13642

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In Re: Petition by ITC^DeltaCom Communications, Inc., d/b/a ITC^DeltaCom for arbitration of certain unresolved issues in interconnection negotiations between ITC^DeltaCom and BellSouth Telecommunications, Inc.

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SECOND DAY -- AFTERNOON SESSION

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PROCEEDINGS: ARBITRATION

BEFORE: COMMISSIONER SUSAN F. CLARK
COMMISSIONER E. LEON JACOBS

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TIME: Commenced at 9:30 a.m.

PLACE: Betty Easley Conference Center, Room 152
4705 Esplanade Way

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P R O C E E D I N G S

(Transcript follows in proper sequence from Volume 5.)

BY MR. ALEXANDER (Continuing):

Q Mr. Varner, do you have a summary of your testimony, both your direct and rebuttal and your supplemental direct and supplemental rebuttal?

A Yes, I do.

Q Could you give that for us, please?

A Yes.

My testimony addresses many of the unresolved issues in this case, but in my summary I'm only going to focus on three of them: the ISP issue, the enhanced extended loop or EEL, and the prices for UNEs and for reciprocal compensation.

First, regarding the ISP issue, the first thing I want to stress is this issue is about establishing policy concerning how ISP-bound traffic should appropriately be treated in the new Interconnection Agreement. In the FCC's ruling on this subject, state commissions were given authority to establish an interim compensation arrangement for this traffic. Consequently, any arrangement implemented by a state will apply at best until the FCC imposes its own solution.

And the reason I say at best is because

BellSouth believes that the FCC did not have the power to grant this authority to states to develop an interstate compensation mechanism. But, in any event, the courts will decide that.

The Commission doesn't need to do anything on this issue. The FCC has, will retain, and will exercise jurisdiction over this traffic. The FCC will determine the appropriate compensation mechanism. Any effort devoted by this Commission to establish an interim arrangement could be wasted effort.

Now, if this Commission chooses to exercise this authority, the Commission's focus here should be to design a mechanism that best serves the public interest.

Now, BellSouth proposes that neither party should bill compensation for this traffic until the FCC issues its rules. Each party would agree to apply the FCC's arrangement retroactively to the approval date of the Interconnection Agreement.

This approach would simply mean that this Commission would be adopting the FCC's compensation mechanism.

Now, contrary to DeltaCom's claim, they would not go without compensation during this period. They would be compensated by the ISP. Rather, it is BellSouth who would be the uncompensated party.

And if the Commission chooses to establish a compensation mechanism at all, it should be based on the fact that ISP-bound traffic is access traffic. And BellSouth has proposed such a mechanism for the Commission to employ.

The interim compensation mechanism proposed by BellSouth is far superior to reciprocal compensation for this traffic. In no event should the Commission adopt reciprocal compensation.

First, there is no requirement to apply reciprocal compensation to this traffic. The FCC has clearly stated that ISP-bound traffic is not local traffic but is access traffic. And I won't go through all the references in detail again. However, as an example, footnote 87 clearly states their finding, and I did want to quote that one. Footnote 87 specifically states, "We conclude in this declaratory ruling, however, that ISP-bound traffic is nonlocal interstate traffic."

Thus, the reciprocal compensation requirements of Section 251(b)(5) of the Act and Section 51(h), reciprocal compensation for transport and termination of local telecommunications traffic of the Commission's rules, do not govern inter-carrier compensation for this traffic.

Second, applying reciprocal compensation to ISP traffic would not be sound public policy. To explain why it isn't sound public policy, I want to first examine why reciprocal compensation was designed for local traffic only.

Reciprocal compensation was designed to compensate the terminating carrier for cost calls by the originating carrier's customers. Where reciprocal compensation properly applies, the originating carrier collects all of the revenue from its end user and should share that revenue with the terminating carrier. And this is the case for local calls.

For reciprocal compensation to apply to ISP-bound traffic, BellSouth would have to be the only carrier collecting revenue. However, the exact opposite is occurring. DeltaCom is the only carrier collecting revenue. DeltaCom's proposed arrangement is based on BellSouth collecting the revenue when, in fact, BellSouth doesn't; DeltaCom does. Compensation is due for this traffic, but it's BellSouth instead of DeltaCom who should be compensated. DeltaCom is already being compensated by the ISP.

The effect of applying reciprocal compensation to ISP-bound traffic is illustrated by the following facts; First, DeltaCom keeps all the revenue paid by the ISP for the access service. BellSouth is not compensated for any of the costs it incurs. In addition to DeltaCom keeping all the revenues for the service, BellSouth would pay for part of DeltaCom's costs which are and should be recovered from the ISP. DeltaCom then recovers some of its costs twice and BellSouth recovers none of its.

In effect, BellSouth subsidizes DeltaCom's provision of service to ISP or subsidizes the ISP.

Now, contrary to Mr. Rozycki's claim, an end user who places calls through the ISP is a customer of the ISP and deals directly with the ISP regarding pricing, billing and accessibility issues pertaining to the ISP's service.

When an end user purchases basic local exchange service from BellSouth, they don't get Internet access. They have to purchase that separately from AOL, Mindspring, BellSouth.net, or some other ISP.

The appropriate action for this Commission, I believe, is to wait for FCC to establish a compensation mechanism for this ISP-bound traffic. And this issue is best left for the FCC to decide.

Now, should this Commission deem it necessary to act prior to the FCC's establishing their own mechanism, it should adopt the interim mechanism proposed by BellSouth. That mechanism is based on the fact that ISP-bound traffic is access traffic and it's consistent with the compensation mechanism currently in place for jointly provided access traffic.

The next issue is the enhanced extended loop, or the EEL. Now, an EEL is a combination of loop and dedicated transport that connects a customer to an ALEC at a distant wire center.

Contrary to their claim, BellSouth has not provided DeltaCom with an EEL. DeltaCom ordered channelized specialized access service, a tariff service, and then ordered unbundled loops to be terminated on the special access facility and BellSouth provided those in error.

However, the issue here is not one of availability but one of price. Although not required to do so, BellSouth has offered to provide the EELs of the type requested by DeltaCom to DeltaCom. We have simply offered to do it under a professional services arrangement that is not under the auspices of the Act.

DeltaCom can also purchase special access service to obtain the same functionality. The issue is that they want this functionality at unbundled network element prices and we're not willing to offer that and not obligated to do so.

Now, as you know, the FCC recently decided on a list of issues that BellSouth must offer. The order has not yet become effective, nor its requirements really known at this time.

However, whatever action this Commission takes must ultimately be consistent with that order. So, I want to briefly describe what we've surmised from the press release that they have issued.

First and foremost, BellSouth is not obligated to combine UNEs for DeltaCom, and certainly not at the sum of the UNE prices. The FCC's rules that attempted to require BellSouth to do this were vacated by the Eighth Circuit Court of Appeals and they remain vacated today.

To provide EELs as requested by DeltaCom, we will have to combine the UNEs. Since BellSouth is not obligated to perform this function, DeltaCom's request should be denied for this reason alone.

Now, second, the FCC stated in its press release that EELs would not be included on the list of UNEs that BellSouth must offer.

Third, DeltaCom plans to use its EEL, which would contain unbundled network element transport service, as a substitute for access.

The extent to which transport can be used to replace access service will be examined in another FCC proceeding. In the interim, ALECs may not be permitted to substitute transport for access service. Therefore, it's not clear whether DeltaCom can use transport, either alone or as part of this enhanced extended loop, in the manner they requested.

Last, BellSouth must provide combinations of loops and transport only where they are currently combined. In the case of the EEL, they're not.

The definition of currently combined, I will admit, is not clear. But based on the FCC's action, BellSouth believes that currently combined means that the combination of UNEs must already be in existence and providing service to a BellSouth end user. This is the position that the FCC took before the Supreme Court.

If that interpretation is correct, there are no currently combined units that constitute the EEL. Therefore, DeltaCom's claim that the EEL consist of currently combined UNEs is erroneous.

Given this current environment, what BellSouth recommends is that this Commission simply rule that EELs are to be provided to the extent required by law. The FCC and the courts are the only bodies that can really resolve these questions.

Unlike DeltaCom, BellSouth believes that the Commission does not need to speculate about what the FCC or courts will do.

The last issue is interconnection and UNE pricing issues. Now, DeltaCom has raised several issues that relate to the appropriate prices to be charged by BellSouth for interconnection and UNEs. This Commission has already established cost base prices for interconnection and most UNEs in previous orders. Those rates are in compliance with the FCC's pricing rules. There is no need to revisit them here.

Specifically regarding OSS prices, BellSouth is requesting this Commission to establish prices for access to OSS. BellSouth has presented cost studies for these OSS interfaces that were developed for the CLECs that are consistent with this Commission's cost methodology.

The proposed prices recover only the cost of the systems that are used solely by ALECs and the ongoing costs for those systems.

Finally, BellSouth has filed cost studies for those elements requested by DeltaCom that were not already established by this Commission. Bellsouth's prices are in compliance with the Commission's orders and the FCC's rules.

That concludes my summary.

MR. ALEXANDER: Commissioner Clark, Mr. Varner is available for cross examination.

COMMISSIONER CLARK: Mr. Adelman.

MR. ADELMAN: Thank you, Commissioner.

CROSS EXAMINATION

BY MR. ADELMAN:

Q Good afternoon, Mr. Varner; I'm David Adelman. I represent ITC^DeltaCom.

A Good afternoon.

Q Mr. Varner, you referred to a professional services agreement in your summary; did you not?

A Arrangement.

Q Excuse me. Arrangement. Is that the same as a voluntary commercial agreement, as you've called it on page 23 at line 18 of your direct prefiled testimony?

A Yes, it is.

Q And that's a contract that BellSouth would enter into with an ALEC; is that correct?

A Yes.

Q And I believe in your summary you referred to it in the context of a contract for the provisioning of UNEs in combinations; correct?

A Not for the provisioning of UNEs. It's provisioning of the professional service for BellSouth to combine UNEs.

Q Okay. To combine UNEs, a service to combine UNEs; is that right?

A Yes.

Q And, as I understand your intention with regard to these voluntary commercial agreements, they would not be submitted to the Florida Public Service Commission for approval; is that correct?

A That issue, I'm not sure, whether they would or they won't. We did not believe that they were, but I know this issue has come up and there is something ongoing dealing with it. And I just don't know the status of that.

Q Well, do you -- Is it your understanding that Section 252 of the Telecommunications Act requires that any Interconnection Agreement between BellSouth and a competing carrier, an ALEC, as we call them here, would have to be submitted for approval to the Florida Commission?

A I believe that is correct.

Q And is it your position that these professional services agreements are covered by that Act, by that provision of the Act? Excuse me.

A I'm not sure whether the agreement itself is covered by the Act. What I am sure of is that the prices for the services provided are not covered by the pricing rules under the Act.

Q Okay. So, is that to say that the prices need not be nondiscriminatory?

A That's correct.

Q So, in other words, BellSouth could have a voluntary commercial agreement with multiple ALECs where there are different prices that you are charging to different ALECs; is that correct?
A For the professional services involved, that's correct.
Q So, even for exactly the same service, you might charge ITC^DeltaCom a price different from that which you might charge to another ALEC; is that correct?
A Yes, that could be. That's permissible.
Q In your opinion, that's -- In Bellsouth's opinion, that's permissible?
A Yes.
Q Do you know of any commission, state commission in your region that has expressly found that such practice is permissible?
A I don't know that anybody has been -- The answer is no. I don't know that anybody has been asked, though.
Q Now, when we refer to an extended loop in our petition and in the testimony that you've heard this week, you understand that ITC^DeltaCom is talking about a combined UNE loop cross connect and transport, dedicated transport; correct?
A No. DeltaCom actually refers to two different

things when it says extended loop. It refers to what you described as an extended loop. And it also refers to an arrangement that combines an unbundled loop with special access tariff service as an extended loop. And it's referring to both of those sort of interchangeably as extended loops.

Q Okay. Fair enough. So, it's either a UNE loop with a cross connect and dedicated transport or it's a UNE loop with a cross connect and special access service; is that fair?

A Yes; seems to be one of those two.

Q And I believe you testified that BellSouth has provisioned approximately 2,500 of these extended loops region-wide over the past approximately two-year period; is that correct?

A Well, it hasn't been over two years, to my recollection. We have provided about 2,500 of these arrangements that have the unbundled loop connected to special access, tariff service.

Q So, it's been some period shorter than two years; is that --

A Based on what I have been able to find out, that seems to be -- that seems to be about right. It seems that DeltaCom started issuing orders for these the latter part of last year. And the best that I've been able to tell, that's when it began.

Q So, assuming it was sometime last year, there has been provisioned, doing simple math, more than a dozen a day; is that correct?

A I don't know where you are getting a dozen a day from.

Q Well, 2,500 divided by the number of days since you began provisioning them.

A Well, no, that presumes that the provisioning has sort of been constant over time. What happened is they started ordering these. When they ordered them, the way that they ordered them, and our technicians worked them -- At first, our technicians didn't think we should do it. They went to the account manager and the account manager gave them bad information and said it was okay to do this. So, they went ahead and connected them. And then as a result of that, DeltaCom found out they wouldn't work. There were certain plug-ins, as I understand it, that needed to be different. And then, as a result of that, when DeltaCom reported service problems to us --

Q Mr. Varner --

A -- we went and looked at it.

MR. ALEXANDER: Excuse me. Mr. Adelman, I think he can finish his answer.

MR. ADELMAN: I object to the answer as nonresponsive. I'll give him a chance to explain the whole rationale.

I asked him whether on average its approximately a dozen a day if it's 2,500 divided by the number of days that's been provisioned.

BY MR. ADELMAN (Continuing):

Q We'll get into this in a minute, Mr. Varner, but I do want to have you confirm the math.

A And I said, no, I don't agree with that because that presumes a provisioning that is different than the way it was done.

MR. ALEXANDER: And I would object, it's been asked and answered. He said he didn't know specifically and you've given him a chance and tried to divide it equally among the days that you're trying to pin him down to.

BY MR. ADELMAN (Continuing):

Q I asked you about an average number of extended loops to be provisioned over a day of 2,500 -- per day, if 2,500 are provisioned over a period of approximately 18 months.

COMMISSIONER CLARK: I think he answered it, that you can't do it that way. You can't -- That's not the way it happened.

MR. ADELMAN: An average. Okay. I'll move on. Excuse me, Commissioner.

COMMISSIONER CLARK: I guess, you know, we can agree on math.

BY MR. ADELMAN (Continuing):

Q And you understand that ITC^DeltaCom would like BellSouth to continue to provision these extended loops so that it can provide service using the extended loops in Florida; correct?

A I'm not really sure that that's the case. Based on their testimony, that appears to be the case. However, but DeltaCom reached a verbal agreement with BellSouth, which they've already acknowledged in at least two states to convert these arrangements to collocation space once the collocation arrangements are available,

So, there seems to be a conflict between what DeltaCom has agreed to do with BellSouth and what it appears that they're asking for in their testimony.

Q Well, Mr. Varner, you understand that DeltaCom doesn't agree that there has been an agreement that's amended its Interconnection Agreement in Florida or any state; don't you?

A Agreement that amended -- I don't know. I don't know that that's ever been asked.

Q Well, you just gave an answer and you're referring to an oral agreement between the parties; is that your reference?

A Yes.

Q Okay. And you understand that ITC^DeltaCom takes the position that there has been no such oral agreement? You've heard that before; haven't you?

A No, I really haven't heard that. And, in fact, the transcript in South Carolina clearly reflects the exact opposite. And Mr -- and I'm not sure whether it was Mr. Rozycki or Mr. Hyde -- actually confirmed it in North Carolina as recently as -- what -- last week, I believe it was.

Q So, is it your testimony today -- Well, let's do it this way, Mr. Varner, because I don't want to quibble with you. Did the testimony that's been presented by ITC^DeltaCom in this docket request that the Commission order BellSouth to provide extended loops to ITC^DeltaCom over the period, the term of the contract, which is being arbitrated here; is that correct?

A That's correct.

Q Okay. And do you understand the testimony that was filed here today to express ITC^DeltaCom's intention to use such extended loops to provide service at retail to Florida consumers?

A I believe -- I don't recall that, but that makes sense.

Q You filed supplemental testimony to your direct testimony that covered the September 15th FCC press release; correct?

A That's correct.

Q And that related to the FCC Section 319 remand proceeding; correct?

A Yes.

Q And that press release in part related to combination of UNEs; correct?

A Yes.

Q And BellSouth anticipates as a result of its reading of that press release that the FCC will require BellSouth and other ILECs to provision only UNEs in a combined form where such UNEs were currently combined; is that correct?

A I don't recall them using any term about in combined form. It says we'll obviously have to comply with 315(b), which will require us to provide UNEs that are currently combined. We can't separate them if they're already combined in our network.

Q And I'm trying to understand Bellsouth's interpretation. You filed prefiled testimony explaining Bellsouth's reaction to the press release; correct?

A Yes, I did.

Q And in your testimony and in your supplemental, supplemental direct testimony, you stated that you anticipate that the FCC will require that combinations of UNEs be made available only where such combinations are, quote, already in existence; is that correct?

A That's correct.

MR. ALEXANDER: Mr. Adelman, where are you reading from? What page?

MR. ADELMAN: I'll be glad to read it back. The witness responded, and it was his testimony.

MR. ALEXANDER: And if I heard him correctly, he said he didn't agree with that.

BY MR. ADELMAN (Continuing):

Q Did you agree with that, Mr. Varner?

A Well, there was one thing I agreed with and one I didn't. Which one are you referring to?

Q Is it BellSouth's -- Let's do it this way: Is it Bellsouth's position that -- Is it Bellsouth's anticipation that the FCC order will require that BellSouth provide combinations of UNEs only where such combinations were already in existence?

A I believe that's correct. We will not be permitted to separate UNEs that are already combined in our network. Now, if you're implying that it will also require us to combine UNEs, I disagree with that.

Q Okay. Let's take a look at page 4 of your supplemental testimony, beginning at line 2.

Do you see that?

A Yes.

Q Do you see where you say, "The press release does not define 'currently combined'"? Do you see that?

A That's correct.

Q Now, based on the FCC's action, you go on to say, "BellSouth believes that 'currently combined' means that the combination of UNEs must already be in existence providing service to a BellSouth end user." Do you see that?

A That's correct.

Q Okay. You don't want to change that testimony today; do you?

A No, I do not.

Q Okay. You go on, on the same page, while we're there, to state that the FCC and the courts are the only once that can ultimately make this decision; correct?

A No, that's not correct. That statement is in the next, answer to the next question. And I was referring to there all of the issues surrounding the 319 order, not just that particular one, but the issue around the extent to which, for example, transport can be used as a substitute for special access; of course, the issue of what constitutes currently combined. There were a couple of other issues also that were sort of left open at the FCC and the courts will eventually have to deal with.

The upshot of it is you really won't know what all the issues are until the FCC issues the order and they haven't done that yet.

Q But in your testimony here, you're talking about extended loops, or, as you abbreviate them, EELs; correct?

A Yes, I am.

Q And beginning on line 13, you say, "The FCC and the courts are the only bodies that can resolve the question regarding obligations to provide the EEL;" do you see that?

A That's correct.

Q So, you're talking about the EEL there; correct?

A Yes, I am.

Q And the way you're using the term EEL, it's the combined loop cross connect and either dedicated transport or special access transport; correct?

A No, I'm only talking about dedicated transport. The issue of special access I don't think will even be addressed because that's not a UNE. See, for example, and DeltaCom can have special access today. If they want this functionality to just get from a wire center to another wire center, they can buy special access today and do that.

The issue here is that they don't want to pay the special access price. They want a price lower than special access or the UNE price. And we're just not obligated to do that.

Q Does that complete your answer?

A Yes.

Q Do you agree that the press release indicated that the transport is going to be considered a UNE?

A Oh, yes; it did say transport would be considered a UNE. However, it did also say that the Commission will examine any further notice of proposed rulemaking the extent to which transport will be submitted, transport as a UNE, will be permitted to substitute for special access service.

