STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

FOCAL COMMUNICATIONS CORPORATION OF ILLINOIS Petition for Arbitration Pursuant to Section 252(b) of the Telecommunications Act of 1996 to Establish an Interconnection Agreement with Illinois Bell Telephone Company d/b/a Ameritech Illinois	)	Docket 00-0027

AMERITECH ILLINOIS' EXCEPTIONS TO HEARING EXAMINERS' PROPOSED ARBITRATION DECISION

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Illinois Bell Telephone Company d/b/a Ameritech Illinois ("Ameritech Illinois") respectfully submits its exceptions to the Hearing Examiners' Proposed Arbitration Decision dated April 3, 2000 ("HEPAD").

INTRODUCTION

Ameritech Illinois takes exception to three recommendations in the HEPAD:

(1) the proposal on Issue 1 that Focal be permitted to charge Ameritech Illinois a transport and termination rate of $.005175 per minute when Focal terminates local telecommunications that originate on Ameritech Illinois' network (HEPAD at 7);

(2) the recommended conclusion on Issue 2 that Internet traffic that Focal delivers to its Internet service provider customers for transmission to distant Internet sites is local traffic subject to reciprocal compensation under section 251(b)(5) of the Telecommunications Act of 1996 ("1996 Act") at the same rate as local traffic (HEPAD at 11); and

(3) the proposal on Issue 4 that Focal not be required to establish a point of interconnection within 15 miles of the rate center for any NXX code that Focal uses to provide foreign exchange service (HEPAD at 16).

Because of the extraordinary importance of Issue 2, Ameritech Illinois addresses it first. The HEPAD recommendation on Issue 2 is contrary to federal law and, as the Commission Staff agrees, would vastly over-compensate Focal for the costs it incurs when it delivers Internet traffic to its ISP customers. Indeed, the rate the HEPAD recommends is nearly four times (388%) the rate Staff proposed as the most accurate measure of Focal's costs. Accordingly, without waiving any argument it has made in connection with Issue 2, Ameritech Illinois offers for the Commission's consideration two alternatives to the inflated $.005175 per minute rate recommended in the HEPAD: a rate of $.000946 per minute, which was initially proposed and supported by Ameritech Illinois, or alternatively, a rate of $.001333, which was proposed and supported by Staff.

Ameritech Illinois offers substitute language for the HEPAD's recommended Commission Conclusions on Issues 1, 2 and 4 in Attachment A to this submission.

ISSUE 2: INTER-CARRIER COMPENSATION ON ISP TRAFFIC

According to the HEPAD, ISP traffic is "a call utilizing telephone exchange service" and therefore is subject to "the payment of reciprocal compensation to the terminating carrier under Section 251(b)(5) of the [Telecommunications] Act [of 1996]." (HEPAD at [illegible].) The HEPAD is wrong. *In December of 1999, in a decision that is the law and that is controlling here,* the FCC held:

> [W]e conclude that typically ISP-bound traffic does not originate and terminate within an exchange and, therefore, does not constitute telephone exchange service within the meaning of the [1996] Act. . . . [Rather], such traffic is properly classified as "exchange access."

In the matter of Deployment of Wireline Services Offering Advanced Telecommunications Capability, CC Docket Nos. 98-147 *et al.*, ¶ 16 (Dec. 23, 1999) ("*Advanced Service Order*").

The HEPAD says the FCC has "muddied the waters considerably" with respect to ISP traffic. (HEPAD at 11.) But there is nothing muddy about the FCC's holdings that ISP traffic "does not originate and terminate within an exchange," that it "does not constitute telephone exchange service within the meaning of the [1996] Act," and that it "is properly classified as 'exchange access.'" Nor is there any uncertainty about the proposition that traffic of that sort — non-local, exchange access traffic— is *not* subject to reciprocal compensation under section 251(b)(5) of the 1996 Act. The *Advanced Service Order* is the law, it is controlling here, and so it will remain unless and until it is set aside by a federal court of appeals.[1] The HEPAD disapproves of the FCC's motive (supposedly "to maintain jurisdiction of the issue"), but the Commission cannot disregard controlling federal law. As the Supreme Court has held, there is no question whether "the Federal Government has taken the regulation of local telecommunications competition away from the states. With regard to the matters addressed by the 1996 Act, it unquestionably has." *AT&T Corp. v. Iowa Utils. Bd.*, 119 S. Ct. 721, 730 n. 6 (1999).[2]

