

CHAIRMAN JACOBS: I wasn't there, so I will have to go with --

MR. EDENFIELD: I mean, I assume you guys aren't going to turn around and --

MR. HOFFMAN: We have, as I understand from the process that was set up, the right to pose an objection.

At this point, you know, we will leave aside all the objections that we have to the way that this was done, which was very 11th hour. We have agreed to answer one question. It is still a discovery question, and it doesn't make it admissible into the record at all, but we will answer it.

MR. EDENFIELD: And that is my understanding. I just want to make sure that the objections as to every grounds except for admissibility into the record have been resolved as part of the agreement. You still have a right to object as to whether this can come into the record as relevant to the record or on some technical admissibility grounds. But as far as any true discovery objections, those are resolved.

MR. HOFFMAN: Right.

MR. MOYLE: And the only question is, just for the record, Number 23, correct?

MR. EDENFIELD: That is correct.

MR. HOFFMAN: I think, Mr. Chairman, I also need to caveat that I need to consult with Allegiance before I can agree on Interrogatory 23.

CHAIRMAN JACOBS: So you are in the same posture as Time Warner, then?

MR. EDENFIELD: That will be fine.

MR. HOFFMAN: I'm always in the same boat with

Mr. Moyle, Mr. Chairman.

CHAIRMAN JACOBS: No, Time Warner.

MR. HOFFMAN: He resolved it, okay.

CHAIRMAN JACOBS: Okay. All right. That is the ruling, then. Thank you very much for your cooperation. We are adjourned.

(The hearing concluded at 6:05 p.m.)

STATE OF FLORIDA)

: CERTIFICATE OF REPORTER

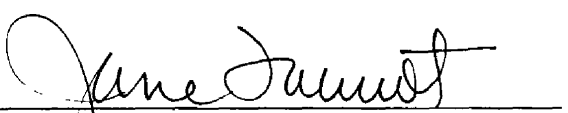
COUNTY OF LEON)

I, JANE FAUROT, RPR, Chief, FPSC Bureau of Reporting FPSC Commission Reporter, do hereby certify that the Hearing in Docket No. 000075-TP was heard by the Florida Public Service Commission at the time and place herein stated.

IT IS FURTHER CERTIFIED that I stenographically reported the said proceedings; that the same has been transcribed under my direct supervision; and that this transcript, consisting of 163 pages, Volume 6 constitutes a true transcription of my notes of said proceedings and the insertion of the prescribed prefiled testimony of the witnesses.

I FURTHER CERTIFY that I am not a relative, employee, attorney or counsel of any of the parties, nor am I a relative or employee of any of the parties' attorney or counsel connected with the action, nor am I financially interested in the action.

DATED THIS 23RD DAY OF MARCH, 2001.



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