Q Okay. And the bottom line here, Mr. Varner, is you're recommending that this Commission do nothing with regard to ITC^DeltaCom's request; is that correct?

A No, that's not my request. What I'm recommending is that the Commission simply obligate BellSouth and DeltaCom to include the language in their contract that we'll be providing that we'll have to do these as required by law.

Q And when you say "as required by law," that's the reference you're making to when the FCC and the courts are the only ones that can decide this issue; correct?

A Yes, that can resolve all the uncertainty that currently exists.

Q So, in effect, you're advocating that the Florida Commission, in this case, simply defer to the FCC and the courts; is that correct?

A No, I'm not suggesting that they defer. What I'm really suggesting is that they recognize that the FCC and the courts really have this issue, that they're going to determine what has to be done and whatever they decide, BellSouth is going to have to comply with. And that's going to be our obligation to DeltaCom.

And, really, in the absence of the FCC's order, I'm hard pressed to see how the Commission really can do much else in the absence of the order that is really going to define these things.

Q Now, when you say the FCC and the courts, you're assuming, I guess, an appeal of the FCC's order; is that correct?

A No, I'm not assuming one, but if one does happen, obviously, that's how it's going to be resolved.

Q Well, let's -- I'm going to ask you a hypothetical. Let's assume that the FCC's order comes out six months from now and turns out that the FCC clearly requires that an extended loop be provided by BellSouth to ITC^DeltaCom and other ALECs in Florida.

Are you with me so far?

A Yes. I don't think that can happen, though, because of the fact that that will require us to combine the UNEs.

The other reference I had here when I said the courts was also the issue of the Eighth Circuit. The Eighth Circuit Court of Appeals is revisiting the FCC's rules that require BellSouth to combine unbundled network elements. Those rules are vacated, but the Court decided to look at them again on their own motion. That case, as I understand it, has already had oral argument and it's just waiting on the Court to decide. Well, that decision will also have some bearing on this issue, in addition to the FCC's rules.

Q So, there's a lot of court proceedings going on that have bearing on this issue,; would you agree with that?

A Well, there's the one in the Eighth Circuit, which is really the only one that I know of.

Q And then we've got the FCC 319 remand; correct?

A But that's not a -- That's not a court per se.

Q That's not a court; I agree. And then we've got that regulatory proceeding at the FCC; correct?

A Yes. All we're doing there is we're just waiting on the order. But, like I said, I don't think that order will necessarily resolve this issue because it will require us -- to give DeltaCom what they want, it requires us to combine the UNEs. I think the Eighth Circuit is the place where that's ultimately going to be resolved.

Q Is it your position then that the order, the remand of order 319 and the FCC decision will have no bearing on the decision of extended loops?

A No. As I said, that's what -- Again, the point that I'm making here is until you see the 319 order, you don't know what it's going to say. And I think the only thing that the Commission can do in the absence of that and in the absence of the results from the Eighth Circuit is to simply rule we have to do this under whatever the law requires. The problem is is you don't really know what the law is going to require as we sit here today and the Commission is in the position of having to make a decision.

Q Would you agree that all state commissions find themselves in a similar position with regard to these two pending issues, one at the FCC, one at the Eighth Circuit?

A I would agree, yes.

Q And would you agree that the Alabama Public Service Commission has required that extended loops be provided?

MR. ALEXANDER: I'm going to object to the premise of that question.

Mr. Adelman, do you have an order from the Alabama Commission or do you have a -- I just think that it's fundamentally wrong. It came out earlier and I objected to it at that time.

MR. ADELMAN: Commissioner, I respond to legal objections. I don't think it's fundamentally wrong. I asked him if he's aware of the Alabama Commission has ordered extended loops. It's an appropriate question. It doesn't require any sort of document for the purposes of asking the question.

COMMISSIONER CLARK: I think the question is allowed. He can ask him if he knows of it.

WITNESS VARNER: Would you ask it again?

MR. ADELMAN: That's fine.

BY MR. ADELMAN (Continuing):

Q Are you aware that the Alabama Public Service Commission has required the provision of extended loops?

A No, they have -- They have not made any such requirement.

Q What about the Pennsylvania Commission, are you aware they've done it?

A I don't know about Pennsylvania.

Q Okay. So, you don't know either way; is that correct?

A No. With regard to Pennsylvania, I don't know either way. With regard to Alabama, I know that they haven't required it.

Q Okay. What about the Texas Public Utilities Commission?

A I don't know.

Q You don't know either way?

A No, I do not.

Q What about the California Public Utilities Commission?

A Don't know.

Q So, we've got these two proceedings, one at the Eighth Circuit, one at the FCC, that are going to have bearing on the extended loop issue; you agree with me there? Both proceedings have bearing on the issue; correct?

A Yes.

Q And is it your position that this Commission should do nothing or should defer or should order that the parties follow the law until that law is embodied in a final nonappealable order?

A I think I'm just proposing one of the three options you suggested, is that the Commission simply order that BellSouth and DeltaCom include language in their agreement that we would provide these to the extent they're required by law.

Q And is it your position that this Commission cannot read the law as it currently exists today and make a decision with regard to extended loops?

A As it -- Well, in effect, yes, because you don't know what it is.

Q Well, there is law today, even when new issues or even old issues are pending before the FCC or the courts, there is a current state of the law; correct?

A Yes. The current state of the law as it exists today, BellSouth is not obligated to provide these because the current state of the law as it exists today, the rules that there is no requirement on BellSouth to combine UNEs for any ALEC. That's the current state of the law. In order to provide this service, we will have to combine the UNEs. So, if you just look at the way it is today, we are under no obligation to do this.

Q Have you ever heard of a special access circuit?

A Yes, I have.

Q And do you know about the components of the facility required to provision a special access circuit?

A Generally, yes.

Q Does it require a loop?

A Yes, it does.

Q Does it require a cross connect?

A Yes, it does.

Q Does it require dedicated transport?

A Usually, yes.

Q And BellSouth currently provides special access circuits today. They're combined in its network today; correct?

A Yes, we do; we provide special access circuits to our carriers. We don't provide them to end users. There are access services provided to carriers.

Q But they are currently combined where those -- that circuit exists in Bellsouth's network today; correct?

A Yes, it does.

Q So, if ITC^DeltaCom were asking for a loop, a cross connect, and dedicated transport in combined form, ITC^DeltaCom would be asking for a combination of components of Bellsouth's facility that are currently combined today as a special access circuit; correct?

A No, because you mixed two different things. When you talked about the loop on special access, what the loop on special access is is a component that goes from DeltaCom's end user, an existing DeltaCom end user, to DeltaCom. It's not a BellSouth end user.

When you're talking about a loop, I think as DeltaCom is trying to get here, they want a loop that is going from a BellSouth end user that will terminate in DeltaCom's collocation space.

Now, what that means is that we don't have a service like that. We do have special access service and DeltaCom can purchase special access service from us today if that's what they want to do, and get this same functionality, get out of the enhanced extended link. So, if they want that, they can do that. But when they purchase special access service, that does not create a preexisting combination of UNEs because the preexisting combination of UNEs would mean that it had to be a BellSouth end user at the end, not a DeltaCom end user.

Q So, the distinction you're making is just who is the end user at the end? It's the identity of the end user; it doesn't actually relate to the facilities; does it?

A No, it's not the identity of the end user. It's who is the service being provided to. What constitutes a combination of UNEs and what doesn't. Access service will be provided to DeltaCom. If we were providing a special access service, DeltaCom would have ordered that from us and we would have provisioned that to DeltaCom. DeltaCom is our customer. We would be sending -- They would be responsible for payment of all of that. There is no end user that we have any relationship with. It's only DeltaCom in that instance.

Q So, the distinction you're making does not relate to the physical facility? It is to whom you're providing the service; is that correct?

A It's -- Well, it's a little bit more than to whom I am providing the service. It is not with respect to the physical facility; that's for sure. But it is with respect to whether or not the service that you have described would constitute a preexisting combination of elements that would have to remain connected. And when you're talking about special access service, it doesn't create that.

Q Mr. Varner, from time to time BellSouth changes its business rules and guidelines; correct?

A Yes, we do.

Q And do you understand that ITC^DeltaCom has asked this Commission to require BellSouth to provide to

ITC^DeltaCom 45-days advance notice of such business rules and guideline changes and to provide such notice by electronic mail and on Bellsouth's Internet Web site; correct?

A Yes, that's correct.

Q And you understand that today ITC^DeltaCom currently receives e-mail notification from BellSouth; correct?

A Sometimes they do; sometimes they don't.

Q Okay. And you understand that BellSouth refuses to commit to provide e-mail notification to ITC^DeltaCom in the contract, which is the subject of this arbitration?

A That's correct. We have no commitment to do that today. What happens is the account manager, as a matter of courtesy, sends DeltaCom an e-mail sometimes as per the confirmation of the Web site. They do that after it's posted on the Web site. Account manager who manages DeltaCom's account sometimes sends it as an e-mail.

Our concern is, obviously, nondiscriminatory notification, which we have to do, which is done through the Web site. So, we object to having an obligation on us to do it through e-mail. We're already notifying everybody at the same time through the Web site.

Q Okay. And just to --

COMMISSIONER CLARK: How much in advance do you do it on the Web site?

WITNESS VARNER: It varies. Our objective is to do it 30 days in advance. There are situations where we can't do that. For example, if we have something that a Commission requires us to do and we have to do it in less than a 30-day notification, we do it to comply with the order, we can't do 30 days. If we find an error in the system somewhere, we get the error fixed as quickly as we possibly could. If it requires some notification from people, you know, to the ALECs, we try to do that, you know, arrange that and do it so that they have enough time to deal with it, but that we get the error fixed as as fast as we can.

So, those are a couple of situations wherein we're not able to do 30-days notice, which I think really works to their advantage. It seems to me, if we have an error in the system, they would want us to fix it as fast as we could.

COMMISSIONER CLARK: You know, I read that testimony. It struck me that it would be appropriate to provide some definite time period where they would know what's been changed.

And I understand the notion that you want to give everybody the notice at the same time, but if you indicate that you put it on your Web site, but then within five days you give e-mail notice, I mean, you comply with it's there for everybody to check. What about --

WITNESS VARNER: Let me deal with sort of both, because those are kind of two issues that give you sort of a separate problem. One is, let me deal with the time frame issue first, the 30 days. BellSouth has no problem at all with establishing a 30-day sort of objective. We recognize, though, that we cannot say that we're all -- We can't commit to always doing this 30 days in advance because we know that there are situations that are going to arise that say you need to do it in less than 30 days.

COMMISSIONER CLARK: Can't you specify the categories of situations that arise that you could exempt from that 30 days?

WITNESS VARNER: We could try. I mean, I've gone off a couple and we could maybe go through and may be able to do something like that. But the objective that we believe is the right one to use is 30 days instead of 45 days.

And the reason for that is this: On the changes that we're going to put in, if we move to 45 days, that means that even if we could do it in less than 45 days, technically, physically could make the change in less than 45 days, we're not allowed to do it in less than 45 days.

And the changes that we're talking about making are enhancements and improvements to the system. So, it just doesn't seem to make much sense to take an enhancement and then make it two weeks later just because you have a commitment in the contract that says I can't do it, you know, two weeks sooner, even though I physically could do that. And that's our concern.

Now, the other issue on the e-mail notification we have is that, like I said, our account managers do go through and in managing their accounts sometimes sends that out. What we object to is having that as an obligation on us. Once that becomes an obligation of e-mail notification, we have to insure that it works and that everybody gets that notification at the same time. And even though we may have a mail server and have lists on it, I have experienced this: You send out an e-mail to a whole bunch of people and from time to time somebody doesn't get it, for whatever reason, you know. Sometimes you never know what the reason is. Sometimes they get it and delete it. Sometimes the system just didn't quite work out.

So, what we're concerned about is creating another obligatory means of notification that is prone to having errors and prone to mistakes and prone to dispute, when we already have a nondiscriminatory means of notification through the Web site that works perfectly well.

COMMISSIONER CLARK: Okay.

COMMISSIONER JACOBS: How -- Maybe you said this already. But when you do the notice over the Web site, how descriptive is it? Is it simply a public press release kind of notification? Does it give technical details?

WITNESS VARNER: For that, you probably need to ask Mr. Pate. I think, from my recollection, I think it depends on what the change is. Typically, what you're talking about here is some sort of change in how you fill out a form, that type thing; says, okay, you need to put a field that this field is now required, or you need to put none in this field instead of NA. That's the kind of changes that you're talking about. They're not usually system-type technical changes. Those kinds of changes are handled through an entirely different process. We have something called a change controlled process, which is a collaborative effort between BellSouth and the CLECs. That's where we do things like new releases of the systems and so forth. And those are coordinated, you know, as they're developed. And even the specifications of what's in it is worked out collaboratively and the timing and so forth.

So, those are not really an issue under this particular item. These are the more sort of mundane, sort of like the less complex, sort of like administrative-type things that happen.

COMMISSIONER JACOBS: Thank you.

BY MR. ADELMAN (Continuing):

Q Mr. Varner, just to follow-up, let's talk about those enhancements. You told Commissioner Clark that usually these are in the form of enhancements and BellSouth would want the ability to enhance their business guidelines and rules with less than 45-days notice; do you remember telling her that?

A I don't think I said that they were usually, but I did say that, yes, in many cases these are enhancements. They could be errors; they could be compliance with Commission orders, whatever we have to do to the systems.

Q Well, let's take the example that you gave. And I think you probably read about it in Mr. Thomas's testimony. The requirement that a field that was previously populated with "NA" for not applicable be changed so that it be populated with "none," the word none. You're familiar with that episode; are you not?

A No, I'm not really familiar. I've heard about it from the previous proceedings and so forth. I didn't read Mr. Thomas's testimony.

Q Would that be an enhancement as you use the word?

A I'm not sure whether that's an enhancement or a correction. Mr. Pate can probably tell you specifically why that particular business rule had to be changed.

Q Okay. And you're aware from being in other proceedings or other hearings, that when that business rule was changed, notice was not -- adequate notice was not provided to ITC^DeltaCom? You're familiar with that; correct?

A No, I'm not familiar with that. And, again, Mr. Pate is the one that has the details of what happened in that specific instance.

Q Okay. Let's talk about the e-mail issue you raised. Is it technically feasible for BellSouth to provide notification by way of e-mail?

A Technically, yes; I believe it is. Again, subject to the fact that whenever you add another process, that process is prone to error, which is our concern.

Q I've asked you this before. I hope your answer hasn't changed. You would agree with me that BellSouth

is a world class communications company; would you not?
A Yes, I would agree with that.
Q And BellSouth is capable of sending an e-mail to a large e-mail group; would you agree with that?
A I would agree with that. I would also -- Again, I would also agree that -- and I've had this happen, and there is no reason for me to believe that it would not happen if we were to implement this. There will be occasions where, for whatever reason, when you set up that type system, it does not work a hundred percent of the time. And everybody who is supposed to get notified that way will not get notified. It happens through no fault of ours, through no fault of anybody's. And I've seen it happen.
Q Well, now, if -- Strike that. I'll move on.
Mr. Varner, would you agree with me that ITC^DeltaCom incurs costs when BellSouth customers place calls to ISP customers of ITC^DeltaCom?
A Yes, I do.
Q And you would agree that the Florida Public Service Commission has authority to establish a mechanism for compensating ITC^DeltaCom in such a case; correct?
A When the ISP end user calls the ISP? Is that the direction we're talking about?
Q A BellSouth customer, BellSouth end use

customer calls an ISP who is a customer of ITC^DeltaCom.

A I misstated when I answered I think your earlier question. In that case, the end user is the customer of the ISP. They're not a customer of BellSouth. They purchase the ISP service from the ISP. They're not a customer of BellSouth on that call. They are a customer of the ISP.

Q I'm sorry; I guess I've confused this whole thing. Let me try to break it up. There's a customer of BellSouth. Let's assume it's Commissioner Clark. And let's assume she places a call from her home to an ISP, Internet service provider, which Internet service provider is a customer of ITC^DeltaCom; do you follow the facts?

A Yes.

Q Does ITC^DeltaCom incur costs associated with carrying Commissioner Clark's call to the ISP?

A Oh, yes. And Commissioner Clark is a customer of the ISP in that case. Assume it's AOL. She's a customer of AOL in that case.

Q I understand. I don't know who her provider is, but I understand it's -- The question is does ITC^DeltaCom incur costs, not who is a customer of who?

A Yes, DeltaCom incurs costs and BellSouth incurs costs. In the case of Commissioner Clark, it wouldn't be

BellSouth, I don't believe.

COMMISSIONER CLARK: You're right. Not today, anyway.

WITNESS VARNER: It may be WorldCom, I guess, in a little while.

BY MR. ADELMAN (Continuing):

Q Well, let's assume -- Now, the next question is this: The Florida Commission has authority to establish a mechanism for compensation for such a call; correct?

A I think that's unclear. The FCC has granted that authority, but, as I stated, the issue of whether they had the power to do that is subject -- is under court review at this point.

Q Okay. Well, let's just work with the FCC. The FCC order has indicated that at least the FCC thinks the Florida Commission has authority to approve or establish a mechanism for compensation in such a case; correct?

A In the interim, until the FCC rules.

Q Agreed, in the interim. I'm trying to understand your proposal as it's on page 35 of your direct testimony, and I think as you've summarized. You suggested to the Florida Public Service Commission that the parties simply track calls placed to ISP customers until there is a final nonappealable ruling, which will establish a mechanism for compensation; is that correct?

A That's only part of it. That's sort of how you would implement it. What I am recommending is that the Commission direct to parties to say that in the -- that with regard to compensation for this traffic, that what they will do is they will apply retroactively to the approval date of this agreement whatever mechanism the FCC ultimately decides. In order to do that, the parties would have to obviously track the minutes for the calls that occur in that interim period, in the intervening period. And then once the FCC rules, you just apply whatever the mechanism they come out with retroactively.

Q So, this is another case where, in effect, you're really asking the Florida Commission to just order that the parties have a provision in their contract that says do whatever the law requires you to do when the law is clear; correct?

A No, I don't think so. I'm simply saying that the Commission would say that they will adopt -- they're adopting whatever mechanism that the FCC currently -- I mean, not currently -- decides is the proper mechanism to apply to this traffic and that that mechanism will apply retroactively from the beginning of this agreement.

Q So, at least until there is a final and nonappealable ruling, you would suggest that no compensation change hands between BellSouth and

ITC^DeltaCom; correct?

A That's correct. BellSouth is willing to forego the compensation that's due it for that, you know, for that time frame and hopefully we'll get it ultimately when the FCC rules.

Q And you understand that it's ITC^DeltaCom's position that you're asking ITC^DeltaCom to forego the compensation that it believes is due to it for such calls; correct?

A I think that's correct.

COMMISSIONER CLARK: Mr. Varner, I want to ask the question. It strikes me that what the FCC has done so far has said it's not -- it's not local traffic, but, nonetheless, in the meantime you're going to be allowed to be paid business rates to get the service?

WITNESS VARNER: The ISP --

COMMISSIONER CLARK: The ISP pays business rates.

WITNESS VARNER: Yeah.

COMMISSIONER CLARK: They're not a carrier. If they were a carrier, wouldn't they be paying access to ITC^DeltaCom?

WITNESS VARNER: No. What's happened is this. This is sort of the way this has come about. This is access. This is interstate access traffic, is the way that they have defined it.

COMMISSIONER CLARK: That's the way that they've defined it and you're happy with that; I understand that.

WITNESS VARNER: I'm not -- I don't know whether I'm happy, but that's --

COMMISSIONER CLARK: Well, you sure don't want it defined as local.

WITNESS VARNER: No, no; I don't think it is. But what they did is that back in the -- Actually, it goes back before the time they established access charges, but starting at the time they established access charges, these people were carriers, people who provided these data services. You had GTN, Telenet and Timenet and Compuserve and people like that way back when. They decided that these people are providing, are receiving access service, but they were giving them an exemption from paying access charges.

COMMISSIONER CLARK: Right.

WITNESS VARNER: Okay. So, what they said was that, okay, these --

COMMISSIONER CLARK: If they were -- If they didn't give them the exemption, then they would be paying ITC^DeltaCom; is that right?