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1 The FCC also ruled that ISP traffic is non-local in its Declaratory Ruling in CC Docket 96-98 and Notice of Proposed Rulemaking in CC Docket No. 99-68 (*Inter-Carrier Compensation for ISP-Bound Traffic*) ("*ISP Order*"). The FCC further held in that proceeding that because ISP traffic is not local, it is not subject to the reciprocal compensation provisions of the 1996 Act or the FCC's rules implementing those provisions. On March 24, 2000, however, the United States Court of Appeals for the D.C. Circuit, in *Bell Atlantic Tel. Cos. v. FCC*, Nos. 99-1095 *et al.* ("*Bell Atlantic*") (Exhibit 1 to Ameritech Illinois' Issue 2 Brief), vacated the *ISP Order* and remanded the matter to the FCC for an explanation of the basis for its rulings. As the Commission Staff explained, "the D.C. Circuit's decision does not call into question the FCC's *conclusion* regarding the character of ISP traffic; rather, it finds that the FCC's *articulated basis for* its conclusion is insufficient . . . to support that conclusion." (Initial Brief of the Staff of the Illinois Commerce Commission, at 8) (emphasis added). Thus, *Bell Atlantic* has no legal impact on the binding holding of the FCC's *Advanced Service Order* that ISP traffic is exchange access.

The FCC has already signaled that it will provide the explanation for the *ISP Order* that the D.C. Circuit asked for. FCC Common Carrier Bureau Chief Lawrence Strickling stated that he "still believes that calls to ISPs are interstate in nature and that some fine tuning and further explanation should satisfy the court that the agency's view is correct." *See* Exhibit 2 to Ameritech Illinois' Issue 2 Brief.

2 The HEPAD's conclusion that ISP traffic is local exchange traffic, while probably the most glaring mistake the HEPAD makes on Issue 2, is by no means the only one. Section IV of the following discussion explains why the HEPAD is also wrong in concluding that compensation for delivering ISP traffic should mirror compensation for terminating local traffic because there supposedly is no "workable" method for segregating the two types of traffic; in relying on the fact that the two types of traffic function identically on the network as a basis for imposing reciprocal compensation on ISP traffic; and in suggesting that the grounds for Ameritech Illinois' position are not grist for this arbitration, but instead should be raised in other proceedings.

If the Commission decides nonetheless to impose a scheme of inter-carrier compensation on ISP traffic, the Commission should take care not to over-compensate Focal for its costs, as the HEPAD proposal would. Staff agrees that Ameritech Illinois should not be required to pay Focal the $.005175 per minute reciprocal compensation rate on ISP traffic recommended in the HEPAD, and proposes a rate of $.001333 per minute. Staff's proposal, as demonstrated below, correctly takes into account two key differences between ISP traffic and local traffic that dramatically reduce the per-minute costs Focal incurs when it delivers ISP traffic: first, the long hold times of Internet calls, which average about seven or eight times as long as local voice calls; and second, the fact that Focal, many of whose ISP customers are collocated at Focal's premises, performs only one switching operation and no tandem-type transport when it delivers Internet traffic to its ISP customers.

Ameritech Illinois has proposed a rate of $.000946 per minute. Thus, Staff and Ameritech Illinois have proposed rates for inter-carrier compensation on ISP traffic that vary. Both proposals, however, are based largely on the same cost-based principles of compensation. Ameritech Illinois begins by identifying those common principles, and then explains, in Section III, the one difference between Staff's approach and Ameritech Illinois' approach th at accounts for the difference between the two proposed rates.

I. AN INTER-CARRIER RATE FOR ISP TRAFFIC MUST TAKE INTO ACCOUNT THE LONG HOLD TIMES OF INTERNET CALLS.

The HEPAD states that ISP traffic and local traffic are functionally identical. That, however, cannot possibly justify the imposition of reciprocal compensation on ISP traffic, because, as further discussed in Section IV below, there are other types of traffic (Feature Groups A and B traffic) that share exactly the same functional traits and that are not subject to reciprocal compensation because, like ISP traffic, they are exchange access traffic. Furthermore, as both Staff and Ameritech Illinois showed in this proceeding, the *cost characteristics* of ISP traffic are radically different from the cost characteristics of local traffic, in ways that must be taken into account in any rational system of inter-carrier compensation for ISP traffic.

The first of these cost characteristics is that ISP calls average approximately seven or eight times longer than local calls, with the result that the per-minute cost of delivering the average ISP call is much less than the per-minute cost of terminating the average local call. The following propositions are uncontested:

- Ameritech Illinois' reciprocal compensation switching rates are per minute rates that assume an average call duration of approximately 3 ½ minutes. (Am. Ex. 2.0 at 14; Am. Ex. 2.5 at 9.)

- Those rates are arrived at by melding two cost streams: (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. (Am. Ex. 2.0 at 14; Am. Ex. 4 at 4-5).

- Since set-up costs are incurred one time per call, they are melded into Ameritech Illinois' per minute reciprocal compensation switching rates by being spread over the 3 ½ minute assumed duration. (Am. Ex. 2.0 at 14; Am. Ex. 4 at 5.) Thus, for example, if the fixed per call set-up cost were 10¢, then approximately 2.85¢ of that 10¢ (*i.e.*, 10¢ ÷ 3.5) would be assigned to each minute, so that, on average, the full 10¢ set up cost would be recovered on each call.[3]

- The average ISP call, however, is between seven and eight times as long as the average local call — approximately 26 minutes. (Am. Ex. 2.0 at 14.)

- Consequently, if Ameritech Illinois' reciprocal compensation switching rate were applied to ISP calls, the inter-carrier compensation for the average ISP call would recover between seven and eight times the set-up costs that it should recover. (Using the numbers in the example, a 26-minute call would recover 26 x 2.85¢ = 74.1¢ in set-up costs, even though the call actually cost only 10¢ (like all calls) to set up.) (Am. Ex. 2.0 at 14; Am. Ex. 4 at 5-6.)

- *Therefore, if Ameritech Illinois' switching rates are going to be used as a starting* point for developing an inter-carrier compensation rate for ISP traffic, one necessary adjustment is to re-allocate the fixed set-up cost over the 26-minute duration of the average ISP call. (Again using the numbers in the example, this would mean spreading the fixed 10¢ set up cost over 26 minutes, so that the set-up cost component of the per minute rate would be approximately .385¢ per minute.)

Staff wholeheartedly subscribes to the foregoing analysis. (*See* Staff Ex. 2 at 10-11, 15-16.) For that matter, even Focal does not dispute any of the facts on which the analysis is based. Focal accepts, for example, that Ameritech's switching rates are based on an average 3 ½ minute call; that ISP calls average 26 minutes; and that one component of current switching rates is a fixed set-up cost that has been spread over the average 3 ½ minute call. Focal argues, however, that the 3 ½ minute average call that was used to develop Ameritech's switching rates takes into account the existence of shorter-than-average calls and longer-than-average calls; that ISP calls are not the only longer-than average calls; and that there is therefore no reason to give ISP calls special treatment. (Focal Ex. 2.1 at 6-9.)

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3 The 10¢ used in the illustration is much greater than actual call set-up cost, and is used only to simplify the calculations. The point made in the illustration is equally valid regardless of the number chosen to represent the set-up cost.

Focal's argument is shameful. In the first place, ISP calls do not get lumped together (or should not be lumped together) with longer-than average local calls because they are not local calls. The object of the exercise is to come as close as possible to designing an appropriate, cost-based, rate for a special class of traffic that by law is not subject to reciprocal compensation or reciprocal compensation rates, not to enrich Focal by trying to shoehorn ISP traffic into a rate structure that was designed for other traffic that has dramatically different cost characteristics.

In the second place, Focal's premise — that ISP traffic is just one of many types of traffic that could be culled out and called "longer-than-average" — is nonsense. It is ISP traffic, not some other type of traffic, that has grown by more than 450% in the last three years. (Am. Ex. 2.0 at 8.) It is ISP traffic, not some other type of traffic, that has accounted for 100% of the increase in minutes of traffic originated by Ameritech Illinois' residential customers in that same period. (*Id.*) And it is ISPs, not some other customers, that buy 72% of the lines that Focal sells. (Am. Ex. 1.0 at 19 n. 27), so that if a duration of 3 ½ minutes (or even five or six minutes, with ISP calls added to the mix) represents the average call on Ameritech Illinois' network, it certainly does not represent the average call on Focal's network. *If* some other category of calls should emerge in the future that (i) lasts many time longer than local voice traffic; (ii) grows in volume at a rate that dwarfs anything the network has ever seen before; and (iii) is subject to reciprocal compensation by law, then the economics of the situation would warrant a change in the law of reciprocal compensation — especially *if* (iv) it is one-way traffic, like ISP traffic. In this proceeding, though, Focal has called upon the Commission to deal with ISP traffic, and it is pure fantasy to pretend, as Focal does, that ISP traffic is just any old longer-than-average local traffic.

Thus, if a compensation rate for ISP traffic is going to be based on Ameritech Illinois' rates, those rates must be adjusted (as Ameritech Illinois witness Panfil and Staff witness Phipps have done) for the hold times of ISP traffic.

II. A COMPENSATION RATE THAT REFLECTS FOCAL'S COSTS FOR DELIVERING ISP TRAFFIC WILL INCLUDE ONLY ONE SWITCHING ELEMENT AND NO TRANSPORT.

Focal's position that it should be compensated for delivering ISP traffic at the rate proposed in the HEPAD is also preposterous because it assumes that Focal performs two switching operations (end office switching and tandem switching) and tandem-type transport when it delivers traffic to its ISP customers. That assumption, however, is false. Indeed, Staff witness Phipps testified that when Focal delivers traffic to its ISP customers, Focal's network performs one switching operation and no transport, and he explained at length why that is so. (Staff Ex. 2 at 11-15.) Mr. Phipps, an obviously impartial and fair-minded witness, was cross-examined extensively on that testimony, and then reaffirmed it without equivocation:

> Q: (By Examiner Woods) Okay, Mr. Phipps, based on all the cross that you went through we are just kind of unclear right now as to what your final position is. Based upon your review of [Focal's] diagram that you discussed with Ms. Hightman has your position now on the recovery of the tandem switching rate changed at all from the position you took when filing your testimony?
>
> A: What I set forth in my testimony is still my position, yes.
>
> Q: And that is your final answer?
>
> A: Yes. I just wish that was for a million dollars.