WITNESS VARNER: They would be paying

ITC^DeltaCom switched access charges instead of the business local rate is what they would be paying if they do not have the exemption.

COMMISSIONER CLARK: Correct.

WITNESS VARNER: So, what they did on the exemption, they said, okay, instead of paying switched access charges for this access service that's still access service, you're going to pay the business local rate for that service. Okay. And you will also pay the subscriber line charge for that service.

That's what the FCC means when they say we're treating these people as local for purposes of assessing access charges. That means that they are paying the business local rate. The only access charge that applies to local service is this travel hind charge.

COMMISSIONER CLARK: Everybody pays that. That's just like -- that's the --

WITNESS VARNER: Every end user pays that. See, a carrier doesn't. And they said that since these people are being treated as end users for purposes of assessing access charges, they would pay the same access charges that an end user pays, which is the SLIC, in addition to their business line rate. And that's what they were getting at with that sort of terminology.

COMMISSIONER CLARK: Well, given the fact that they have said it is access and that in the interim they're going to let them be charged business rates, which include the SLIC.

WITNESS VARNER: Okay. That's not an interim, really, arrangement. The fact that they're paying the business rate is really not something that's subject to review. When they do their further notice of proposed rulemaking, they're not addressing that issue at all.

COMMISSIONER CLARK: Okay. Let me ask it another way. Is it likely that BellSouth is going to have to pay ITC^DeltaCom to deliver that traffic that then is going to go to the ISP?

WITNESS VARNER: I don't see how they could.

COMMISSIONER CLARK: I don't either.

WITNESS VARNER: I really just don't see how that can come out with what the FCC has said so far.

COMMISSIONER CLARK: I don't either. So, who is going to pay it?

WITNESS VARNER: The ISP pays it.

COMMISSIONER CLARK: The ISP is going to pay it. So, the fact that they contract with you at this time to say if you owe us the money -- if we owe you the money, we'll pay you; and if you owe us the money, we'll expect it from you, you don't ever expect to pay them.

WITNESS VARNER: I don't -- I really don't believe so. I believe we're due money is really what the situation is. That's why I said that what's happening, I believe, with the arrangement that we're proposing is that we're foregoing the revenue that's due us for this period.

COMMISSIONER CLARK: Okay. And who is not paying that revenue? Is it ITC^DeltaCom or is it the ISP that's not paying what they ought to be paying?

WITNESS VARNER: Okay. Now, I need just a little bit more. Are you talking about under the interim?

COMMISSIONER CLARK: No. Ultimately, who is likely to have to be -- I guess it strikes me that the FCC has characterized something in such a way that it calls for that end user, the ISP, to actually be the person, the entity, that has incurred the charge and therefore should be paying it.

WITNESS VARNER: Right.

COMMISSIONER CLARK: But because they want to encourage the industry, they are not going to -- they're giving them an exemption?

WITNESS VARNER: Right.

COMMISSIONER CLARK: But they have, in effect, painted themselves into a corner.

WITNESS VARNER: Not really.

COMMISSIONER CLARK: All right.

WITNESS VARNER: Unfortunately, they did leave --

COMMISSIONER CLARK: What is another alternative?

WITNESS VARNER: They left them a little way out, I think. What they did in this case, which is I think why this order gets so confusing, is they were very, very careful to not change what this traffic is. Okay. And they were very, very careful every time that they talked about this exemption and so forth, that it was simply for the price that was to be paid. So, everything else about this service is the same as if it was switched access service other than just what the ISP pays for.

COMMISSIONER CLARK: Right. Let me ask you this: Do you agree that the business rate and the SLIC covered the cost of providing that service to an ISP?

WITNESS VARNER: I really don't know in that case. I think it's close.

COMMISSIONER CLARK: So, who gave you that clue here?

WITNESS VARNER: No, I really don't. What I was -- Typically, they buy what's called a primary rate interface and they pay, you know, a price for that. What we believe, and the reason I say I don't know, because I don't know that we've really done a cost study to demonstrate this, that the volumes of traffic that flow over that particular service far exceed what it would -- what the price is that we're able to charge for that service because, see, we have to charge the same price to an ISP that we would charge to any other business user that buys the same service.

COMMISSIONER CLARK: Don't you have a suspicion that it's likely to be more and that's why they weren't being charged access? That's why the FCC has decided not to require them to pay access?

WITNESS VARNER: Not necessarily that the cost was more. Clearly, if they paid switched access charges, the price would be more. There is no doubt, especially at the time they set up access charges, because the charge was so high.

Now what's happening, though, is the access charges are declining so fast, this may become a moot issue. I think that's their way out of the corner that they have painted themselves in is to drive the access charges down to the point that it doesn't matter any more.

COMMISSIONER CLARK: I see. That's helpful. Thanks.

COMMISSIONER JACOBS: The costs, though, that a CLEC incurs in terminating the traffic to the ISP, that's what -- that's what they're driving for? That's the threshold they're driving for, is to get the access charges to measure or cover that cost?

WITNESS VARNER: That who is?

COMMISSIONER JACOBS: If I understood your conversation just now, the box that they're in now is that you have these costs being incurred for which the revenue doesn't match?

WITNESS VARNER: Right.

COMMISSIONER JACOBS: So, the idea would be for the CLEC to be able to get from their ISP customers an access charge which covers their costs to terminate traffic to that ISP?

WITNESS VARNER: As well as, you know, the total cost of bringing it all away from the first, where the end user first sends it into the network --

COMMISSIONER JACOBS: Right.

WITNESS VARNER: All the way through to the ISP.

COMMISSIONER JACOBS: Well, now, why would you do that? Because then aren't you risking some kind of a subsidy? Because now that's a local call. That's a true local call.

WITNESS VARNER: Okay. See, that's why you've got this sort of strange arrangement. Access, access service was a service that was created to give providers access to the network. If you're thinking about it in the case of an IXC, an interexchange carrier, it was created that way so that the local company that has no relationship with the end user. The carrier buys it; the IXC buys it; or the ESP, which these ISPs are a sub set of, buy it from the local carrier. And then they then turn around and sell whatever service they sell to the end user: Internet access, long distance calls, or whatever.

The price that that carrier, the IXC or ISP, is paying the local company is for whatever costs the local company is incurring to deliver that traffic to them. And that is from the point at which the end user's loop comes into the switch, all the way through to wherever that ISP or interexchange carrier is located.

That's what access service is, is all of those functions along the way that's needed to allow that ISP or that IXC to collect traffic from their end users wherever they're located.

COMMISSIONER JACOBS: And from what I've gathered thus far, the goal is going to be for that person to have as -- and I may be off base. If I am, please correct me -- but I would think that a CLEC who is pursuing that kind of arrangement is going to want to have as much of that trail be digital as possible. Okay.

WITNESS VARNER: I would agree.

COMMISSIONER JACOBS: Okay. And that's going -- The goal, of course, to drive those costs down. And in my mind that's going to get them -- That will put them in a posture, very -- I think that really is how they get to the posture of being equitably compensated in the arrangement that you just described, because if they can pull together pretty much a digital hookup and then they get to these declining costs, these declining revenues, rather, in terms of access, then perhaps they can make that work.

But my problem is if they have to work it out under the present arrangement, where they have difficulty getting the digital connections and that sort of thing, won't that pose them additional hurdles? And then, also, how do we separate out of that the voice?

WITNESS VARNER: Okay.

COMMISSIONER JACOBS: Do they have to forego that all together?

WITNESS VARNER: Maybe I can -- Because there were about three issues in there. I'm going to try to unravel them as best I can.

The issue of them getting a digital connection is not an issue. They're getting digital connections today. The ISPs that we serve -- And, quite frankly, we serve the majority of the ISPs. The majority of the ISPs are being served by BellSouth.

They get digital connections today. The primary rate interface I talked about, PRI service, is a digital connection. It's a DS1 connection from us to the ISPs. So, they're already getting digital service and have been, you know, for years. So, that's not a change. With respect to the CLECs or with respect to BellSouth, we compete with each other for who's going to provide them with that digital connection. And we both do. Okay.

The other issue that you described about separating out the voice from the data is really a different service. Okay. That's the ADSL service that we talked about. And that particular service, the Internet access part is really not an issue here because what you're talking about here are strictly dial up connections where you make a dial up connection to your ISP.

When you buy the ADSL service, what you have then is you have to have a packet switch connection that's an overlay on your loop. You know, your loop provides you with your regular voice grade service. You put a DSLAM there, which separates out the voice from the data. The voice goes over a packet switch network. It never sees, you know, this other equipment that we're talking about here. And it makes a direct connection to the ISP.

So, that service doesn't ever get into it. This is strictly when you make a dial up through the network to the ISP.

COMMISSIONER JACOBS: I think I understand. I'm way beyond my expertise.

COMMISSIONER CLARK: I have one other question. It strikes me that when the FCC said that we could work out a compensation mechanism, I didn't understand that that authority included charging the ISP.

WITNESS VARNER: It doesn't. It doesn't. I don't think that they gave you any authority to change what the ISP pays. What they decided was, they said, okay, what you can decide is how the two carriers are going to divvy up what the ISP pays. That's what it is that you're, this inter-carrier compensation mechanism is, because all you're looking at is, okay, there's two carriers involved here, how are they going to divvy up the money that the ISP is paying for this service. And that's what the compensation mechanism is all about. It doesn't affect at all what the ISP pays for the service.

COMMISSIONER CLARK: You're not suggesting that -- Are you suggesting that ITC^DeltaCom be paying you for your customers terminating to the ISP through their system?

WITNESS VARNER: Our customers -- When an end user --

COMMISSIONER CLARK: Your end user calls an ISP.

WITNESS VARNER: Yes, we're the ones that should be compensated.

COMMISSIONER CLARK: Okay.

WITNESS VARNER: Because DeltaCom is being compensated by the ISP.

COMMISSIONER CLARK: At a business rate?

WITNESS VARNER: Yes. The same rate that we get paid by an ISP if the ISP was served by us.

COMMISSIONER CLARK: Have you suggested that in this proceeding that you be paid a certain amount?

WITNESS VARNER: Yes. That's the proposal that I have starting at page -- Well, in fact, all of my testimony on that subject is going to that point and then the --

COMMISSIONER CLARK: You better tell me exactly what the price is you're suggesting you be paid.

WITNESS VARNER: Okay. And they're in -- Okay. It actually starts at the bottom of page 49 of my direct testimony. The only thing on that page, of course, is the first question. And goes on and it's described on the next several pages.

But let me give you, though, what the punchline is, if you will, instead of going through all of that.

What we've done is we've gone in and said, okay, look, when that service is provided to that ISP, when they're getting that access connection, the CLEC is providing the loop connection to the ISP. They're also providing some switching and transport services and we're providing some switching and transport services.

Now, the only thing on compensation that we're entitled to is whatever the switching and transport services are that we're providing. So, we say, okay, what proportion of the total cost would that likely represent. Okay. They're providing a loop. That's by and large the bulk of the cost.

So, we went to our ARMIS records. And we said, okay, how much is our investment in loops, how much is our investment in switching and transport. We said, okay, all right, loops was, if I remember right, something like 84% of the total. The remaining 16% was switching and transport. And we just split that down the middle.

And we said, okay, what our compensation is due you us is roughly eight and a half percent of whatever the price is that the ISP pays.

COMMISSIONER CLARK: The business rate and the SLIC they pay them, eight and a half percent?

WITNESS VARNER: Exactly. And we would turn around, if their end user calls our end user, we pay them eight and a half percent, you know, of whatever it is that the ISP is paying us.

Now, the reason this is so complicated and it takes so many pages, is that what you've got to do is you've got to figure out how many facilities are involved because you're just sending minutes and you've got to convert that to some number of facilities to determine how many PRI rates or how many business exchange rates you're going to apply the eight and a half percent to. It's not all of them.

You know, if DeltaCom is providing 50 PRIs to an ISP, it may be eight and a half percent of them that they would have to compensate us for.

COMMISSIONER JACOBS: Doesn't that assume some kind of margin, that they're getting some kind of margin in the PRI rate?

WITNESS VARNER: No, it really doesn't. All it assumes is that there is a cost that had that end user been totally served by DeltaCom, that they are no longer incurring because that end user is now -- BellSouth is providing part of those facilities.

If you will think about this for a minute, if they had the ISP and that ISP customer was also their local service customer, they would be providing everything from the switch all the way to that ISP.

If that end user is a BellSouth local service customer, part of those facilities that they would otherwise have to provide, BellSouth is now providing.

So, all we're saying is that you have a lower cost because of the fact that we're providing part of those facilities and we ought to get some compensation for the part of the facilities that we're providing, that you would have provided otherwise.

COMMISSIONER JACOBS: I missed that translation somewhere.

WITNESS VARNER: Okay. It's --

COMMISSIONER JACOBS: Let me kind of go back to where I would start from. Where I would start from is that normally there would be two ends of the call.

WITNESS VARNER: An end user and an ISP.

COMMISSIONER JACOBS: Right. Well, yeah, I guess if you define it that way, but I'm thinking for the total transaction. And that being the end user who calls the ISP, who is not a customer of the serving CLEC, of the CLEC that serves the ISP.

WITNESS VARNER: Right.

COMMISSIONER JACOBS: Okay. That end user still has two ends of his call; doesn't he? He has the originating and the terminating end?

WITNESS VARNER: No.

COMMISSIONER JACOBS: Okay. Help me understand.

WITNESS VARNER: See, the originating -- All he's got is the originating, because, see, the terminating part is out in the Internet somewhere. The call doesn't terminate until it gets all the way through the ISP.

On a local call, you're right, there would be, you know, originating end user, terminating end user. The other end of that call is the connection out into the Internet.

COMMISSIONER JACOBS: So, from the prospective of the public switch network, there is no terminating overhead for that?

WITNESS VARNER: That's right. I guess, if you want to look at a terminating point, it's really the ISP is where the public switch network really ends, and then from that point it's on the Internet. But, as the FCC defined it in their order, they consider that one call, you know, that part.

COMMISSIONER JACOBS: I understand.

WITNESS VARNER: But if you sort of look at it in terms of the public switch network, the terminating point is really the -- it would be the ISP's premises. Just like if you looked at it from the standpoint of a long distance carrier, the terminating point is AT&T's point of presence or MCI's point of presence. The call really doesn't terminate there, but that's sort of where one network ends and the other network begins. I guess sort of a demarc, if you will, between one network and another network.

COMMISSIONER JACOBS: I'm sorry; go ahead.

MR. ADELMAN: Thank you.

BY MR. ADELMAN (Continuing):

Q Mr. Varner, to follow-up a little bit, it's true that Bellsouth's customers pay BellSouth; correct?

A Yes, that's correct.

Q So, if we've got a BellSouth local customer in the Florida service area of BellSouth who places a call that terminates to an ISP customer of ITC^DeltaCom in Florida, BellSouth is being compensated by its customer; correct?

A No, I think we've had that discussion, that when a call is made to an ISP, they are a customer of the ISP on that call.

Q Is BellSouth being paid by its customer for local interconnection?

A Local -- No.

Q Or local service. Excuse me.

A Yes, we're being paid for basic local service, which is the ability to make and receive local calls, and that's all.

Q I understand. And its use of the local facility; correct?

A Yes.

Q Much like if the BellSouth customer calls an ITC^DeltaCom customer that happens to be a physician's office, a local doctor's office, that's purely a local call; correct?

A Yes.

Q And Bellsouth's customer pays BellSouth for local service; correct?

A Yes.

Q And BellSouth pays ITC^DeltaCom to terminate that call because ITC^DeltaCom terminates that call at its customer's premises, the doctor's office; correct?

A That's correct. And in that case, reciprocal compensation properly applies. And I think the only dispute between the parties is what's the right price.

Q But that call follows the same path on Bellsouth's network regardless of whether it is terminated at the doctor's office or whether it goes to an ISP customer of ITC^DeltaCom; correct?

A I believe that's correct. And when you say path, I assume what you're talking about is physical facilities.

Q That is correct.

A Oh, yes; whether it goes to a doctor's office, the ISP; whether it goes to an interexchange carrier, it uses the same physical facilities.

Q It goes over the same physical facilities --

A But the physical facilities are not what's relevant here. What's relevant is what is the service that's being provided, because what you're trying to do is to divvy up revenues. And to divvy up revenues, you have to know who the customer supplier relationships are, who is paying what for whom, and what service is being provided. It's not an issue of the physical facilities.

Q Mr. Varner, before we divvy up revenues, the cost that's incurred on ITC^DeltaCom's network is a result of the use of ITC^DeltaCom's facilities; correct?

A That's correct.

Q And the cost that's incurred by BellSouth is a result of the use of BellSouth's facilities; correct?

A That's correct.

Q And regardless of whether the call is to a doctor's office or the call is to an ISP business customer of ITC^DeltaCom, the same facilities are used, the same path; correct?

A That's right.

Q Now, let's talk about your --

A But the payment is not the same.

Q Let's talk about -- Well, were you here yesterday when Mr. Alexander asked some questions to Mr. Rozycki?

A Yes, I was.

Q And you do remember he asked Mr. Rozycki, and I believe it was Mr. Alexander, asked Mr. Rozycki whether this Commission has authority to establish a bill and keep compensation mechanism for ISP-bound traffic?

A Yes, I do recall that.

Q Okay. And explain to me how bill and keep works?

A What bill and keep essentially means is that the parties just don't bill each other. They incur their own costs and have to recover their own costs from their -- from, you know, whatever other revenues that they have and they just don't bill each other for the interconnection between the two of them.

Q And if adopted, a bill and keep compensation mechanism would undermine local competition; wouldn't it?

A Absolutely not, not for this traffic. And, in fact, what would -- I think a bill and keep mechanism for this traffic is certainly closer to a proper compensation mechanism by a wide margin than reciprocal comp.

Reciprocal compensation I think is the thing that deters development of local competition because it gives CLECs disincentives to serve end users to call the Internet. Why would they want to serve an end user that calls the Internet when they may very well have to pay more in reciprocal compensation than they even get from the end user for the service. And it creates that disincentive.

We've seen situations where CLECs have established arrangements that are designed for nothing more than to generate reciprocal compensation revenues. And, I mean, I'm talking about arrangements that are generating numbers in the nine figures. So --

Q Mr. Varner -- I'm sorry.

A -- that's what you're getting with reciprocal compensation applicable to this type of traffic. That's the kinds of incentives you're putting in place.

Q Mr. Varner, do you have any evidence, even a scintilla of evidence, that ITC^DeltaCom has entered into any arrangement with a customer simply for purposes of generating reciprocal compensation?

A And I did not suggest that they did. I have said that we have seen situations where CLECs have and it's a direct result of this reciprocal compensation arrangement, is what has created that incentive.

COMMISSIONER CLARK: Mr. Adelman, can we take a break here? And what I'd like to do is, if we're going to stay a little later, we better make sure they crank up that air conditioning now; right?

MR. ALEXANDER: I appreciate that.

COMMISSIONER CLARK: I think -- because it automatically shuts off at a certain point, but if we could just cool it a good deal now, maybe we can last.

We'll go ahead and take a break until 4:30, and we'll come back at 4:30.

(Recess.)

COMMISSIONER CLARK: Let's call the proceeding back to order.

Mr. Adelman.

MR. ADELMAN: Thank you, Commissioner.

BY MR. ADELMAN (Continuing):

Q Mr. Varner, right before the break I asked you whether you agreed that a bill and keep compensation mechanism would undermine local competition. And you answered it, but I forgot your answer. Can you give it to me again, please?

A I'm going to give you the short version. No, I don't agree with that. The explanation I have already given, so I won't repeat that.

MR. ADELMAN: Okay. Could I approach the witness, please, Commissioner?

COMMISSIONER CLARK: Yes.

BY MR. ADELMAN (Continuing):

Q Mr. Varner, who is Robert Scheye?

A He works for the BellSouth BSE. It's a subsidiary of BellSouth Corporation.

COMMISSIONER CLARK: I know Mr. Scheye.

WITNESS VARNER: I was trying to remember how to describe him. That was the difficulty.