(Tr. at 578-79.)

Mr. Phipps's final answer was correct. As Mr. Phipps explained in his pre-filed statement, some of the ISP traffic that Focal delivers goes straight to ISPs that collocate in

Focal's switching office. Even Focal witness Barnicle admitted that "the cost of serving customers is less for collocated than non-collocated customers from Focal's perspective." (Tr.112-113.)[4] *That is in part because Focal does not incur any transport mileage for that traffic,* as Focal witness Starkey admitted when he proposed, in the fall-back proposal in his Supplemental Verified Statement, to exclude transport mileage charges for such traffic. (Focal Ex. 2.1 at 26.) It is also in part because of the obvious efficiency (*i.e.*, relative cheapness) of routing the traffic, once it has been switched the one and only time that it is switched by Focal, to the collocated ISP equipment in the same building.

When Focal delivers traffic to a collocated customer, Focal merely routes the traffic from its switch to the customer's equipment a few floors away. (Tr. 146-47). For customers that are not collocated, Focal uses high-capacity digital transmission systems to connect customers in "on-net" buildings to Focal's end office switch. (Focal. Ex. 2.1 at 14-15). While Focal claims it uses "transport" facilities to do this, the facilities are in fact more akin to the local loop, as Staff witness Phipps testified. (Tr. 539-40). And loop costs (as opposed to inter-office transport costs) are not properly included in a system of inter-carrier compensation. (Tr. 186.)

Mr. Phipps testified that Focal can route Internet traffic to the collocated ISP equipment by means of a simple cross-connect. (Staff Ex. 2 at 11.) Mr. Starkey disagreed, and claimed that Focal serves its collocated customers with an "OC-48 backbone," which, he said, was "about as far removed from a 'simple cross-connect' as one can imagine" and "is likely to require an investment more akin to hundreds of thousand of dollars." (Focal Ex. 2.1 at 12.) That point gets Focal nowhere,

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4 Mr. Barnicle's admission is corroborated by Starkey Cross-Exhibit 1, which shows that Focal charges its collocated ISP customers less than it charges its non-collocated ISP customers.

however, because the fact remains that Focal performs only the one switching operation. Indeed, this is a perfect illustration of the consequences of Focal's failure to offer a cost study (*see* Section VI below): Focal asks to be compensated for two switching operations (end office switching and tandem switching); the record is clear that it performs only one; Focal says, though, that it is doing something extra with its OC-48; but the closest Focal comes to telling the Commission what that something extra costs is to say that the OC-48 "is *likely* to require an investment more *akin to* hundreds of thousands of dollars." (*Id.*)[5]

Another illustration of the consequences of Focal's failure to offer a cost study can be found in another "correction" that Mr. Starkey made to Mr. Phipps's testimony about collocated ISPs. Where Mr. Phipps testified that "the majority" of Focal's ISP customers are collocated at Focal's central office (Staff Ex. 2 at 11), Mr. Starkey pointed out that a Focal response to a Staff data request indicated that something less than a majority were collocated (Focal Ex. 2.1 at 11). What, though, is the Commission supposed to do with that information? Focal apparently would have the Commission *assume* that the percentage of Focal's ISP traffic that goes to collocated ISPs equals the percentage of ISPs that are collocated. That may be the case, but it also may be that the collocated ISPs receive more traffic on average (or less) than the non-collocated ISPs. A proper cost study would answer that question, and would spare the Commission from having to guess what to do with Focal's admission that it costs less to serve collocated ISPs than non-collocated ISPs.

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[5] Mr. Starkey also uses some sleight of hand to make his case. His vague reference to something "akin to hundreds of thousands of dollars" for an OC-48 conveniently ignores the fact that an OC-48 transmission system can provide more than 32,000 individual connections to Focal's collocated customers. Even if one assumes the OC-48 system requires a $300,000 investment, that still amounts to less than $10 per connection, and thus represents a monthly cost that would be only a small fraction of $10 for each local loop equivalent connection.

It is not only to collocated ISPs, but to all ISPs, that Focal routes traffic with only one switching operation. There can be no serious contention that Focal performs two switching operations, for the simple reason that each ISP call that Focal routes passes through only one Focal switch. (*See* Focal Ex. 2.1 at 14.) Moreover, Focal does not incur, and therefore is not entitled to recover, transport costs because, as Staff witness Phipps explained, Focal carries traffic to its non-collocated ISP customers via "high capacity facilit[ies], with capabilities to handle large volumes of traffic at a relatively low cost" (Staff Ex. 2.0 at 11; *see also* note 5 above) *and*, in any event, the facilities on which it carries that traffic are not transport facilities, but loops (*id.* at 11-12). As Focal admits, loop costs are not properly recoverable in any inter-carrier compensation scheme. (Tr. 186.)