BY MR. ADELMAN (Continuing):

Q And he used to work in the regulatory group at BellSouth; correct?

A Yes, he did.

Q And he testified for Florida regulatory commissions; correct?

A Yes.

Q And I've just handed you a document, which is excerpts from some of Mr. Scheye's prefiled testimony in the state of North Carolina; is that correct? Can you identify that?

A No, I really can't, but I'll accept it subject to check.

Q Fair enough. Can I get you to turn to page 41 of his, of that North Carolina testimony of Mr. Scheye, please?

A Yes.

Q Line 24, the sentence that begins half-way through line 24; can you read that into the record, please?

A Half-way through line 24, you said?

Q Line 24 at the bottom of page 41.

A "Second, as mentioned above"?

Oh, I'm sorry, I'm looking at -- You said --

Q Page 41, line 24.

A I'm sorry; I was on page 40.

"Adoption of bill and keep"?

Q Yes.

A Yes. "Adoption of bill and keep will undermine long distance competition as well as local competition."

Q So --

A He was referring there to traffic, to local traffic, what bill and keep would do with respect to local, local traffic.

This traffic is not local traffic. This was a proceeding dealing with the traffic that is under 251(b)(5). This traffic is not under 251(b)(5). And he was also dealing with it back at -- I think this was in the AT&T arbitration back in 1996, which at that point in time there was a lot of uncertainty around what the rules were, which has been cleared up.

Q Would you agree that Mr. Scheye's testimony predates the FCC's declaratory ruling with regard to ISP-bound traffic?

A Oh, yes, but our position, even back then was that this traffic was not subject to reciprocal compensation; it was not covered by 251(b)(5). That's always been our position.

Q So, am I hearing you say then, not surprisingly, you agree with Mr. Scheye when it relates to local traffic to business customers who are not ISPs; correct?

A Not entirely. I agree that that was probably a reasonable position to have back then, three years ago. I'm not so sure that that is the case, you know, three years later, after we've gotten further into this. I do disagree that there is any relevance -- that statement has any relevance to the statement here because those statements are dealing with traffic that is local traffic and this traffic is not.

Q Mr. Varner, I have I guess what I hope we can agree is a housekeeping question. I'm looking at the revised Exhibit AJV-1, and I'm trying to compare it with the exhibit that you prefiled with your testimony. Do you have both of those documents with you?

A You might have to give me dates. I have the one dated October -- Well, actually, no, I don't. I only have one. The one, October 27th, is the only one that I have.

Q You do not have the one that was attached to your prefiled testimony and filed?

A No, I do not.

MR. ADELMAN: Commissioner, if I could, I have just the one copy. If I could just approach, please.

BY MR. ADELMAN (Continuing):

Q Mr. Varner, I'm handing you what was served on us with your prefiled direct testimony. It's a schedule entitled "Florida Rate and Cost Analysis," with a date August 16th, 1999, in the top right-hand corner; do you see that?

A Yes.

Q And you said you already have what's been marked as one of the exhibits in Exhibit 23, which is a

three-page AJV revised October 27th?
A Yes.
Q Do you have those side by side?
A Yes, I do.
Q Now, all I'm trying to do is locate the space preparation charge for collocation.
A Okay. Item H.1.2 on the one that we filed today, it's on page 2, next to -- Well, it's like the third line up from the bottom.
Q Okay. I see that. And is that, is there any entry for space preparation for physical collocation on the August 16th version of this?
A No, that was one of the reasons that this was revised, is that was inadvertently left off. It should have said individual case basis.
Q Okay. So, that's not one of the corrections you made. And I was trying to follow this as closely as I could. And the corrections that I made related to the --
MR. ALEXANDER: If I may, I explained to Mr. Adelman before we presented that, before Mr. Varner got on, BellSouth did file with the Commission on October 21st a revised AJV-1. And in that revision, one of the things that took place, I believe, was the -- I think it was the only change, in fact, that took place on

that document. And it was H.1.2 on page 2. And it is that physical collocation space preparation fee. And that occurred -- That change occurred on revised, the filing on October 21st.

MR. ADELMAN: Okay. And I don't mean to -- I'm trying to make sure I've got the right exhibit, the one that's in with the corrections.

BY MR. ADELMAN (Continuing):

Q And you also changed the rates in F.1.1; correct? That's what you changed from the stand; correct?

A Yes. From 6.78 to 6.63.

Q And the other change is the inclusion of ICV for space preparation; is that correct?

A Between these two?

Q Between the one you prefiled and the one that is Exhibit 23.

A Oh, I really don't know what the changes are because there was an intervening filing between these two that made some changes. So, between the August 16th version and the one we had today, there was -- I know there was at least one, there may have been two, intervening filings. And I was just giving the changes today that were made from the October 21st to the one that we did today.

Q Okay, just so I understand. I know that you added the two sentences to the footnote; correct?

A Yes.

Q And I know that you changed the rates to 6.63 in F.1.1.; correct?

A Yes.

Q And I don't mean to quibble with you, but I just want to understand. Each .1.1 has ICV as the space preparation; correct?

A Yes.

Q And there may be other changes from the original; is that what I hear you saying?

A Yes, but those have been filed previously. Those have been filed before.

MR. ALEXANDER: Let me just clear that up for the record. I explained it. There has been revised filing on October 21st. The only change, as I understand it, was that H.1.2, the site preparation fee for collocation, and then Mr. Varner went over the revised filing on October 21st. Excuse me. That was the October 21st revised AJC-1. And then today he went over the changes from that filing, included on the October 27th filing.

COMMISSIONER CLARK: Well, I just add -- I think Mr. Adelman was just verifying that those were the only changes.

WITNESS VARNER: Actually, he was comparing the original prefiled version to this. And there are more changes than just those between the original prefiled version and this.

BY MR. ADELMAN (Continuing):

Q And so there's another AJV-1, and that's dated October 21st; correct?

A Yes, there is.

Q Is that one in the record? I don't know. And, if it is, if I could just get the identification, that would help.

MR. ALEXANDER: We have filed it with the Commission. If we need to move that in, we will. And I've also just been told that there was a revised, an AJV-1 revised on September 3, 1999.

But all of the revisions from the August 16th, September 3, October 21, are contained in the revision that was moved into evidence. Since it was all captured there, I only moved the one in. And that is the Exhibit AJV-1 dated October 27. If we need the prior ones in, I'll be happy to move those in.

MR. ADELMAN: Commissioner, I don't -- Actually, I think it would be easier not to have the prior ones, so long as I just understood the difference between the original and the one that's in evidence. That's -- And we can do this at another time. My concern is I know that there are changes. I don't know exactly what they are. I don't know if they would have caused me to ask cross examination questions. I just don't know.

COMMISSIONER CLARK: Well, I'm sure we'll have a break sometime and you can look over them and see if you have any concerns. But as it stands now, what you've handed out today revised contains all of the updates we need and what was changed and he spoke to on the stand, and that's the one that's going to be part of Exhibit --

WITNESS VARNER: Twenty-three.

COMMISSIONER CLARK: -- 23.

WITNESS VARNER: Yes.

COMMISSIONER CLARK: Okay

MR. ADELMAN: With that Commissioner, I have no further cross examination for this witness, and would just ask, I think, if we could get a red-line version of the August 16th, with the October -- with the changes from yesterday or today.

MR. ALEXANDER: Well, I'll be happy to show you from page to page, but I don't know that a red-line version on this document now that's got gray material on it and nonshaded and things like that, I'll be happy to go over each change with you.

MR. ADELMAN: And format doesn't matter to me, just so long as we can understand what the changes are. That's all I ask.

COMMISSIONER CLARK: I guess you can do that at a break.

And, now, Ms. Caldwell, it's your opportunity to cross examine Mr. Varner.

MS. CALDWELL: Thank you, Commissioner.

CROSS EXAMINATION

BY MS. CALDWELL:

Q Mr. Varner, I'm Diana Caldwell representing Commission staff. Good afternoon.

A Good afternoon.

Q Does BellSouth have to combine the loop and the dedicated transport to comprise the extended loop?

A Yes. Well, in order to make it available, yes. We're not obligated to do it.

Q Do they have to include anything else besides the loop and the dedicated transport to make that extended loop?

A You have to have a cross connect. That's how you connect them together is with a cross connect between them.

Q Is it Bellsouth's contention that the extended loop or the loop/port combination recreates an existing

BellSouth retail service?

A Yes, we believe it does. But that really doesn't affect our positions in this arbitration, really.

Q You indicated that it does. Could you give me an idea of what those services would be or that service would be?

A Yes. When I say loop/port, I'm including transport. It's sort of the combination of loop, port and common transport, which goes with the port. And those would be like basic exchange service, 1FRs, 1FBs, PBX, trunks. What else? Any of the -- that class of services.

Q Paragraph 4(b)(14) of the existing Interconnection Agreement between BellSouth and ITC^DeltaCom reads, and, you know, this could be subject to check, "The parties shall attempt in good faith to mutually devise and implement a means to extend the unbundled loop sufficient to enable DeltaCom to use a collocation arrangement at one BellSouth location per LATA, for example, tandem switch, to obtain access to unbundled loops at another such BellSouth location over BellSouth facilities."

Could you name me every method that you are aware of to implement this provision?

A No, I can't because those negotiations never took place. What that language in the contract contemplated is that BellSouth and DeltaCom would sit down, agree on a method to do this, agree on a price and so forth that would be paid to do this, and then go on from there, because that's really all that language obligates us to do is to devise a method.

Those negotiations never took place. We never came up with a method. We never discussed it, and we never agreed on a price, or even what the service would be to do it.

What happened was DeltaCom started sending us orders for special access in UNE loops, which we worked in error, and then there we are, but those provisions were never carried out.

Q Would you have any of your own personal ideas as to what this would have meant, what services would have been covered?

A Probably -- Well, for example, one of them would have been the one that we offered DeltaCom in the professional services arrangement. We made them an offer for a service where we would combine the loop and the transport in a professional services arrangement. And I'm sure that would be one of them.

There may be others, you know, for other types of extended loops or other combinations they might have wanted.

Q Mr. Varner, on line -- on page 39, line 24 through 40 of your deposition, you testified -- and if you would like to get to that, otherwise I might be able --

A I don't have it. I thought you were going to say testimony.

Q You testified in depositions that interconnection parity is that -- is that we have to provide interconnection that is comparable to that which we provide ourselves; is this correct?

A That was my general recollection. Since then I've gone back to actually find it in the FCC's order, which is what I was trying to refer to. And it's in the Ameritech Michigan order in paragraph 223 is really where the standard is. And it says, "In our local competition order, we concluded that the equal in quality standard requires an incumbent LEC to provide interconnection between its network and that of a requesting carrier that is at least indistinguishable from that which the incumbent provides itself." So, that's what the actual standard is.

Q All right. In that language that you just read, what would be your interpretation of the term "interconnection"?

A Interconnection is the -- I'm trying to define it without using the term definition -- would be us connecting the two networks. That's all interconnection is, is us connecting in this case with DeltaCom.

Q So, that would be an interconnection between two, say, unaffiliated entities?

A Yes.

Q Would it be your testimony that BellSouth provides interconnection to itself?

A No, no; not in this instance.

Q So, your definition of interconnection would be unaffiliated entities?

A Yes. It's the interconnection that's referred to in the Telecom Act between ILECs and other LECs.

Q General references in the Ameritech order and your depositions, page 39 of your deposition, you testified that pursuant to the FCC's definition of parity in the Ameritech order, parity consists of three parts; is that correct?

A Yes.

Q In paragraph 139 of the Ameritech order, the FCC concluded for those OSS functions provided to competing carriers that are analogous to OSS functions, that a Bell operating company provides to itself in connection with retail service offerings, the BOC must provide access to competing carriers that are equal to the level of access that the BOC provides to itself, its customers, or its affiliates in terms of quality, accuracy and timeliness.

A Yes.

Q I think it goes on to further state -- Well, what would be your understanding of the term "analogous" that's used in that paragraph?

A Yes, what they're talking about is the -- And, in fact, they may in fact define it down here. In fact, they do, in paragraph 140. What they're talking about is the OSS functions like preordering, ordering and provisioning. And they're saying when they -- In this particular instance, they're talking about resale, because they're talking about things that we provide in connection with our retail service offerings. They're saying, look, you have to provide the ability for them to be able to do preordering, ordering, provisioning and so forth for services that they resale, that are analogous to those same preordering and ordering functions that you have available to yourself when you sell that service to a retail end user.

So, if you have a preordering capability, for example, or when you sell a retail service to an end user, they have to have an analogous preordering capability if they want to resell that retail service.

Q In that explanation, would analogous be consistent -- Would you also use the term "functionalities," that the same functionalities exist?

A I would think yes. I think that's pretty close. The only thing I would add to that is that, you know, it has to be -- it can't just be that they can do the same things. They have got to be able to do it, you know, in comparable terms of timeliness and accuracy to the way that we can, also, in addition to just, you know, being able to get the information.

But that's really -- That paragraph and that standard is the resale standard, which I was referring to in my deposition.

Q Right; I understand. As used in this paragraph, what do you understand the term retail service offerings to include?

A It's all of the offerings we have in the GSST and private line tariff.

Q I'm sorry, it was the GSST and the --

A Private line tariff, the services that we offer to end users.

Q Do you agree that the term retail service offerings, as used in this paragraph, will include some UNE-like elements?

A No. No. And with respect to UNEs, they address those in paragraph 141. And they specifically said there that those don't have retail analogs and that's why they came up with a different standard because there really isn't a retail analog for the UNEs. And they set that standard in paragraph 141.

COMMISSIONER JACOBS: The requirement to provide UNEs can never come from that provision then?

WITNESS VARNER: That's right. See, for UNEs, in paragraph 141, they say for those OSS functions that have no retail analog, such as the ordering and provisioning of unbundled network elements, the BOC must demonstrate that the access it provides to competing carriers satisfies its duty of nondiscrimination because it offers an efficient competitor a meaningful opportunity to compete. That's where that standard "efficient competitor a meaningful opportunity to compete" came from.

COMMISSIONER JACOBS: But you do provide at retail the loop and the transport?

WITNESS VARNER: We provide a service that -- We provide a service that has that functionality in it. But we don't provide those as separate elements.

COMMISSION JACOBS: Elements as broken out?

WITNESS VARNER: Yeah. And, see, when you have to provide them in separate elements, you have to do something different than you do when you do it as a service; for example, basic exchange service, we provide that with the loop and the switching all together. If you have IDLC, for example, if it's all going in the switch, it doesn't matter. When you're providing an unbundled loop, however, you can't do that any more because you've got to give it to them separate from everything else. That means you've got to go in, you've got to break it apart from the network, where it's connecting, and turn it over to them as an individual element, or you've got to take the service, break it into piece parts and just give them the piece parts that they want. And that's why you don't have retail analogs for those things.

BY MS. CALDWELL (Continuing):

Q Will transport elements such as interoffice transport elements be considered both Bell operating company's retail service offering and a UNE?

A The functionality would be. When you call it an element, element by definition would be a UNE. But when you have certain UNEs, for example, custom calling features, for example, that have been identified as both retail service, obviously, and we also have to make them available as unbundled network elements, and transports the same way.

Q In your deposition you also testified that when I provide them with these UNEs, and then you go on to say they can come in and actually compete against BellSouth or against other CLECs for these customers given the standards under which they are going to get the UNEs. Is this -- You agree with this?

A Yes.

Q Would you please explain what you meant by standards?

A Yes. I was referring to the efficient competitor a meaningful opportunity to compete standard, that that standard enables them to be able to come in -- Us providing UNEs that meet that standard enables them to come in and compete in the marketplace, utilizing UNEs, if that's what they want to do.

Q Would it be your testimony that CLECs are operating under a different standard than BellSouth?

A Well, with regard to the standards we're talking about, I think so, because they don't have any of these obligations. Well, I shouldn't say any. They do have the obligation to interconnect and I think they have a resale obligation. They don't have an obligation to provide unbundled network elements. So, that standard only applies to BellSouth.

Q In your opinion, are the standards conducive or favorable for any CLEC to become an efficient competitor?

A I'm not -- I don't -- I don't believe so. And the reason I'm having difficulty is that's kind of getting the cart before the horse. The standards would not, are not conducive to making them an efficient competitor. They have to make themselves an efficient competitor.

What the standards do is say, okay, if you've gone to the trouble to make yourself an efficient competitor, you can get these elements from BellSouth in such a manner that you have a meaningful opportunity to compete. So, what the standard does is it insures that an efficient competitor can get these UNEs from us in a manner that allows them to have a meaningful opportunity to compete for the customer, but the standard itself doesn't make them an efficient competitor. They have to do that on their own.

Q You also testified in your depositions of conducting workshops in Louisiana and Georgia for the purpose of establishing benchmarks for provisioning and installation intervals; is this correct?

A Yes.

Q Was there any outcome to these workshops? Were there any benchmarks that were approved?

A There are some benchmarks included in the SQM, service quality measurements. To the extent that they've been established, there are some in those.

Q Do you know which benchmarks they would be?

A I really don't remember. If we have the SQM document, they're listed in the document.

Q Do you know when the document came out?

A Well, the document was last published -- We updated it periodically. It started probably sometime early last year. The latest version is dated I believe sometime in September.

Q And that's September of '9- --

A '-9.

Q '-9. Are you aware of any impact of these benchmarks in general as they have affected the provisioning of UNEs or resale?

A No, not really. The benchmarks that have been established I think are ones that are reasonable and represent a reasonable ability for them to be able to get the service, and a reasonable reflection of our ability to provide it.

Q Are these benchmarks the same as Bellsouth's service quality measurements or measures?

A The benchmarks are a part of the service quality measurements, as I refer to the SQM, the service quality measurements. Included in the service quality measurements are benchmarks where they have been established. When you look at the document, it has a description of the measurement and how the measurement is calculated, you know, what reports you get, what level of this aggregation you get, and also if there is a benchmark for it, what that benchmark is.

MR. ALEXANDER: Commissioner Clark, I just, I don't know how much more questioning we'll have on this subject, but this is one of the issues that was stricken, and we did have a separate witness on this that we had released on Monday. I didn't know we would need him.

BY MS. CALDWELL (Continuing):

Q On page -- In your depositions on page 44, you testified, you stated that capacity or that service is a service that's unique to the ALEC community.

A Would you repeat that? I'm just having trouble recalling that, the context around it. Maybe if I read a little bit more of it, I might remember it.

Q Let me get to your -- I think in the deposition I had asked you a question about UNEs and --

A I have a copy of the deposition now. If you have a reference, I can find it.

Q I'm on page 44, and specifically we were looking at lines 16 through 18.

A Okay. Okay.

Q And all I wanted to ask you is to explain what you meant by that service. Do you mean -- Do you mean the process of separating the requested UNE or the UNE itself?

A I mean the UNE itself. What the UNE is, and loops is probably the easiest one to explain. When we give an ALEC an unbundled loop, that means that we've given them a connection from the customer's premises to our wire center separate from everything else. I mean, there is nothing else there. That's all they've got is that connection. And that's what I was referring to, that that service, called an unbundled loop, is unique to the ALEC community. It's not something that we would ever provision to ourselves. We don't have any reason to do that. The work for us is to take it and separate it out and make it available.

Q All right. Thank you. Just to reference on page 75 of your deposition, you testified that IDLC is an integrated technology that integrates the loop into the switch.

A Yes.

Q So, if you want an unbundled loop separate from the switch and that customer is getting basic service off on IDLC, you can't get this; is this correct?

A That's correct. Now, you can't get an unbundled loop on IDLC. I mean, by definition, that really doesn't work.

Now, and I think Mr. Hyde talked about this side-door capability, which Mr. Milner knows more about, that's a very, very limited ability to do, you know, some small quantities. And, in effect, what you're doing is you're still utilizing the switch in order to get them into it, but you have to convert that back to an analog loop.

You have to remember when they want an analog loop, if they ask us for a two-wire analog loop or an SL1 loop or an SL2 loop, we have to give them an analog loop. The reason for that is most of the telephones have analog sets. It doesn't do them any good to get a digital loop to serve a customer who has an analog set. If they ask us for a digital loop, we give them a digital loop. We have an ISDN loop, which is a digital loop, if that's what they want. We've got ADSL loops.

So, when we're talking about loops, there are a number of varieties of loops that they can request that have certain specific parameters and technical descriptions associated with them. It's not just, you know, like one type. There are several different types: some digital, some analog, some high capacity, some voice grade.

Q Thank you. Just to be clear, the switch you're referring to is BellSouth's switch?

A Yes.

Q And is it your testimony that if ITC wants IDLC with a switching capability, that BellSouth will provide it?

A With a switching capability.

Q They want IDLC with a switching capability.

A The only way they can do that is they'd have to get the combination of the loop and the port. And we'll know what we have to do there. Some instances, based on what the FCC has said we'll have to do that. In the instances where switching is not a UNE, then, no, we won't have to do that.

Q When IDLC is separated from the switch, what is the stripped off UNE called?

A It's called an unbundled loop. See, IDLC is not -- It's not a service. It's just a technology. It's a way that the connection is provided. With IDLC, though, what you've done is you've taken two things, two functionalities, loop and switching, and integrated them.

Under the Telecom Act, though, and under the FCC's rules, if somebody wants a loop separate from switching, we have to do that. We have to do whatever it takes to unbundle that loop and give it to them by themselves. Well, if it's already on IDLC, we've got to get it off of there in order to unbundle it. We can't unbundle it and leave it on IDLC, because if we leave it on IDLC, it's going to go into a switch. So, if they want the loop without the switching, we've got to get it off of there in order to give it to them.

Q So, if you've -- If ITC were to then reconnect that unbundled loop after you've -- we've separated the IDLC from the switch, what we've just been discussing, the stripped off UNE, would ITC be getting a functional equivalent of IDLC or could they get a functional equivalent of IDLC after it's been stripped off?

A Not if they're purchasing unbundled loop from us. I guess if DeltaCom really wanted something, sort of get something from us that kind of looks like an unbundled loop but also have the IDLC technology, there's probably a way they could do that, but what they would do from us is they wouldn't buy an unbundled loop. They'd probably just buy from us the loop distribution facilities, which we would bring up to a remote terminal, and then they would have to put in their own IDLC system and interconnect at the remote terminal to that loop distribution, and then they can put it on an IDLC system and carry it on to their switch and integrate their own

IDLC into their switch.

But in that case, they're not buying the unbundled loop from us. They're buying just a part of it. They're buying the distribution, just the loop distribution facility from us, putting it on their own IDLC. So, I guess they could do that if that's what they wanted to do.

Q In Mr. Rozycki's deposition, Mr. Rozycki testified that essentially parity means that the customer does not see any difference in the service that he gets, whether it's from ITC or BellSouth. Do you agree with that?

A I don't agree that that's a standard at all. I believe -- Mr. Rozycki defined that as I think his definition of parity, but the obligation that we have is nondiscriminatory access. And the standards for determining whether we're doing that are really defined by the three items that we went over: interconnection, resale, and unbundling, out of the FCC's Ameritech order I think is the clearest delineation of what the standards truly are.

Q Thank you. On page 67 of your direct testimony, in lines 14 through 17, you state, "If there are any instances when BellSouth does not incur any costs associated with the disconnection, BellSouth should not charge ITC^DeltaCom for the disconnection." Under what circumstance does BellSouth not incur costs during the disconnection process?

A I don't know. I was responding to the issue as DeltaCom had raised it, which I thought was a rather strange way to state it, was that should we charge them for disconnect costs when we don't incur any disconnect costs. We'll, we've never proposed to do that. We've only proposed to charge them disconnect costs where we do incur disconnect costs.

Q Does BellSouth seek to recover any costs associated with disconnection?

A Yes, we do. We have, and the Commission has approved rates for that, but they're assessed at the time of disconnect.

Q Does BellSouth seek to recover any specific costs from ITC through disconnection charges assessed to ITC^DeltaCom?

A Yes, at the time that the service is disconnected. And they are ones that have already been approved by the Commission or they're listed on my Exhibit 1 to my direct testimony.

Q In Bellsouth's prehearing statement it states that BellSouth is entitled to recover its reasonable costs to perform the function of converting customers from resale to unbundled network elements. What reasonable costs does BellSouth believe it's entitled to cover from the conversion of customers from resale to unbundled network elements?

A It will be whatever costs that are incurred to do that. And if it's simply converting the customer from resale unbundled network elements, those costs are the same costs that would apply for provision of any other UNE.

When we provide DeltaCom with a UNE, it doesn't matter whether the customer is formally a resale customer or our own retail customer or brand new, the cost to us for provisioning of the UNEs are the same.

Q Issue 13 deals with SL1 orders without order coordination. And ITC^DeltaCom is asking for an a.m. or p.m. designation. Would you explain to me what SL1 orders without order coordination are?

A Yes. I think that one was resolved. I don't mind answering it.

That one is not resolved? Okay.

Q I wasn't aware that it was.

A All right. Explain what an SL1 order is without order coordination.

Q Without order coordination.

A Yes. An SL1 loop without order coordination means that when we issue the order, actually go out and work the order, that we will work it within roughly a 60-minute window of the time that they've been stated. And the costs, the nonrecurring costs for that loop, reflect the fact that we don't have, you know, like them on the line and have committed to doing it within a tighter window. We have a couple of -- We have another service that we propose, which is called an SL2 service.

We also had a service called manual order coordination, which means that you go in and you arrange it so that it's done within fifteen minutes.

So, SL1 without order coordination is really sort of the lowest price nonrecurring cost loop that we could come up with, that we could provide to somebody. We've taken, you know, all of the costs for order coordination, taken them out, but we don't perform the function.

Q Was the cost determined as to the functionality of the SL1 to complete the SL1 order or is it a function of that or it's just a function of the coordination that you may have to send somebody out, but by designating it a.m. or p.m., it becomes more costly the more closely you designate the time frame?

A Yeah. Now, with regard to the a.m./p.m., this is what we've offered to do in that case: We've offered to do, even on a loop without order coordination, that we will give them an a.m. or p.m. designation under the same conditions we offer a.m./p.m. designations to retail customers. And that is we offer an a.m. or p.m. designation if there is access required to the customer's premises and the customer wants, you know, wants us to designate it. That's what we do with retail customers. We've offered to do the same thing with DeltaCom with respect to unbundled loops that they purchase from us, even those that have no order coordination with them.

Q Now, when you were first describing it, you said something about a 60-minute window?

A Yes. What I was getting into, and I think I misunderstood your question. What I was really getting into was trying to differentiate an SL1 from an SL2 and what's included in order coordination, which is really not -- really doesn't have anything to do with the a.m. -- It really doesn't -- The a.m. or p.m. is really a different issue.

Q Well, I guess my question is just first trying to find out what SL1 without order coordination is and it's -- and then trying to determine, you know, the issue is should SL1 orders without order coordination be specified by BellSouth with an a.m. or p.m. designation.

A Okay.

Q And my first question was, you know, just what is SL1 orders without order coordination.

A Okay. Yeah, that means that we go back in and we designate to them. They give us a due date or give us a date that they want on the order, want the order worked. We go back, we tell them, you know, what the provisioning date is going to be and so forth.

I think -- And now you're getting sort of beyond me. You might want to ask Mr. Pate, once you get past that point. The important -- The distinction here between the a.m. or p.m. is what DeltaCom is asking for is that on those orders, that we designate at that point in time that they issue that order that we're going to work that order in the a.m. or p.m. on that particular date. And we said fine, we're willing to do that, but only where we do that for retail customers. And we only do that for retail customers if we have access to the premises and the customer wants it. Otherwise, we just do it any time during that day. So, unless it's one of those two instances, we're just going to work it any time during that day.

Q Now, the a.m. or p.m. designation is just morning or afternoon; it's not a specific time?

A That's correct.

Q You indicated that BellSouth does not provide this to any other CLEC, a specific designation?

A No. I'd have to go back and check the contracts, but we don't provide even what we've offered to DeltaCom to anybody else.

Q And the SL1 orders are simply the basic loop, sort of like the plain old telephone service? It's nothing really --

A It's the most basic of the basic loops. And sort of that's the concern here. The SL1 was designed to be the very cheapest possible loop you could provide. The reason in doing that, that means that there are functionalities that were left out, left out on purpose, in order to keep the costs down. And now if you're going to start going back and putting in those functionalities that were purposefully left out to keep the costs down, you're not creating another service. We had a loop, an SL2 loop, that is a higher-price loop, that has some of this additional functionality already built into it.

So, what they're -- What we're concerned about is they're saying, okay, we want to take the low-price loop, but we want to get some of the functionality that's in the higher-price loop. Well, the reason that one is lower priced is because the functionality wasn't included; that's why the price is lower.

Q All right. Now, in this order coordination, does the SL1 loop, when somebody -- or when ITC is ordering it, does it require coordination with their technician to be there?

A Oh, yes. So, we have to do that at a certain time. The difference between that and sort of like manual order coordination, or SL2, is the time frame is wider. We don't commit to as tight a time frame to doing it on that loop. We commit to a time frame that's more like what you had with regular basic exchange service.

That loop is really designed sort of for a case where you've got a brand new customer coming in. There is no customer there now, and the customer, their time frame is not as tight about getting the service cut over because they don't have service in place already.

If you've got an existing customer already in place, that's probably not the best unbundled loop for you to purchase. You probably should do the SL2 loop if you've got an existing customer because they've got service in place, you want to insure that it's within a tight time window. And the SL2 provides all that capability in it.

This was really designed for the case where you're trying to provide service to a brand new customer.

Q Okay.

A And you don't need all of that coordination.

Q But if this might require somebody to go to the residence or whatever, and a BellSouth technician has to meet an ITC technician, wouldn't a.m. or p.m. designation help BellSouth out in that if they don't give any kind of designation and a BellSouth technician gets there at 8:00 o'clock in the morning, he's either going to have to come back?

A I don't think we would have to meet the ITC^DeltaCom technician at the customer's premises. These kinds of loops we're talking about are two-wire analog loops, which are like basic POTs loops. If we go to the customer's premises, it may be to install, you know, a NID, or something like that, that we might have to go and enter the customer's premises to do something with. And that's what we're talking about when we say we have to go to the premises. We don't really have to meet the DeltaCom technician at the customer's premises.

The only thing we need to do for coordination between us and the DeltaCom technician is when we turn the loop over to them and terminate it in their collocation space, they need to know that it's there so that they can switch it up to their switching and give the customer service.

Q Were you here yesterday when Mr. Hyde gave his definition of parity being at least equal to or at a level equal to or greater?

A Yes, he kept saying -- I recall the at least equal to. I disagree that at least equal to is the same as equal to or greater than. At least equal to means equal to or less than.

Q Okay. And all I wanted to do was find out what your impression of his -- What would be your definition of parity?

A Yes. Well, parity is, you know, the standards out of -- that we talked about out of the Ameritech Michigan order. With regard to this specific issue, BellSouth proposed that, fine, we will be willing to accept their language if they would just simply strike the "greater than" provision. If they would just strike that provision, the language was fine with us. That's what we offered to them. It was that simple: Their language, just strike the "greater than" provision.

COMMISSIONER CLARK: I probably didn't hear you correctly. You said at least equal to means it can be less?

WITNESS VARNER: Well, it can -- It doesn't obligate you to do anything more than. That's what I was trying to get at. What you do is you say at least equal to, it says you're not obligated to do anything more than what's equal. When you say equal to or greater than, and that's our problem with their language. If we have that language in there, what that means to us is DeltaCom can come to us and say, look, I want something better than you provide to your own end users and you have this language in your contract that says you're obligated to give me that.

COMMISSIONER CLARK: What if it was clarified to say that it's at least equal to or greater than and it is up to BellSouth to decide if they want to provide a greater than service?

WITNESS VARNER: We have no problem at all with that.

COMMISSIONER CLARK: Okay.

WITNESS VARNER: We just don't want an obligation on us to provide service that is greater than what we provide, you know, greater than the nondiscriminatory access or greater than we provide to our own end users.

BY MS. CALDWELL (Continuing):

Q And I just -- My last line of questioning goes back to your discussion earlier about the notification of the guidelines and business rules on the Web site. You stated in your deposition that the main objective with respect to change notification is that everybody gets notified the same way and that the guaranteed notification is through the Web site; correct?

A Yes.

Q Are you required to provide a -- And I think you also said that you were required to provide a nondiscriminatory means of notice?

A Yes.

Q And that's required through the FCC?

A I'm not sure -- Well, yes, it would be through the FCC. It may be through the Act. I was just trying to recall whether it was a specific rule. It may be just straight out of the Act.

Q And is your Web site the only means of notification that you provide for these changes?

A It's the only one that we commit to. Obviously, as I said, account managers do other things, sometimes sends e-mails, sometimes we do letters. We have the change control process, but our only committed means of notification is through the Web site for all changes.

Q Yesterday in Mr. Thomas's direct testimony, I think Mr. Thomas indicated that ITC wanted to be individually noticed by BellSouth of any changes in the business rules; are you aware of that?

A Yes.

Q Do you provide any individual notices? And I think you testified that you provided individual notices, but that was not your normal practice. It was simply the -- what is it -- not the technician.

A Account manager.

Q Account manager.

A Yes, we're not committed to do that. We don't -- We're not obligated to do that. But if an account manager wants to send an e-mail to their client, we're certainly not going to say don't do that. They can't do it before we do the e-mail, I mean, the Web notification anyway. So, it doesn't change -- It doesn't affect our nondiscriminatory obligation because we've given the Web notice. Everybody has been on notice at the same time through that. If the account manager subsequently wants to come along and send an e-mail, that's fine. We don't have a problem with that. But it's not a commitment or obligation.

Q Would you say or do you know whether BellSouth would be prohibited from providing individual e-mail notices?

A We would -- Per se, I don't think we would. We would be prohibited from doing it in a manner, I think, that didn't give the notice to people, you know, sort of like same notice to people at the same time.

Q Right.

A Whatever method we came up with, if we were to do e-mail, we would have to insure that everybody got it, you know, at the same time, which is a little difficult, you know, to do. And then if somebody didn't get it, you always run into this problem of, okay, well, have you missed your obligation or violated something or something as a result of that. To avoid all of that is why we just use the Web site.

MS. CALDWELL: That's all I have.

Thank you.

WITNESS VARNER: Thank you.

COMMISSIONER JACOBS: Going back to the issue of IDLC.

WITNESS VARNER: Yes.

COMMISSIONER JACOBS: You heard the testimony, I think it was by Mr. Hyde, about the detriment that they experienced when they go to the UDLC.

First of all, would you agree that those, that those would be legitimately experienced by a CLEC that looks to have the same functionality as what you'd have on that loop?

WITNESS VARNER: I can't swear to it, but they do -- What he describes sounds reasonable to me. I mean, I don't have any reason to disagree, when he was talking about the thing with the v.90 modem.

COMMISSIONER JACOBS: Right, high-speed modem.

WITNESS VARNER: And if it's on IDLC it might work and then if you move it and add the additional analog digital conversions, then it may not work. That sounds reasonable to me. But -- I didn't mean to cut you off.

COMMISSIONER JACOBS: That's okay.

WITNESS VARNER: The problem there, though, is that it sounds like Mr. Hyde's problem is not with us, it's with the standards setting of bodies. You see, when we provide an unbundled loop, if we're providing, in this case, if he's, the one he's talking about is a two-wire analog loop. I mean, that's what he's looking for in that case. The standards bodies have set up a set of technical specifications that a two-wire analog loop must meet. And no matter what technology we use, whether it's UDLC, plain copper wire, next generation digital loop carrier, or whatever, we're obligated to provide them a two-wire analog loop that meets those standards, those technical specifications.

Those technical specifications do not guarantee that the modem he described will work. Those technical specifications only provide for the ability to transmit at 9600 cycles per second, or 9.6 kilobytes. That's all those specifications provide for.

Now, we all know that many of the loops give you an ability that's greater than that. You can go over a speed that's greater than that. But none of that is guaranteed.

So, if he wants an unbundled loop that will meet those higher specifications, it seems to me that he wants something other than the two-wire analog unbundled loop. And they are the loops that give him higher specifications that he can purchase if that's what he wants to do. But for a two-wire analog loop, it doesn't have to meet those specifications.

COMMISSIONER JACOBS: You anticipated my next question then. And that was what should the CLEC do that's looking to have that?

WITNESS VARNER: I would say he would have to purchase another type of unbundled loop that has a higher set of technical specifications that enables him to do what it is that he needs to do.

COMMISSIONER JACOBS: Now, you described a -- You described a specification earlier, and I'm sorry, I can't remember the details of it. In the cross examination I think you described some kind of a, what I described earlier as a digital patch.

WITNESS VARNER: Oh, yeah; uh-huh.

COMMISSIONER JACOBS: Is that something, that little segment that you described, is that something that's available as a UNE?

WITNESS VARNER: No. I recall Mr. Hyde talking about that.

COMMISSIONER JACOBS: When you -- Later on, not associated with the discussion by Mr. Hyde, you described a -- I'm sorry -- I'm way beyond my technical competence right now -- but you described a facility whereby, I think what you said was if they wanted to get that kind of functionality, they could have this kind of an arrangement.

WITNESS VARNER: I think with the enhanced extended loop?

COMMISSIONER JACOBS: Yes. No; was it? I don't think it was. I think it had to do with IDSL. And the question had to --

WITNESS VARNER: Oh, yeah, I remember, from Ms. Caldwell.

COMMISSIONER JACOBS: May have been, but described an arrangement.

WITNESS VARNER: Yes, I recall now.

COMMISSIONER JACOBS: Is that something that is technically feasible?

WITNESS VARNER: Yes. That's technically feasible, but what that means is that DeltaCom puts in the IDLC system. It's their IDLC system.

COMMISSIONER JACOBS: And you said they would run the IDLC system?

WITNESS VARNER: They would have to put in the IDLC system in order to do that. And then what we would do is we would give them a loop distribution facility from the end user's premises. We would bring it into -- some way we would have to cross connect over to their IDLC system, they put in their own, and then off they go.

COMMISSIONER JACOBS: And they would have to do that by some other arrangement other than UNE?

WITNESS VARNER: Oh, yeah; they'd have to purchase that from a vendor, just like we would. They purchase their own. And some companies have insisted on us just providing loop distribution. I don't know that any of them do IDLC, but all they purchase from us is loop distribution instead of the full loop.

That's a sub loop element. You know, instead of just getting the whole loop, you can just get a piece of the loop. And there are several sub loop elements; loop distribution is one of them. So, that's -- If they were concerned about IDLC, that's a way they could do it: purchase loop distribution from us, put in their own IDLC system, they can integrate that into their switch, and off they go.

COMMISSIONER JACOBS: Okay. Thank you.
COMMISSIONER CLARK: Redirect.
MR. ALEXANDER: Yes. Thank you.

REDIRECT EXAMINATION

BY MR. ALEXANDER:

Q Mr. Varner, you were asked some questions regarding other state commissions' decisions regarding what's known as the enhanced extended loop, or EEL; do you recall that?
A Yes.
Q Mr. Adelman specifically asked you about whether the Alabama Commission had issued an order regarding enhanced extended loops; do you remember that?
A Yes, I do.
Q How does the Alabama Commission speak? Is it through written orders?
A Yes, they do.
Q Do you know whether or not there has been a written order issued by the Alabama Commission on the issue of extended enhanced loops?
A There has not been.
Q You were also asked some questions about both the regulatory as well as the legal, that is, the FCC rules were issued from a regulatory agency and they've gone through the legal process, the Eighth Circuit, U.S.

Supreme Court; do you recall that?

A Yes.

Q And, in fact, you discussed, I believe, the status of the rules are back in front of the FCC and in front of the Eighth Circuit; is that correct?

A Yes.

Q What is your understanding of the Supreme Court's reinstating the FCC's Rule 315(b) regarding currently combined network elements, Mr. Varner?

A What the Supreme Court did was that when they reinstated that rule, what they said was that was to keep us from separating elements that were already combined. And somewhere I've got a copy of the -- Here it is.