In sum, as Staff and Ameritech Illinois agree, a compensation rate that reflects Focal's costs for delivering ISP traffic will include only one switching element (not the two switching elements that are included in the proposed HEPAD rate) and (again unlike the proposed HEPAD rate) no transport element.

III. THE COMMISSION SHOULD NOT CREATE BAD PUBLIC POLICY BY ENDORSING AN INTER-CARRIER COMPENSATION SCHEME THAT LETS FOCAL OVER-RECOVER ITS COSTS.

In its March 29, 2000, Order in Dockets 97-0601 *et al.*, this Commission endorsed the principle that inter-carrier rates should track costs as closely as possible. Applied here, that principle would mean that Focal should not be allowed to over-recover its costs. And it is especially important that Focal not be allowed to over-recover its costs in this instance, because even an apparently small per minute over-compensation of Focal will quickly balloon into an enormous subsidy with especially undesirable consequences for the consuming public.

The volume of ISP traffic that originates on Ameritech Illinois' network, and the rate at which it is growing, is staggering. In the period from March, 1997, to October, 1999, while non-Internet traffic on the network grew by just 2.3%, Internet access minutes grew by more than 450% (477% for residential subscribers alone, to a total of 1.9 **billion minutes per month**). (Am. Ex. 2.0 at 8.) With this growth likely to continue (*id.*) on top of the already huge basis of ISP access traffic, an inter-carrier compensation rate that is even a fraction of a cent higher than cost would yield an enormous windfall for Focal and similarly situated recipients of the payments, and an equal forfeiture for Ameritech Illinois.

Such a dislocation, moreover, would benefit people least in need of the benefit, at the expense of those who can least afford to pay for it. (Am. Ex. 1.0 at 23-24.) The subsidy would, of course, benefit Focal and (to the extent Focal's arbitrage profits are passed through) Focal's ISP customers and their subscribers. (Am. Ex. 1.0 at 23-24.) But those subscribers tend to be affluent, and least in need of such a subsidy. (*Id.* at 24.) On the other side of the coin, the ultimate source of the subsidy would be the most disadvantaged ratepayers — those who are not Internet users. (*Id.*)

In addition, a rate that over-compensates Focal, such as the rate recommended in the HEPAD, would disserve every pertinent goal of the Telecommunications Act of 1996. Specifically:

- It would reduce competition among local exchange carriers for residential customers (Ameritech Illinois' Post-Hearing Brief on Issue 2 ("Ameritech's Issue 2 Brief") at 36-37);
- It would encourage market entry by inefficient competitors instead of by efficient competitors (*id.* at 37);
- It would institutionalize irrational pricing of local exchange and Internet services (*id.* at 38-39); and

would be capped at one-half of the local usage revenues that the paying party derives from that customer. (*Id.* at 16.)

Staff, agreeing with part but not all of Ameritech Illinois' proposal, recommended that the Commission set a rate of $.001333 per minute, but without the phase-out or the cap proposed by Ameritech. Staff's proposal takes properly into account the long hold times (and therefore lower than local per-minute costs) of switching ISP traffic, and the fact that Focal performs only one switching operation and no tandem-type transport when it delivers Internet traffic to its ISP customers. Thus, Staff's proposal is highly commendable for its recognition that a cost based inter-carrier compensation rate for ISP traffic will not mirror current reciprocal compensation rates for local traffic, and Ameritech Illinois wholeheartedly endorses the policy underlying Staff's proposal.

Ameritech Illinois, however, has countered Staff's proposal with one that Ameritech Illinois believes comes even closer to the cost-based objective that Staff and Ameritech Illinois agree should be the guiding principle for any inter-carrier compensation rate. While Ameritech Illinois did propose $.001333 as a starting point for a phase-out process with a cap, that rate is less appropriate as a permanent arrangement for the duration of the parties' agreement, for reasons that Ameritech Illinois set forth in testimony that it incorporates here by reference. (*See* Am. Ex. 2.5 at 6.) Accordingly, Ameritech Illinois responded to Staff's proposal with a revised proposal designed to mitigate Staff's apparent concerns with the rigid phase-out and cap that were part of Ameritech's original proposal, while at the same time coming closer to eliminating the harms, described above, that are inherent in any arrangement that includes inter-carrier compensation for ISP traffic.

The compensation rate that Ameritech Illinois proposes is $.000946 per minute of use. This rate, which takes into account the ability of Focal and all other LECs to recover at least some of their costs of serving ISP customers (*see* note 9 below), is equal to the cost of the tandem switching element of reciprocal compensation, adjusted to reflect the impact of a 26-minute average hold time on the allocation of setup and duration costs to a melded per-minute rate. (*See* Am. Ex. 2.0). Ameritech Illinois' proposed rate differs from Staff's in that it is based on the tandem switching element of reciprocal compensation, while Staff's proposal is based on the end office switching element.