Out of the Supreme Court's opinion, and here they're describing their reinstatement of 315(b) and their rationale for it. And they say, "As the Commission explains," referring to the FCC, "if," being rule 315(b), "is aimed at preventing incumbent LECs 'from disconnecting previously connected elements over the objection of the requesting carrier, not for any productive reason but just to impose wasteful reconnection costs on new entrants.'" And the part starting "from disconnecting" to "new entrants" is in quotes.

So, what the Court, based on that position of the FCC, what the Court said is that Rule 315(b) forbids an incumbent to separate already combined network elements before leasing them to a competitor.

And it's those statements by the FCC and the Court which form the basis for my belief that in order for these things to be currently combined, these units be currently combined, they have to already be in place and already providing service to an end user because that's what these words seem to say to me.

COMMISSIONER JACOBS: Always retail?

WITNESS VARNER: Yes.

BY MR. ALEXANDER (Continuing):

Q And the end user you're referring to, is that the end user of the incumbent LEC?

A Yes.

Q If DeltaCom requests, as they're asking this Commission to do through this arbitration, an extended and enhanced loop, and they've asked for, in aberration of that they've asked for it to be hooked to a service, an access service; is that right?

A Yes.

Q If they ask for the combination of UNEs, that is the loop, cross connect and actual transport, in order to provide service to a new customer, under Rule 315(b) that's been reinstated, is BellSouth required to do that

in your opinion, Mr. Varner?
A No, we're not.
Q You were also asked some questions about notice of business rules?
A Yeah.
Q And when those are changed and the type notice we provide to ALECs; do you recall those discussions?
A Yes, I do.
Q I believe Ms. Caldwell asked you some questions about it, and Mr. Adelman, and I believe Commissioner Clark also asked you questions about it. Could you describe the impact, if any, on Bellsouth's obligations to provide nondiscriminatory access to ALECs if e-mail notices are required to be sent out for business rule changes?
A Yes. We've talked about a few of them. For example, timing; we've got to insure that everybody is notified at the same time. You run into these problems of insuring that people get notified.
With the Web site, we know everybody gets notified because everybody is getting the same message and they're going to get it from the same place.
You may even run into problems with content. The problem is that when you do this sort of fragmented way of doing it, you create a process that gives you the

potential to add additional error into the notification process.

Had this been a better way to do it, we would have done that in the first place.

COMMISSIONER JACOBS: How does one know to look at the Web site?

WITNESS VARNER: They monitor it. All the CLECs do that and DeltaCom does that. They monitor the Web site for, you know, changes.

This isn't the only thing that goes into that Web site. There is all kinds of information on that Web site. That's where they go to get performance measurements and just about any information that we have concerning their account.

BY MR. ALEXANDER (Continuing):

Q And just to be clear as well, you were asked some questions about releases, not just changes in business rules, but, for example, releases that are coming out of the -- I believe its the EICCP?

A The change control process.

Q The change control process where ALECs and BellSouth, you know, work together cooperatively to look at how --

MR. ADELMAN: Objection; Commissioner, this is testimony. This isn't a question.

MR. ALEXANDER: I haven't even finished my question. And I need -- It's not leading --

MR. ADELMAN: I object to the form of the question.

MR. ALEXANDER: It's not leading to lay a predicate for a question.

COMMISSIONER CLARK: Go ahead, Mr. Alexander; I'll listen to your question.

MR. ALEXANDER: Thank you.

BY MR. ALEXANDER (Continuing):

Q Mr. Varner, do you recall being asked questions regarding not just changes in business rules, but whether or not new releases that have been the product of the change control process, providing notices about those as well?

A Yes.

Q Do you know whether or not those are subject to the notice requirements as well?

A Yes. We, even though the ALECs are involved in actually developing those and already know about them, we still post those on the Web site, just like we do any other change that we make.

Q Mr. Varner, you were also asked some questions by several different folks regarding reciprocal compensation and the service that's provided ISPs; do you recall those decisions?

A Yes.

Q Do ISPs pay for the services that they are provided either through the incumbent LEC or the ALEC today?

A Oh, yes, they do. They pay whatever the business exchange rate and the subscriber line charge for their service.

Q Does BellSouth know whether or not DeltaCom is recovering its costs for providing -- for handling an ISP call?

A No, we don't because DeltaCom has not produced any cost studies. So, I don't know that they're recovering their cost. The one thing we do know, though, is that the only revenue that's available to cover anybody's cost, theirs or ours, is being collected by them from the ISP.

Q To your knowledge, does the customer pay the ISP to have access to the Internet?

A Oh, absolutely. That's how they do it.

Q And when a call to the Internet takes place, is the end user acting as a customer of BellSouth or of the ISP in your opinion, Mr. Varner?

A He's the ISP's customer. He's paid the ISP. That's who he is getting his service from. That's who he contacts if he has any problems with that service and so forth. Now, an ISP may call us if it's our fault or something like that. But that's -- He's an ISP customer.

Q Do you know how rates were set for local service, Mr. Varner?

A I'm ashamed to admit that I do. Not ashamed to admit, but for the reason that I've been around it for that long.

Q Were the rates that are in place today here in Florida for basic local exchange set to include the costs that BellSouth incurs for its part in handling the calls made to ISPs?

A No, it was not.

Q Given that fact, do the basic local exchange rates that are in place today cover Bellsouth's costs for handling an ISP call?

A No, they do not.

Q Mr. Adelman asked you some questions about BellSouth customers making calls to a doctor's office and then he compared that to a BellSouth customer and making calls to ISP customers. In both those situations, they were customers of DeltaCom; do you recall that discussion?

A Yes, I recall that.

Q And he asked you if those calls use the same physical facilities?

A Yes.

Q Talking about the network facilities?

A Yes, I recall that.

Q Are there differences between those type calls, the nature of those calls?

A Yes, there are.

Q What are the differences?

A The difference is in the service provided. In the one case, with the doctor's office, that's a local call. I don't think there is any dispute over that.

The problem is that with the other service, it's not a local call. It's an access service. And when you start dealing with an access service, in that case, the ISP is the customer for the service. The ISP is the one that's paying the local companies for the service that's being provided to them.

Q Do you recall Mr. Adelman -- I'll have to lay another predicate. You were asked some questions about your statements, I believe, in response to Commissioner Clark's questions about the abuses that can occur for reciprocal comps paid for ISP calls?

A Yes.

Q And Mr. Adelman asked you if BellSouth had any evidence, and I believe the quote was, any evidence, even a scintilla of evidence that DeltaCom has any special arrangements with its ISPs that would be subject to that type of arrangement; do you recall that?

MR. ADELMAN: Objection. That was not the characterization. If he wants to get the court reporter to read it back. I asked if ITC^Delta -- If he had even a scintilla of evidence that ITC^DeltaCom had engaged in practices solely for the purpose of generating reciprocal compensation revenue.

MR. ALEXANDER: That's fine. I'll let that --

BY MR. ALEXANDER (Continuing):

Q Do you recall that question, Mr. Varner?

A Yes, I recall that.

Q Do you know whether or not BellSouth has asked questions of DeltaCom through discovery that would relate to that subject matter?

A No, I don't.

Q Okay.

MR. ALEXANDER: May I approach this witness? I have just this copy, but I'll refer to it.

BY MR. ALEXANDER (Continuing):

Q Mr. Varner, I need to show you two since they relate to one another. This is interrogatory 25 that BellSouth propounded to DeltaCom; do you see that?

A Yes.

Q Would you read interrogatory 25 and the response from DeltaCom?

A "For the Florida ISP customers in response to Interrogatory No. 22, please state on an annual basis the total amount billed by DeltaCom for service to those customers from inception of service to present, the amounts of any credit, rebate or adjustments given to such customers, and the total amount of revenue collected from such customers." I recall that now.

Q Finish it, please.

A Oh, "from inception of service to present."

Q What was DeltaCom's response?

A "See response in Interrogatory No. 20 above."

Q And what is the response? Do you see No. 20 in the response? What's the response to No. 20?

A "ITC^DeltaCom objects on the grounds that the information requested is not relevant to any issue in the proceeding, nor is it reasonably calculated to lead to the discovery of admissible evidence. Furthermore, BellSouth is a direct competitor of ITC^DeltaCom and this information is highly confidential and proprietary."

Q So, when Mr. Adelman asked you if BellSouth has even a scintilla of evidence regarding that matter, BellSouth has asked DeltaCom for it but DeltaCom has refused to provide any information regarding that?

A That's correct.

Q I want to go back to some questions I believe Commissioner Clark asked you about parity. Mr. Varner, is it necessary to have a definition of parity included in the parties' Interconnection Agreement?

A No, I don't believe that there is.

Q Has the FCC defined parity in some order?

A Not really. The FCC has defined nondiscriminatory access. Parity is a term that DeltaCom has really created with their own definition.

Q Has nondiscriminatory access been defined differently depending on whether it's interconnection, resale or access to UNEs?

A Yes, it has.

Q And you indicated, I believe, to Commissioner Clark that BellSouth certainly is willing to provide the equal to and, if it desired to, would volunteer to provide more than that to DeltaCom; do you recall that?

A Yes.

Q Doing that voluntarily, do you know whether or not, if it's technically feasible, would that be a part of that requirement?

A Oh, absolutely; it would have to be.

Q And do you know whether or not BellSouth might ask for some compensation to provide a superior service?

A Yes. My understanding, as I understood it, is that what we were saying is that under that language, we would only be obligated to provide equal to. If we wanted to provide greater than, we were not precluded from doing that. But that's obviously going to be subject to us working that out with DeltaCom in terms of terms, conditions, prices, and whether we even wanted to do it. We're not obligated to provide greater than under that arrangement; it's purely voluntary.

MR. ALEXANDER: I have no further redirect, but I do want to say I can give Mr. Adelman a copy of the revisions that took place that bring us to the exhibit, AJV-1, dated October 27th, 1999.

COMMISSIONER CLARK: All right. What we're going to do is just leave the admission of Exhibit 23 pending. You can do that at a break.

But there being no further questions for Mr. Varner, he's excused.

WITNESS VARNER: Thank you.

COMMISSIONER CLARK: All right. We're going to go to Dr. Taylor now.

MR. ALEXANDER: BellSouth calls Dr. William Taylor.

COMMISSIONER CLARK: You have been sworn in, have you not?

WITNESS TAYLOR: No, I haven't.

WHEREUPON,

WILLIAM E. TAYLOR

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

MR. ALEXANDER: May I proceed?

COMMISSIONER CLARK: Yes.

DIRECT EXAMINATION

BY MR. ALEXANDER:

Q Dr. Taylor, would you please state your full name and business address for the record?

A My name is William E. Taylor. My business address is One Main Street, Cambridge, Massachusetts, 02142.

Q And, Dr. Taylor, by whom are you employed and what are your responsibilities?

A I'm Senior Vice President at National Economic Research Associates, Inc. I am head of the Cambridge office and of NERE's telecommunications practice.

Q And could you just briefly describe your educational background and experience?

A BA in Economics, Masters in statistics, Ph.D. in Economics. I was in academic for awhile, teaching at Cornell; did a post doc at Louvain; taught at MIT; spent a lot of time at Bell Labs in the good old days, and then went to Bellcore at divestiture, learned about access charges, and have been doing mostly economics of telecommunications ever since. Came to NERA in 1988.

Q Are you the same William E. Taylor that caused to be prefiled rebuttal testimony on September 13th in this case?

A Yes.

Q And, Dr. Taylor, do you have any changes, corrections, deletions to make to your prefiled rebuttal testimony?

A No, I don't, except for the parts that were struck.

Q And we'll cover those. It was 44 pages and I believe one exhibit?

A Yes.

Q And what was that one exhibit?

A That was my vita.

MR. ALEXANDER: At this time, I believe -- I'm not sure if I have extra copies to hand out -- but there is one issue that will be deleted pursuant to the Commission's order regarding issues in the case. And it would start on page 40 of Dr. Taylor's testimony, line 6. And I believe it goes through --

COMMISSIONER CLARK: Mr. Alexander, are you going to hand that out or not?

MR. ALEXANDER: Well, I don't know if I have -- I have four copies; I can hand that out.

COMMISSIONER CLARK: The court reporter needs one.

MR. ALEXANDER: We will do that.

COMMISSIONER CLARK: And I think maybe if you'd give the Commissioners one, we'd appreciate it.

MR. ALEXANDER: I didn't know if I had enough copies, but we do.

COMMISSIONER CLARK: Thanks. Go ahead.

MR. ALEXANDER: And it goes from -- Really, the only thing that's struck is line 6, beginning on page 40, all the way through line 15 on page 44.

BY MR. ALEXANDER (Continuing):

Q Dr. Taylor --

A I believe you also want to eliminate the part of the introduction. On my copy it's page 4.

MR. ALEXANDER: I thank you for catching that. Actually, there's also a reference on the Table of Contents, the subsection IV, regarding "Performance Benchmarks, Parity, and Penalties," that line will be struck, as well as page 4, line 19 through 38.

BY MR. ALEXANDER (Continuing):

Q Does that capture it all, Dr. Taylor?

A That's all I found.

Q Dr. Taylor, with those changes being struck, if I were to ask you the same questions that appear in your prefiled rebuttal testimony, would your answers be the same today?

A Yes, they would.

Q At this time I would like to have Dr. Taylor's prefiled rebuttal testimony, as modified as discussed this afternoon, as well as his one rebuttal exhibit, admitted in this proceeding.

COMMISSIONER CLARK: His prefiled rebuttal testimony as revised will be inserted in the record as though read.

And his exhibit, WET-1, will be marked as Exhibit 24.

(Exhibit 24 marked for identification.)

MR. ALEXANDER: Thank you.

BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

IN RE:	)
PETITION FOR ARBITRATION OF ITC^DELTACOM	)
COMMUNICATIONS, INC. WITH BELLSOUTH	) DOCKET NO. 990750-TP
TELECOMMUNICATIONS, INC. PURSUANT TO	)
THE TELECOMMUNICATIONS ACT OF 1996	)

REBUTTAL TESTIMONY

OF

WILLIAM E. TAYLOR, Ph.D.

ON BEHALF OF

BELLSOUTH TELECOMMUNICATIONS, INC.

SEPTEMBER 13, 1999

n/e/r/a
Consulting Economists

000910

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

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REBUTTAL TESTIMONY OF WILLIAM E. TAYLOR, Ph.D.
BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION
DOCKET NO. 990750-TP
SEPTEMBER 13, 1999

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 about 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 many state public service commissions, including the Florida Public Service Commission ("Commission"). Since 1983, I have testified or otherwise participated before this Commission about ten times. Most recently, I have appeared before the Commission in Docket Nos. 980696-TP (on sizing and measuring the cost of a state universal service fund) and 980000-SP (direct and reply affidavits on determining fair and reasonable local exchange rates using economic principles) on behalf of BellSouth Telecommunications, Inc. 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. I have also testified on market power and antitrust issues in federal court. 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 the regional Bell companies and their subsidiaries, independent telephone companies, long distance 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 provided testimony or other input to governmental entities such as the Federal Communications Commission ("FCC"), the Department of Justice, the U.S. Congress, state regulatory commissions and legislatures, 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 and regulatory issues raised in the arbitration of an interconnection agreement between BellSouth and ITC^Deltacom Communications, Inc. ("ITC^DeltaCom")—an alternative local exchange carrier ("ALEC"). To this end, I review and comment on the testimonies of witnesses for ITC^DeltaCom, principally Don J. Wood and Christopher J. Rozycki, regarding (1) reciprocal compensation for traffic sent to Internet service providers ("ISPs"), (2) non-recurring charges ("NRCs") for BellSouth's operations support systems ("OSS"), ~~and (3) performance benchmarks, parity, and penalties for non-compliance.~~

Q. PLEASE SUMMARIZE YOUR POSITION ON THOSE ISSUES.

A. My position on the issues is summarized as follows:

I. Inter-Carrier Compensation for ISP-Bound Calls

1. The FCC has ruled that ISP-bound calls are jurisdictionally interstate, not local. Therefore, the proper model of interconnection that applies to ISP-bound calls is not that between an originating ILEC and a terminating ALEC, but that between an originating ILEC and an inter-exchange carrier ("IXC").

2. Reciprocal compensation should not be paid by the originating ILEC for ISP-bound calls. Instead, the ISP should compensate that carrier (and any other carrier that switches the ISP-bound call) for the end-to-end cost caused by the ISP customer, and recover that cost directly from the ISP customer.

3. Contrary to ITC^DeltaCom's view, the ISP is not an end-user (of a serving ALEC) but rather a carrier. Therefore, like the IXC that pays carrier access charges to defray the cost of originating and terminating a long distance call, the ISP should pay analogous usage-based charges to defray costs incurred by other carriers on its behalf to originate an ISP-bound call.

4. Persisting with reciprocal compensation (from the ISP customer's originating ILEC to the ALEC that ultimately switches the call to the ISP) would generate an inefficient subsidy for Internet use, distort the local exchange market, and generate unintended arbitrage opportunities for ITC^DeltaCom and other ALECs. These would be opportunities for those ALECs to specialize in serving ISPs with the sole aim of accumulating reciprocal compensation revenues.

5. Based on the FCC ruling that ISP-bound calls are primarily interstate, two states (Massachusetts and New Jersey) have recently declared that the payment of reciprocal compensation by ILECs originating ISP-bound calls be stopped. Massachusetts

regulators, in particular, have noted that by encouraging arbitrage opportunities, the reciprocal compensation regime of inter-carrier compensation for ISP-bound calls subverts real local exchange competition.

II. Charges for Operations Support Systems

1. ALECs seeking access to the ILEC's OSS must use electronic interfaces and related systems created specifically for that purpose. The economic principle of cost causation requires that (1) OSS-requesting carriers pay for the costs they cause and (2) the prices charged for that purpose reflect the forward-looking costs to provide access to OSS.
2. Access to OSS generates both recurring and non-recurring costs. The non-recurring costs themselves arise from development (of interfaces and the like) and use (associated with every service order). Development costs vary primarily with the amount of capital (degree of automation) built into the interfaces, while use costs vary primarily with the extent of labor required. There is a trade-off between these two types of cost: the higher one is, the lower the other will be.
3. OSS-requesting carriers must be required to pay for both development and use costs. Contrary to ITC^DeltaCom's position, if development costs are not recovered from those carriers, there would be a strong incentive for those carriers to demand interfaces and related systems excessively, in terms of both quantity and quality.

III. Performance Benchmarks, Parity, and Penalties

1. The so-called three-tiered "performance guarantee system" proposed by ITC^DeltaCom for its interconnection agreement with BellSouth calls for penalties or liquidated damages for specified levels of failure by BellSouth to achieve performance benchmarks. This system is unnecessary for assuring acceptable performance, and suitable opportunities for redress are available elsewhere.
2. ITC^DeltaCom chooses its proposed penalties or liquidated damages capriciously and fails to link the size of those penalties or liquidated damages to actual proven economic loss or damage. Therefore, ITC^DeltaCom's proposed method for seeking competitive parity is arbitrary and a potential source of unearned income.
3. If ITC^DeltaCom's ill-conceived performance guarantee system is implemented, there could be a strong incentive for ITC^DeltaCom to engage in moral hazard behavior (which, in economics, is a form of gaming by which one party to a contract may act in ways—within the framework of the existing contract—that create an unanticipated competitive or financial advantage for that party *at the expense of the other party* to the contract). Under moral hazard, the better informed of the two contracting parties has an incentive to induce an increase in the risk of default by—or loss to—the other party. ITC^DeltaCom's performance guarantee system would likely to raise the risk of non-compliance by BellSouth and provide opportunities for ITC^DeltaCom to receive unearned income.

II. INTER-CARRIER COMPENSATION FOR ISP-BOUND CALLS

Q. MR. ROZYCKI STATES [AT 22] ITC^DELTACOM'S POSITION THAT RECIPROCAL COMPENSATION SHOULD BE CONTINUED TO BE PAID FOR ISP-BOUND 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"). Therefore, 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 ISP-BOUND CALLS ARE JURISDICTIONALLY MORE LIKELY TO BE INTERSTATE.

A. The FCC recently stated that it:

> traditionally has determined the jurisdictional nature of communications by the *end points* of the communication and consistently has rejected attempts to divide communications at any intermediate points of switching or exchanges between carriers.[2]

Based on this premise, the FCC explained that calls made to the Internet:

> do not terminate at the ISP's local server ... but continue to the ultimate destination or destinations, specifically at an Internet website that is often located in another state. The fact that the facilities and apparatus used to deliver traffic to the ISP's local servers may be located within a single state does not affect [the FCC's] jurisdiction. ... Indeed, in the vast majority of cases, the facilities that incumbent LECs use to provide interstate access are located

[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 ("Internet Traffic Order"), released February 26, 1999.

[2] Internet Traffic Order, ¶10. Emphasis added.

entirely within one state.[3]

The FCC's reasoning is absolutely correct. A call is said to be terminated when it is *delivered to the called party's premises*.[4] In this sense, an ISP-bound call may transit the switch of the carrier serving the ISP, but the call is then delivered to the Internet web site which, as the FCC noted, may be located outside the state in which the call originated. The FCC made it perfectly plain that what matters for determining jurisdiction is the end-to-end transmission itself, not how many different carriers or facilities handle the Internet call on its way.

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.[5] 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 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

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[3] *Id.*, ¶12. Footnotes omitted.

[4] 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 8, 1996, ¶1040.

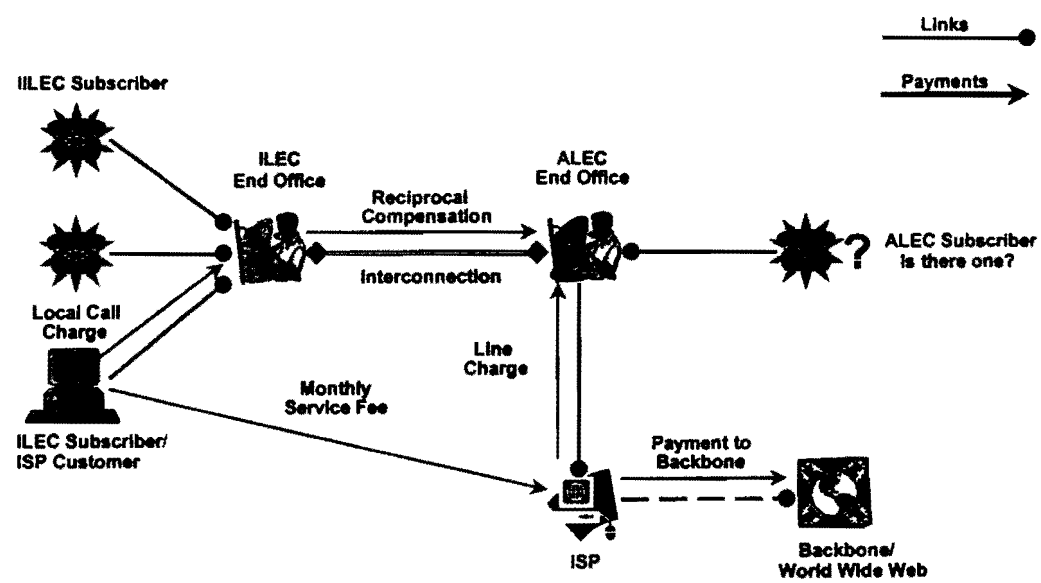
[5] Internet Traffic Order, ¶18.

call would be "jurisdictionally mixed," as the FCC has already correctly determined.

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

A. To understand this point, it is first necessary to recapitulate the erroneous view of the network that underlies ITC^DeltaCom's belief that an Internet call is jurisdictionally local.

Figure 1. Charges and Inter-Carrier Compensation (The ITC^DeltaCom View): Originating ILEC Pays Reciprocal Compensation to Terminating ALEC



This view of the network, depicted by Figure 1, rests on two crucial assumptions:

1. The ILEC subscriber that calls the Internet is acting as a *customer* of the originating ILEC,[6] even when the call goes through the ISP to which it pays monthly access

[6] 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 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.

fees.[7]

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 two assertions by Mr. Rozycki:

> BellSouth's proposal [about reciprocal compensation] discriminates … [by denying] … ITC^DeltaCom the ability to recover its costs for terminating local calls for BellSouth.[8]

and

> The ISP pays for its local phone line, just as any user or receiver of telephone calls.[9]

The first statement confirms ITC^DeltaCom's view that the cost of an ISP-bound call made by the ILEC's subscriber must be recovered from the ILEC. The second statement reflects ITC^DeltaCom's view that an ISP is akin to all end-users. Mr. Rozycki also rules out [at 28] the recovery of any other cost associated with carriage of an ISP-bound call from the ISP.

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 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 ISP-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*

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[7] An implicit assumption here is that the ISP has a point of presence in the local calling area of the Internet caller.

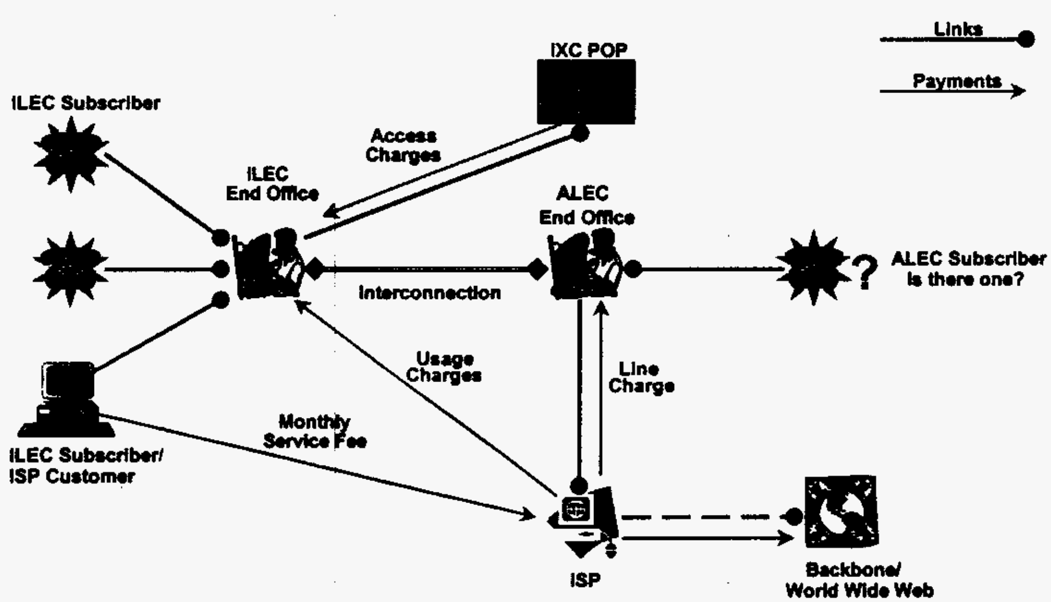
[8] Direct testimony of Christopher J. Rozycki, at 22.

[9] *Id.*, at 27.

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—is explained in Figure 2.

Figure 2. Charges and Inter-Carrier Compensation (The BellSouth View):

ISP Pays Compensation to Originating and Terminating LECs



This view of the network, depicted by Figure 2, rests on two different assumptions:

1. The ILEC subscriber that calls the Internet is acting as a customer of the ISP to which it pays monthly access fees, even though the call is facilitated by 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 (or, ISP-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 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.

Validity for this set of assumptions comes from the principle of cost causation. This principle suggests 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 be usage-based charges analogous 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 a 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 a ALEC customer and BellSouth or another ALEC terminates the call.

Thus, under ILEC-ALEC interconnection (see Figure 1), 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 a 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 a 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 a ALEC[10], 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 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

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

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. Figure 2 shows that 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 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.

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 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 charges analogous to interstate access charges. As far back as 1983, the FCC concluded 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."[11]

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 services.[12] 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 foreign exchange ("FX") lines to haul Internet traffic from considerable distances while still offering service to the ISP customer for the price of a local call.[13] Some ISPs offer 800 service for their customers to access their network when flat-rate local calling is unavailable, although there are some

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

[12] The POCs are points at which the carrier serving the ISP (which may be a ALEC) terminates the ISP-directed call and routes it to the ISP.

[13] 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.

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 ISP-bound traffic is the originating ILEC's subscriber who acts in the capacity of an ISP customer. In this sense, ISP-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 ISP-BOUND CALL?

A. A theoretical difference is that an ILEC subscriber that places a long distance call does not 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 ISP-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.[14] 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 ISP-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, in fact, competitive forces in the ISP market have encouraged ISPs to incur costs and lease facilities so that their customers do not pay additional local exchange costs.

[14] Indeed, if the longer holding times of ISP-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 ISP-bound traffic would effectively charge ISP customers less than incremental cost and ordinary voice customers more than otherwise for local exchange usage.

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 ISP-bound call.[15]

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 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.

Q. HOW DO YOU RESPOND TO MR. ROZYCKI'S BELIEF [AT 26] THAT THE CALLING PARTY SHOULD PAY FOR AN ISP-BOUND CALL?

A. I agree that the calling party (here, the ISP customer) should pay for the ISP-bound call. But that does not logically translate into the requirement that *BellSouth* (whose subscriber happens to be the ISP's customer) should pay part or all of the cost of that call. Instead, from the cost-causative standpoint explained above, the ISP itself and its customer (the true calling party) should pay all facilitating carriers (the ILEC and the ALEC alike) for the ISP-bound call. This is exactly the situation when the ILEC's subscriber makes a long distance call. The costs incurred by ILECs and/or ALECs to carry that call to and from the IXC's network are recovered from the IXC and its long distance customer, not from the carriers that provide access.

Q. IS MR. ROZYCKI CONSISTENT IN HIS OWN VIEW ABOUT REQUIRING THE CALLING PARTY TO PAY?

A. Ironically, no. Mr. Rozycki draws a parallel [at 27] between long distance calls and

[15] 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.

Internet calls, and concludes that each carrier facilitating the carriage of those calls should be compensated. For example, Mr. Rozycki states:

> Calls to the Internet are similar [to long distance calls] in that there are multiple parts to each Internet session. Assuming the call is initiated over standard phone lines, the initial part of the call, its delivery to the … ISP, may be handled by one or more carriers. Each of these carriers plays a roll (sic) in delivering the call to its destination, and as such, *each should be compensated*. [emphasis added]

This opinion reflects both ambivalence and a confused understanding of a "call." Mr. Rozycki appears to conclude, correctly in my opinion, that facilitating carriers should be compensated by those who cause costs. This would fit perfectly with the cost-causative view of compensation that I explained above. Nothing in his statement above provides any logical reason to seek compensation *from* the ILEC (or BellSouth); instead it eloquently makes the case for payment to be made *to* the ILEC (or BellSouth). The rest of Mr. Rozycki's testimony, however, does not square with this statement.

Mr. Rozycki's attempt to break a call down into its parts (based on which carrier is conveying the call at any given point) may be useful for understanding the network configuration that underlies the call, but it says nothing about how the *cost* of the call should be recovered. Instead, understanding the parts helps primarily in determining which carriers participate in the carriage of the call and would, therefore, need to be compensated. For purposes of determining the full cost caused by the calling party, however, it is necessary to view the call from end to end, rather than in its intermediate stages. That is why the FCC declined to view the Internet call in terms of its parts. Instead, in reaching the judgment that Internet calls are generally interstate in nature, the FCC viewed such calls from end to end.

Q. MR. ROZYCKI CLAIMS [AT 28] THAT "IN ESSENCE, BELLSOUTH HAS TOLD ITC^DELTACOM THAT [ITC^DELTACOM] MUST PROVIDE [BELLSOUTH] FREE USE OF [ITC^DELTACOM'S] NETWORK FOR ALL CALLS TO THE INTERNET." IS THIS TRUE?

A. Absolutely not. Quite the contrary, BellSouth does not deny ITC^DeltaCom compensation for the costs it incurs to handle ISP-bound calls. Instead, BellSouth's position, correctly based on cost causation, is that the costs in question should be recovered from the ISP and, indirectly, the ISP customer rather than from BellSouth or any other carrier facilitating ISP-bound calls.

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

A. No. Even though the FCC has recently declared that ISP-bound traffic is, at best, jurisdictionally mixed and is, in most instances, interstate, no rulemaking has yet occurred to establish such charges for ISPs. There remains considerable uncertainty as to when rules to this effect will be established. Also, ISPs are currently beneficiaries of an exemption from paying interstate carrier access charges that has been granted to ESPs since 1983.[16] I understand, however, that the exemption itself 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. IN THE ABSENCE OF FCC ACTION TO ESTABLISH INTER-CARRIER COMPENSATION RULES, HOW HAVE THE INDIVIDUAL STATES ACTED?

A. For a period of time until the FCC's Internet Traffic Order 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 ISP-bound calls just as they would for local voice calls. After the FCC's Internet Traffic Order 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 ISP-

[16] 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.

bound traffic to be antithetical to real competition in telecommunications.[17] More recently, regulators in New Jersey also ordered that reciprocal compensation not be paid for ISP-bound traffic.[18]

Q. WHAT REASONS DID MASSACHUSETTS REGULATORS GIVE FOR THIS REVERSAL?

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 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 ALECs, ISPs, and their customers, at the expense of Bell Atlantic's telephone

[17] 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 Compensation 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 ALECs serving ISPs in Massachusetts currently do not themselves receive any compensation for ISP-bound traffic.

[18] 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.

customers and shareholders.[19]

Q. WHY WOULD THE ILEC-ALEC LOCAL INTERCONNECTION REGIME WITH PAYMENT OF RECIPROCAL COMPENSATION FOR ISP-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 ISP-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.

Q. PLEASE EXPLAIN HOW THE ILEC-ALEC INTERCONNECTION REGIME FOR ISP-BOUND TRAFFIC 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 its call imposes on the circuit-switched network.[20] Suppose inter-carrier compensation for ISP-bound traffic is treated as in the ILEC-ALEC interconnection regime (Figure 1). 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 terminate 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

[19] *Id.* Emphasis added (in part) and in original (in part).

[20] 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.

both the ILEC's incremental cost to originate the call and the ALEC's incremental cost to terminate the call. In other words, once reciprocal compensation has been paid, the ILEC would fail to recover its cost of carrying the ISP-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 terminate an ISP-bound call is *less* than the cost to terminate the average 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 ISP-bound call. Again, the Internet user would not be paying the cost he imposes on the originating ILEC (equivalent to receiving a subsidy).[21]

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 ILEC-ALEC interconnection regime. 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 the termination only of ISP-bound traffic. I discuss the resulting distortion of the local exchange market below.

Q. WHAT IS THE DILEMMA THAT THE ORIGINATING ILEC WOULD THEN FACE WITH RESPECT TO ITS OWN CUSTOMERS?

A. The originating ILEC's dilemma would then be to find a solution to the subsidization problem that is both economically correct and politically feasible. The subsidy to Internet

[21] Ironically, Mr. Rozycki too is worried about subsidization, except he finds it in the wrong place. For example, he asserts [at 23] that "BellSouth is trying to establish a pricing scheme where ITC^DeltaCom and its customers will subsidize the profit margins and the stockholders of BellSouth." This represents not only a distorted view of a subsidy—typically the *price* paid by a group of customers is subsidized, not profit margins—but also turns the actual direction of the subsidy on its head.

use can be eliminated by charging differently for such use than for voice calls. Specifically, this would mean that Internet use is charged a higher rate than other local calls. While this solution would, in principle, appear economically feasible, it would require that ILECs be able to distinguish calls headed for Internet destinations from those headed for non-Internet destinations within the local calling area, and to charge for *each call* accordingly. Assuming that ILECs are able to make that distinction, such a solution would, nevertheless, mark a significant departure from the current practice of charging all customers within the same calling area the same averaged residential local rate on a flat-rated basis (i.e., not per call). A movement in this direction is far from certain at this time.

Q. HOW WOULD THE ILEC-IXC INTERCONNECTION REGIME WITH THE PAYMENT OF ACCESS-LIKE USAGE-BASED CHARGES REMEDY THIS PROBLEM?

A. In the ILEC-IXC regime (Figure 2), 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 exemption from charges analogous to interstate access charges, remains responsible for paying costs of originating, transporting, and switching its traffic to the ISP. Because of the access charge exemption, ILECs and ALECs that jointly supply access services to ISPs are not compensated for those services but, in the ILEC-IXC regime, the ILECs and ALECs that jointly provision ISP-bound calls each contribute 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 ISP-bound traffic. In this regime, an ISP has no particular incentive to become a 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 THE ILEC-ALEC INTERCONNECTION REGIME FOR ISP-BOUND TRAFFIC COULD CAUSE THE LOCAL EXCHANGE MARKET TO BE DISTORTED.

A. Under the ILEC-ALEC interconnection regime, the compensation paid to ALECs evidently exceeds the cost they incur in terminating the traffic and also exceeds whatever costs BellSouth might save when ALECs terminate the traffic. That the prices do not reflect costs should not be surprising. In Florida, interconnection prices are based on BellSouth's forward-looking TELRIC costs of terminating traffic averaged over a wide range of end-users.[22] 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[23] 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, the accuracy of the TELRIC study for the traffic served by that ALEC is critical. If the cost to BellSouth to deliver ISP-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 the inapplicability of the averaged TELRIC to ISP 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.

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[22] Average holding times are significantly longer for ISP-bound traffic: roughly 20 minutes compared with 3 minutes for ordinary voice traffic. Thus, the cost of call setup on a per minute basis is roughly only one-seventh of the per minute cost of call setup for ordinary voice traffic.

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

Q. DOES THAT MEAN THAT RECIPROCAL COMPENSATION IS ILL-ADVISED BECAUSE TRAFFIC BETWEEN THE ORIGINATING ILEC AND THE ALEC THAT TERMINATES ISP TRAFFIC IS UNBALANCED?

A. Yes, but the problem here is not simply that traffic is unbalanced. First of all, ISP-bound traffic is *not* local and, therefore, not eligible for reciprocal compensation, a form of inter-carrier compensation reserved for local interconnection only. However, even on the matter of traffic balance, it is worth noting that reciprocal compensation was never envisioned as appropriate inter-carrier compensation when all traffic is essentially one-way. This would be particularly true when the true cost to terminate for the carrier that only *receives* traffic is actually lower than the termination cost (experienced by the carrier that *sends* traffic) on which a symmetrical compensation arrangement is based. But, even with balanced traffic, requiring reciprocal compensation payments for ISP-bound calls would violate the economic principle of recovering cost in accordance with cost causation.

Q. PLEASE EXPLAIN HOW THE ILEC-ALEC INTERCONNECTION REGIME FOR ISP-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 ISP-bound traffic on the ILEC-ALEC local interconnection regime. When the compensation available to the ALEC for terminating ISP-bound traffic exceeds its actual cost of terminating that traffic, the ALEC will have a strong incentive to terminate as much ISP 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. For example, the ALEC's profits would increase whenever a BellSouth subscriber—or its computer—could be induced to call the ISP and remain on the line 24 hours a day. Sensing this pure arbitrage profit opportunity, ALECs would also have a strong incentive—indeed, have as their *raison d'être*—to specialize only in terminating ISP-bound traffic, to the exclusion of offering any other type of local exchange service. These "ISP-specializing" ALECs can—and do—easily form a three-way axis with the sole purpose of generating revenues from reciprocal compensation: the ALECs themselves, ISPs that have their traffic terminated by those ISPs but may also receive a share of the reciprocal compensation revenues—the spoils of this arrangement—to insure their loyalty and cooperation, and ISP customers on the originating ILEC's network that generate the ISP-bound traffic. Also, the ISPs themselves are better off if their customers obtain their non-Internet local telephone service not from the ALECs that terminate ISP-only traffic but from the ILEC or other ALECs that do not serve ISPs. 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 ("1996 Act").

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.[24]

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.[25]

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

[24] Massachusetts ISP Compensation Order.

[25] Local Competition Order, ¶1093.

rate. Note that the paging case also involves one-way calling; like ISPs, paging companies do not originate traffic.