There is a second difference between Staff's proposal and Ameritech Illinois', but it does not have to do with the rate *per se*. In Ameritech Illinois view, any compensation rate for ISP traffic that the Commission sets in this proceeding should be subject to prompt adjustment to meet changed circumstances. The rate of change in the telecommunications industry is accelerating each year. Ameritech Illinois believes that even the $.000946 rate it now proposes is likely to adversely impact the potential for balanced competitive entry for all customer segments, the market potential for advanced services, and untimed calling rates. (Am. Ex. 2.5 at 10.) Evidence of adverse impacts in the next year could be greater than expected by Staff and could warrant a mid-course correction. (*Id.*) In addition, many other foreseeable changes in circumstance might warrant an adjustment to whatever rate the Commission sets here. (*Id.*) Accordingly, Ameritech Illinois submits that in the context of its rate proposal, and in the context of the treatment of this issue in a two-party arbitration rather than in a more broadly-based generic proceeding, it would be prudent to allow for a change to the compensation arrangements applicable to ISP traffic after a period of one year.

Ameritech Illinois therefore proposes that any inter-carrier compensation provisions for ISP traffic in the parties' agreement be subject to renegotiation on 60 days' notice by either party, but with the effective date of any replacement provisions not to precede one year from the initial effective date of the agreement. The parties would then negotiate a replacement compensation arrangement, subject to the dispute resolution process in the agreement with the ultimate possibility of a resolution mediated or arbitrated by the Commission. In order to remove any incentive for either party to slow down the negotiation process for the new arrangement, the agreement should specify that the replacement compensation arrangement would be applied retroactively (if necessary) to the date of cancellation of the initial arrangement.

Alternatively, Ameritech Illinois proposes that the Commission conduct a generic proceeding on the question of inter-carrier compensation on ISP traffic, as other State commissions are now doing, so that this important question can be addressed in a broad-based proceeding in which all interested parties can particpate.

IV. THE COMMISSION MUST REJECT THE HEPAD PROPOSAL ON ISSUE 2.

Regardless whether the Commission adopts Ameritech Illinois' proposal, or Staff's proposal, or some variation on either, it is clear that the Commission should not adopt the decision recommended in the HEPAD.

The HEPAD's rationale on Issue 2 is that ISP traffic is "a call utilizing telephone exchange service" and therefore is subject to "the payment of reciprocal compensation to the terminating carrier under Section 251(b)(5) of the [Telecommunications] Act [of 1996]." (HEPAD at 11.) That is just plain wrong. Section 251(b)(5) of the 1996 Act imposes on local exchange carriers the "duty to establish reciprocal compensation arrangements for the transport and termination of telecommunications." In its regulations implementing the Act, the FCC ruled that section 251(b)(5) applies only to local traffic, that is, "traffic that originates and terminates within a local service area."

47 C.F.R. § 51.701. Thus, ISP traffic would be subject to the reciprocal compensation provisions of the 1996 Act, and to the FCC's rules implementing those provisions, if and only if it were local.

The FCC has repeatedly ruled, however, in an unbroken line of decisions over a period of nearly two decades, that Internet calls are interstate, exchange access calls. Most recently, in December of 1999, the FCC, in its *Advanced Service Order* held:

> [W]e conclude that typically ISP-bound traffic does not originate and terminate within an exchange and, therefore, does not constitute telephone exchange service within the meaning of the [1996] Act. . . . [Rather], such traffic is properly classified as "exchange access."

In a word, controlling federal law holds that ISP traffic is exchange access service, and not, as the HEPAD concludes, local exchange service.[6] And that, in turn, means that ISP traffic is not subject to reciprocal compensation under section 251(b)(5) of the 1996 Act. Thus, if the Commission were to adopt the HEPAD's recommendation on Issue 2, the resulting award almost certainly would not survive review in federal district court.

Beyond its mistaken rationale that ISP traffic is subject to reciprocal compensation under the 1996 Act, the HEPAD says very little in support of its recommended decision on Issue 2. The recommended Commission Conclusion does not say a word about why Ameritech Illinois should compensate Focal seven or eight times over for Focal's set-up costs for ISP calls, as the rate proposed in the HEPAD would require. Nor does it say anything about why Ameritech Illinois should pay Focal for switching and transport costs that Focal does not incur when it delivers traffic to its ISP customers, as the rate proposed in the HEPAD would also require. And the little that the HEPAD

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6 The *Advanced Service Order* is but the most recent in a string of FCC rulings dating back to 1983 that hold that the service that Internet service providers obtain from local exchange carriers is *exchange access service* that the ISPs use for *interstate* communications. *See* Ameritech's Issue 2 Brief at 9-13.

does say by way of explanation for its recommended decision falls far short of a justification for the decision. Specifically:

- The HEPAD says (at 11) that ISP traffic is functionally identical to local traffic. That, however, cannot possibly justify the HEPAD's conclusion that reciprocal compensation should apply to ISP traffic just as it applies to local traffic. In the first place, the undisputed evidence shows that Feature Group A traffic and Feature Group B traffic are "functionally identical" to local traffic in all the same ways, but Feature Group A traffic and Feature Group B traffic are not subject to reciprocal compensation because, like ISP traffic, they are exchange access traffic. (*See* Am. Ex. 1.0 at 13-14.) In the second place, ISP traffic and local traffic are functionally different in one critically important respect: local traffic terminates in the local service area where it originates, while ISP traffic, as the FCC has repeatedly held, does not. In the third place, labeling ISP traffic and local traffic "functionally identical" mistakenly ignores the very different cost characteristics of the two types of traffic — characteristics that must be taken into account whether they are labeled "functional" or something else.

- The HEPAD says (at 11) that "Ameritech's arguments boil down to two predicates," one of which is that "ISP's should be paying access charges to ILECs when they transmit calls to distant websites," and that, "This is a matter for the FCC." That misses the point. Ameritech Illinois is not asking this Commission to do anything about the fact that Focal's ISP customers should be paying some form of access charges but are not; that, obviously, is a matter for the FCC. The point, rather, is that the FCC has repeatedly ruled that ISPs would be subject to access charges except that the FCC has exempted them. That corroborates that ISP traffic is, as the FCC has also held, interstate, exchange access traffic and not, as the HEPAD holds, local exchange traffic subject to reciprocal compensation.

- The HEPAD also says that Ameritech Illinois argues "that current rates do not reflect reality because the widespread use of the Internet has undermined many of the assumptions . . . that went into setting those rates," but that Ameritech Illinois should seek redress for such problems in a different proceeding. (*Id.*) Again, the HEPAD misses the point. Ameritech Illinois' point is not that there is something wrong with Ameritech Illinois' transport and termination rates for local traffic. Rather, it is that it is irrational to permit Focal, the great bulk of whose business is Internet traffic, to charge for delivering that traffic at rates that were designed for traffic that costs much more to deliver.[7]

- Finally, the HEPAD says that to require Focal to charge Ameritech Illinois differently (or not at all) for delivering ISP traffic would "require the segregation and tracking of ISP bound traffic by the combined efforts of Ameritech and Focal [and] is basically unworkable." (*Id.*) That plainly does not justify the recommended decision. In the first place, any difficulty in precisely quantifying how much of Focal's traffic is ISP traffic cannot possibly justify a requirement that Ameritech Illinois pay Focalnearly four times the correct rate (or more) for ISP traffic. At worst, the parties' best efforts to estimate the volumes of ISP traffic, even if they were off by, say, 10%, would

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[7] The HEPAD does not make entirely clear whether the "current rates" on which it is commenting are Ameritech Illinois' transport and termination rates or Ameritech Illinois' local exchange rates. Ameritech Illinois believes the HEPAD is referring to the former. If not, the HEPAD misses the point for a different reason: An across-the-board adjustment in local per-call rates to take into account the additional costs of grossly over-compensating Focal and other CLECs for delivering rapidly-growing volumes of ISP traffic (even assuming the Commission would support such a change, as the HEPAD seems to assume) would result in customers who do not use the Internet (typically, poorer customers) subsidizing customers who make much use of the Internet (typically, richer customers).

obviously be a better solution than to throw in the towel, as the HEPAD recommends, and require Ameritech Illinois to live with overpayments that are orders of magnitude greater than any inaccuracy in measuring their ISP traffic could ever be. Furthermore, State commissions have ruled that incumbent carriers are not required to compensate competing carriers for delivering ISP traffic. (*See, e.g.*, Am. Ex. 1.0 at 20-22.) The carriers in those states are measuring the traffic, and Ameritech Illinois and Focal can do so as well. Finally, Staff explained how the parties could identify and measure ISP traffic. (Staff Ex. 2.0 at 21-22.) The HEPAD apparently claims that Staff's proposal is "basically unworkable" because it would require "the combined efforts of Ameritech and Focal." But if the necessity for combined efforts by ILECs and CLECs were an acceptable basis for rejecting an otherwise acceptable solution, the 1996 Act might as well be repealed.

V. AMERITECH ILLINOIS SHOULD NOT BE REQUIRED TO COMPENSATE FOCAL FOR DELIVERING INTERNET TRAFFIC TO ITS ISP CUSTOMERS BECAUSE AMERITECH ILLINOIS DOES NOT CAUSE THE COSTS THAT FOCAL INCURS WHEN IT SERVES THOSE CUSTOMERS.

In an effort to encourage a resolution of Issue 2 that at least is not patently unlawful and destructive of every pertinent goal of the Telecommunications Act of 1996, Ameritech Illinois has set forth above the reasons that the Commission should, if it is going to set an inter-carrier compensation rate for ISP traffic, adopt Ameritech Illinois' or Staff's proposal in preference to the HEPAD recommendation. At the same time, however, there are two powerful reasons for denying Focal's request for inter-carrier compensation on ISP traffic altogether.

First, a firm that incurs costs to supply services should recover those costs from the customer that caused them. This "cost-causer pays" principle is not in dispute. On the contrary, Focal agrees that "[t]he question to be answered is who is responsible for causing the costs associated with ISP bound traffic." (Verified Statement of Michael Starkey (Focal Ex. 2.0) at 16.)

The cause of the costs associated with ISP traffic lies in a characteristic of ISP traffic that makes it fundamentally different in terms of cost causation from local traffic. That characteristic is this: Every ISP call occurs *because* the ISP subscriber who originates it has purchased services from the ISP which he can use only by employing the local network. Unlike the local exchange customer who uses the local network to communicate with a pizza parlor, a bank or a lawyer, the customer who dials up the Internet has a pre-existing contract with the party whose number he dials pursuant to which (i) he purchases from the ISP a service that by its very nature can be accessed only via the local network; (ii) in order to avail himself of this service, he dials a number that the ISP has given him so he can connect with the Internet through the ISP; and (iii) he cannot use the service the ISP sells him except by dialing that number (or one like it) and thereby making use of the local network.

Thus, as Dr. Robert Harris demonstrated in his Verified Statements (Am. Ex. 1.0 and 1.5), it is the ISP/subscriber relationship that causes the costs of ISP traffic, and there is no basis in economic or public policy for requiring Ameritech Illinois to defray the costs that Focal incurs when it serves its ISP customers.

We demonstrated at length in Ameritech's Issue 2 Brief (at pages 20-30) that Ameritech Illinois does not cause the costs that Focal incurs when it delivers traffic to its ISP customers, and therefore should not be required to reimburse Focal for those costs, and that demonstration is incorporated by reference here. In summary form, Ameritech Illinois showed that

- Focal agrees that the question of inter-carrier compensation on ISP traffic turns on who is responsible for causing the costs associated with that traffic. (*Id.* at 20.)

- When an AOL subscriber clicks the AOL icon on his PC and his modem dials the assigned AOL number to establish an Internet connection, the subscriber performs that cost-causing action because he is a customer of AOL, not because he is a local exchange customer of Ameritech Illinois. And when the carrier that provides AOL access to the network (Focal) delivers the call to AOL and incurs costs to do so, that happens because AOL has sold Internet access services to its subscriber, not because Ameritech Illinois sold local exchange services to the subscriber. (*Id.* at 21-22.)

- Focal's cost-causation rule, on the other hand — namely, that Ameritech Illinois is automatically responsible for all costs that its local exchange customers impose on the network — makes no sense (*id.* at 25-27) and fails when it is tested against the real world (*id.* at 27-28).

- In addition to the fact that Ameritech Illinois' economic analysis makes sense and matches up with the real world while Focal's rule does not, the Commission should also take into account, as Illinois law counsels, that Ameritech's analysis is supported by a highly qualified economist, while Focal's rule is advocated by a witness with no qualifications as an economist. (*Id.* at 28-30.)

Thus, a correct application of universally accepted economic principles — principles to which this Commission should adhere and normally does adhere in order to advance the public interest and consumer welfare — there should be no inter-carrier compensation on ISP traffic.[8]

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[8] At a bare minimum, Focal should be required to recover *some* of its costs of delivering traffic to its cost-causing ISP customers from those customers. Indeed, the FCC has made clear that the business rates that ISPs pay for access to the network (*i.e.*, the rates Focal's ISP customers pay Focal) are supposed to be a substitute for the access charges the ISPs would otherwise be required to pay. (*See* Am. Ex. 2.0 at 6-7.)

Staff has taken the position that Focal should "have the opportunity to recover" its costs. But if the Commission imposes an inter-carrier compensation scheme designed to cover 100% of Focal's costs for delivering ISP traffic, it will not merely be giving Focal the "opportunity" to recover its costs, but instead will be guaranteeing Focal the recovery of those costs without the need to look to its own customer, the ISP, to provide any portion of the recovery. The basic tariff rates for the types of sophisticated business services (e.g. Primary Rate ISDN services and digital thunking) typically used by ISPs have traditionally been priced well above cost in ILEC tariffs. (Am. Ex. 2.5 at 5.) This is one of the ways that the FCC has always expected the costs of ISP traffic to be recovered under its ESP exemption policy. Given that history, it is reasonable to expect that the rates charged to ISPs by Focal (or any other LEC) should be able to cover at least some of the call delivery costs. (*Id.*)