More recently, the FCC has acknowledged that

> efficient rates for inter-carrier compensation for ISP-bound traffic are not likely to be based entirely on minute-of-use pricing structures. In particular, pure minute-of-use pricing structures are not likely to reflect accurately how costs are incurred for delivering ISP-bound traffic.[26]

This is clear recognition of the fact that TELRIC-based rates are fundamentally unsound for inter-carrier compensation for ISP-bound 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 ALECs, ISPs, and their customers do not make society as a whole better off, because they come artificially at the expense of others.[27]

Q. WHAT DO YOU CONCLUDE IN LIGHT OF THESE ACKNOWLEDGEMENTS?

A. In light of these acknowledgements, it is reasonable to expect that a fairer system of inter-carrier compensation may yet be more widely adopted for all forms of one-way traffic. The ILEC-IXC interconnection regime offers one such alternative. More importantly, under that alternative:

1. perverse incentives and unintended arbitrage opportunities are removed,
2. cost causation guides cost recovery (including the payment of access-like usage-based charges by ISPs to ILECs and ALECs that handle their traffic),
3. more efficient use is made of network resources,
4. inefficient entry for the sake of earning opportunistic arbitrage profits is prevented, and
5. true competition (undistorted by the gain from specializing in terminating one-way traffic) can be realized in the local exchange market.

[26] Internet Traffic Order, ¶29.

[27] Massachusetts ISP Compensation Order. Emphasis added.

Q. MR. ROZYCKI CONCLUDES [AT 28-29] THAT BELLSOUTH'S REFUSAL TO "NEGOTIATE A FAIR PRICE" FOR THE HANDLING OF ISP-BOUND CALLS, IN EFFECT, HOLDS ITC^DELTACOM HOSTAGE BECAUSE ANY FAILURE BY ITC^DELTACOM TO CONTINUE CURRENT TERMS AND CONDITIONS TO THE ISPs IT SERVES WOULD "DRIVE" THOSE ISPs BACK TO BELLSOUTH. IS THAT CONCLUSION CORRECT?

A. No. Mr. Rozycki's conclusion is based on the illusion that the current situation—in which BellSouth is paying reciprocal compensation to ITC^DeltaCom for ISP-bound calls—is economically efficient or socially desirable. Far from it, as I have explained, the payment of such compensation subsidizes Internet calling and distorts local exchange competition. If the cessation of reciprocal compensation were to force ITC^DeltaCom and other ALECs to provide their services to ISPs at cost-based, rather than subsidized, prices, then fair competition (for the business of ISPs) would be restored. ALECs that are thriving currently on a reciprocal compensation-driven strategy of ISP-specialization would then have to abandon those arbitrage opportunities and compete on fair and cost-based terms for the *full* range of network services offered by an ILEC like BellSouth. Such an outcome would clearly be in the public interest and consistent with the goals of the 1996 Act.

III. Charges for Operations Support Systems

Q. IN THIS PROCEEDING, ITC^DELTACOM PRESENTS—MAINLY THROUGH MR. WOOD'S TESTIMONY—ITS VIEW OF THE ECONOMIC ISSUES UNDERLYING THE SUPPLY OF OSS INTERFACES BY BELLSOUTH. IN RESPONSE TO MR. WOOD'S TESTIMONY, FIRST PLEASE EXPLAIN WHAT OSS ARE.

A. OSS include electronic interfaces, databases, and other systems required for various functions, e.g., pre-ordering, ordering, provisioning, maintenance and repair, billing, etc. An ILEC like BellSouth routinely uses its OSS to serve its customers. In its implementation of various competition-related provisions of the 1996 Act, the FCC found that OSS functions are "essential to the ability of competitors to provide services in a fully competitive local service market."[28] The FCC further concluded that "[OSS] and the information they contain fall squarely within the definition of 'network element' and must be unbundled upon request under Section 251(c)(3) [of the 1996 Act]…."[29]

Q. WHAT ARE THE *NON-RECURRING* COSTS ASSOCIATED WITH OSS?

A. There are two economically distinct types of non-recurring OSS-related costs: (1) one-time costs to modify existing and/or build new interfaces that give ALECs access to BellSouth's OSS databases and systems, and (2) non-recurring transactional costs associated with the provisioning of services, i.e., costs to use the necessary interfaces to process a service order.[30] The first type of OSS-related cost may be characterized as an "OSS development cost," and the second type as an "OSS use cost."[31] There is general agreement that the standard for costing in both instances should be forward-looking economic costs.

Q. WHAT IS THE ESSENTIAL DIFFERENCE BETWEEN OSS DEVELOPMENT AND OSS USE COSTS?

A. The difference between the two types of cost is analogous to the difference between fixed and variable costs. OSS development cost is similar to fixed cost: it arises at the point a new OSS is installed or an existing OSS is modified, but the level of that cost does not vary with the number of unbundled network elements ("UNEs") ordered or the actual use of the OSS. The OSS may never actually be used by a ALEC, but the OSS development cost would have been incurred anyway. OSS use cost, on the other hand, is more akin to variable cost, namely, a cost that only arises in connection with use of a resource. Thus, OSS use cost varies with the level of use (with a minimum of zero when no use occurs).

[28] Local Competition Order, ¶522.

[29] *Id.*, ¶516.

[30] Even though I use the shorthand "OSS," it should be noted that my reference throughout is to OSS interfaces that BellSouth builds specifically for use by ALECs. Also, to be precise, while the type of cost in question may arise repeatedly as the interfaces are used to process different service orders, that cost remains fixed, hence, non-recurring *for each individual order*. There are also true recurring costs that are ongoing maintenance costs associated with each service order processed through the interfaces. My testimony does not address these recurring costs although BellSouth is entitled to recover them fully as well.

[31] This terminology roughly parallels that adopted by Mr. Wood in his testimony.

Despite this essential difference, like fixed and variable costs generally, both OSS development and OSS use costs should be measured on a forward-looking basis.

Q. MR. WOOD DISTINGUISHES [AT 14] BETWEEN OSS DEVELOPMENT AND OSS USE COSTS. IS THERE A RELATIONSHIP BETWEEN THOSE COSTS, OR ARE THEY TOTALLY INDEPENDENT?

A. Even though, as explained above, the two costs are different in nature, they may still be related through an important economic trade-off. The level of technology embodied in an OSS is not fixed in the long run. For example, systems may be more or less mechanized or automated, and rely on computer or artificial intelligence, expert systems, etc. to varying degrees. The less automated or complex systems require less human involvement or operation, while highly sophisticated and fully automated systems may require little or no human involvement. In this respect, capital and labor are substitutes, and more capital-intensive systems tend to be generally more expensive.

OSS development cost usually depends more upon the amount and type of capital built into the OSS. Thus, OSS embodying greater amounts of capital (or degree of automation) tend to have higher OSS *development* costs, while OSS that rely on less capital tend to have lower such costs. Since human labor is usually an important use-related or variable cost, the level of OSS use costs varies directly with how much of that resource is used. Thus, OSS that employ more capital but less labor tend to have lower OSS *use* costs, and those that employ less capital and more labor tend to have higher such costs. This inverse relationship between OSS development and OSS use costs is thus a product of the type of OSS installed.

Q. WHAT DECIDES THE OPTIMAL LEVEL OF OSS DEVELOPMENT AND OSS USE COSTS?

A. In a market economy, the actual technology platform that is adopted derives from the choices that suppliers and users of OSS make. No single individual or firm may ultimately be responsible for the system that emerges. Suppliers may have varied preferences about the types of systems they wish to install, how much intelligence they wish to invest in their systems, how quickly they wish to recover the economic cost of their systems, how much of their own labor or other resources they wish to dedicate to the operation of their systems, etc. Users may consider ease of use, availability of their own resources, customer willingness to pay, etc., and different users may value these characteristics differently. It is therefore difficult to determine the overall level of quality of OSS that would emerge in an unregulated, competitive market. Systems for buying and selling stocks or withdrawing money from banks are highly automated and accurate; systems for purchasing airline tickets are labor intensive and relatively more prone to error. In any case, whatever type of OSS emerges, it is certainly the case that—for a given level of quality—the technology platform should minimize the present value of the *combined* OSS development and OSS use costs associated with it. This minimization would take into account the economic trade-off between OSS development and OSS use costs discussed above.

Q. IS BELLSOUTH ENTITLED TO RECOVER ITS OSS-RELATED COSTS?

A. Yes. In light of the FCC's conclusion that OSS are network elements to which requesting carriers (e.g., ALECs) must be granted non-discriminatory access,[32] cost recovery for OSS should occur in the same manner as designated for other UNEs. Specifically, Section 252(d)(1)of the 1996 Act provides for recovery of the costs of UNEs and describes the methodology for doing so. This provision allows the UNE provider (such as BellSouth) to charge just and reasonable rates that are (1) based on forward-looking cost, (2) nondiscriminatory, and (3) inclusive of a reasonable profit.

Q. MR. WOOD SUGGESTS [AT 14] THAT OSS DEVELOPMENT COSTS (WHICH HE LABELS "TRANSITION COSTS") MAY NOT BE RECOVERED FROM OSS-REQUESTING CARRIERS BY BELLSOUTH. HAS EITHER THE 1996 ACT OR THE FCC LIMITED RECOVERY TO SOME, BUT NOT ALL, OSS-RELATED COSTS?

A. No. The 1996 Act makes no specific mention of OSS. In its implementing rules, the FCC

[32] Local Competition Order, ¶523 and ¶525.

has declared that OSS be treated just like any UNE. The FCC has never specifically limited recovery to some, but not all, OSS-related costs. From this, I conclude that the FCC has intended all along that the provider of OSS should be able to recover *all* costs related to the development and use of OSS. As explained above, these costs include both one-time and ongoing costs.[33]

Q. WHAT ECONOMIC PRINCIPLE GOVERNS THE MANNER IN WHICH THE COST OF ANY SERVICE SHOULD BE RECOVERED?

A. As I stated earlier, the economic principle that determines how the cost of a service should be recovered is cost causation. Requiring that entrants into a regulated market pay for the costs caused by their entry ensures that only efficient entry takes place. After the 1996 Act was passed, the FCC issued a *Notice of Proposed Rulemaking* in which it described its purpose as being:

> not to ensure that entry shall take place irrespective of costs, but to remove ... barriers ... that inefficiently retard entry, and to allow entry to take place where it can occur efficiently.[34]

Economists concur with this objective because it recognizes that entry into markets previously served by single suppliers, and subsequent competition in those markets, are not ends in themselves.[35] Rather, social policy should favor entry and competition where such entry ensures that customers *are made better off*. Where social policy mistakenly attempts

[33] Thus far, this Commission has left it to the interconnecting local exchange carriers themselves to work out terms and conditions for the provision of OSS interfaces. In its Order No. 98-0604-FOF-TP (in Docket Nos. 960757-TP, 960833-TP, and 960846-TP), the Commission noted that both the FCC and the Eighth Circuit Court of Appeals have deemed that OSS be regarded as UNEs and priced accordingly. In that Order, the Commission deferred the setting of rates for recovery of OSS-related costs to a future proceeding and, in Order No. 99-1013-FOF-TP (in Docket No. 981052-TP), reaffirmed that such rates would be determined in a future generic cost proceeding, not as part of an ongoing arbitration. Even though the Commission had earlier suggested (in Order No. 96-1579-FOF-TP in Docket Nos. 960833-TP, 960846-TP, and 960916-TP) that OSS-related costs be recovered in the same manner as costs of local number portability—under the standard of competitive neutrality, i.e., entrants and incumbents alike are responsible for cost recovery—the applicable cost recovery standard for UNEs (such as OSS) is instead "cost plus a reasonable profit," as noted above.

[34] *Notice of Proposed Rulemaking* ("NPRM") in CC Docket 96-98, ¶12.

[35] Adam Smith reminded us that with sufficient money and will, Scotland could enter the wine market and compete with France but that Scottish consumers—and surely Scottish oenophiles—would not necessarily be made better off by the experience.

to ensure the entry and survival of suppliers that are *less* efficient than incumbents, consumers typically end up paying for those protections in the form of higher prices or poorer service.

Q. HOW DO THESE PRINCIPLES APPLY TO OSS-RELATED COSTS?

A. Cost causation determines the source of a cost and assesses charges on that source for effecting full cost recovery. If BellSouth develops OSS for its own use, then it alone should properly be responsible for recovering all OSS-related costs. However, if BellSouth has to develop OSS for use by *other* carriers, then those other carriers should be responsible for recovery of the additional OSS-related costs caused directly by them. Any failure to charge those other users of BellSouth's OSS for the additional OSS costs they cause—especially costs to develop OSS—would only generate perverse incentives and encourage inefficient behavior by the users. Specifically, carriers requesting access to BellSouth's OSS would then have an incentive to do so excessively, in terms of both quantity and quality. This incentive could be strong because higher up-front OSS development costs incurred to construct more sophisticated systems can actually lower transactional or OSS use costs. If entrants are not charged for OSS development costs, it would clearly be in their self-interest to insist upon the construction of the most sophisticated OSS-related interfaces and systems imaginable, e.g., those with complex error-processing systems that make human intervention unnecessary. The cost of the ongoing use of OSS in such an environment would be lower than with less sophisticated systems, but the *total* economic cost of the OSS interface or capability could conceivably be higher, leaving society worse off. It does not pay to automate every transaction, and it may not be cost-effective to minimize human intervention. Rather, public policy must recognize the trade-off between OSS development costs and OSS use costs when determining what OSS-using entrants must be responsible for paying. If the cost causation principle is not reflected equally in the prices paid to recover *both* of these types of costs, entrants will demand excessively capital-intensive systems, and costs to telecommunications users will be higher than necessary.

Q. MR. WOOD FURTHER ASSERTS [AT 14] THAT OSS DEVELOPMENT COSTS ARISE FROM THE 1996 ACT'S REQUIREMENT THAT LOCAL EXCHANGE MARKETS BE OPENED TO COMPETITION AND SHOULD, THEREFORE, HAVE TO BE ABSORBED BY INCUMBENT CARRIERS LIKE BELLSOUTH. DO YOU AGREE?

A. No. The notion proffered by Mr. Wood that by writing the Act, Congress is causally responsible for OSS development costs is incorrect as a matter of regulatory economics. In telecommunications, regulatory bodies have frequently required regulated firms to undertake costly investments that are subsequently recovered from the customers who use the facilities. For example, when classified as a dominant firm, AT&T was required to maintain sufficient capacity to provide long distance service to any customer in the U.S. at geographically averaged rates. Arguably, some costs would be incurred even if no customer demand materialized. Nonetheless, AT&T's capacity costs were recovered—on a usage basis—in its retail prices charged to its own end-users, not from telecommunications users in general.

Q. DO YOU AGREE WITH MR. WOOD'S BELIEF [AT 15] THAT ANY EFFORT BY BELLSOUTH TO IMPROVE ITS OSS WILL EVENTUALLY IMPROVE ITS OWN EFFICIENCY AND BENEFIT ITS OWN CUSTOMERS?

A. No, I disagree with Mr. Wood's implication that BellSouth's customers will benefit from OSS development requested by ALECs and that, therefore, the cost of such development ought to be absorbed by BellSouth. First, Mr. Wood ignores the fact that the OSS development costs at issue here pertain *solely* to the interfaces and systems that BellSouth has developed to serve ALECs like ITC^DeltaCom.[36] Therefore, Mr. Wood errs in at least three respects. First, he confuses OSS development costs to serve ALECs with those BellSouth incurs to serve its own customers. Second, he ignores cost causation: even if BellSouth's customers were somehow to benefit—which they do not—from BellSouth's

[36] Direct testimony of Alphonso J. Varner in this proceeding.

development of OSS for ITC^DeltaCom or other ALECs, it would be improper to ignore the basic underlying fact that ITC^DeltaCom and other ALECs remain the cost causers from whom cost should be recovered. Third, benefits are never the economically proper basis for pricing or cost recovery. A price is charged to recover a cost, never to "tax" a benefit.

Q. DO YOU AGREE WITH MR. WOOD'S CONTENTION [AT 16 AND FN. 4] THAT MAKING ALECs LIKE ITC^DELTACOM PAY FOR THEIR OWN OSS DEVELOPMENT AND USE COSTS AS WELL AS BELLSOUTH'S OSS COSTS WOULD CONFER A SUBSTANTIAL COMPETITIVE ADVANTAGE ON BELLSOUTH AND DISCOURAGE ANY LOCAL COMPETITION?

A. No. If what Mr. Wood claims were true, then I would agree with his contention. But, as stated above, Mr. Wood fails to distinguish between OSS-related costs (such as for interfaces and related systems) attributable to ALECs like ITC^DeltaCom and BellSouth's own OSS costs. This failure alone invalidates his contention. In addition, Mr. Wood overlooks the fact that the OSS that BellSouth uses to serve its retail customers are already in place. BellSouth does not recover the costs associated with its own OSS by charges to other carriers, as it would—and should—for OSS-related costs caused by those other carriers. Instead, BellSouth recovers its own OSS-related costs through its retail prices, and has been doing so all along.

Contrary to Mr. Wood's view, making BellSouth pay for OSS development costs caused by ALECs would not only confer a substantial competitive advantage *on the ALECs*, it would encourage ALECs to demand OSS from BellSouth in excessive quality and quantity. As I explained earlier, because of the economic trade-off between OSS development costs and OSS use costs, this would allow ALECs to artificially lower their costs and would encourage entry by relatively inefficient competitors. Thus, society would be worse off under such an arrangement even as the ALECs are able to harness an unjustified private gain for themselves.

Q. SHOULD BELLSOUTH BE MADE TO RECOVER OSS DEVELOPMENT COSTS

INCURRED ON BEHALF OF ALECs LIKE ITC^DELTACOM FROM ITS OWN RETAIL CUSTOMERS?

A. No. In competitive markets, firms recover costs from the customers who cause the costs. For example, AT&T, MCI and Sprint recover the OSS costs they incur to serve resellers from the recurring and non-recurring prices they charge those resellers, not from their retail customers. Were they to attempt to raise retail prices to subsidize their wholesale customers, they would face two insurmountable problems:

1. a competitive handicap in the retail market because other equally efficient facilities-based carriers could underprice them, and
2. an inefficient margin between the prices of their resold services and of their retail services such that an equally efficient reseller could underprice them.

In any event, this issue is now moot in light of the Commission's acceptance of the principle that OSS development costs should be recovered from OSS-requesting carriers.

Q. DO YOU AGREE WITH MR. WOOD'S RECOMMENDATION [AT 18-19] THAT IN ORDER TO ASSURE ALECs NON-DISCRIMINATORY ACCESS TO OSS, THE OSS DEVELOPMENT COSTS SHOULD, AT THE VERY LEAST, BE RECOVERED IN A "COMPETITIVELY NEUTRAL" MANNER FROM *ALL* RETAIL CUSTOMERS, REGARDLESS OF THEIR LOCAL SERVICE PROVIDER?

A. No. Mr. Wood begins by asserting—correctly, in my opinion—that competitively neutral recovery of OSS development costs occurs when each carrier is held fully responsible for "its own OSS." Mr. Wood's assertion, however, is incomplete; I would add that each carrier should be responsible for the OSS costs (both development and use-related) that it *causes*. Under that principle, cost causation would be respected, and cost recovery would be economically efficient. However, in light of the general tenor of Mr. Wood's testimony, I interpret his assertion to mean that the OSS development costs incurred by BellSouth to serve ITC^DeltaCom's needs should be BellSouth's alone to bear. As I explained earlier, that is an unacceptable conclusion from the standpoint of standard economic theory. Were this Commission to decide that BellSouth's OSS development costs arising from having to serve ITC^DeltaCom (or other carriers) should not be recovered by BellSouth alone, Mr. Wood asks that those costs be recovered equally from *every* retail customer in the local service market.[37] In other words, Mr. Wood recommends the use of a surcharge on *all* local access lines (regardless of which carriers provide them) for recovery of the OSS development costs borne by BellSouth on behalf of ITC^DeltaCom and other carriers. This, too, is unacceptable from the standpoint of economic theory.

OSS development costs incurred on behalf of ITC^DeltaCom or other carriers is a fixed cost that must be recovered from the ALECs that caused them. Failure to do so would only create a subsidy for ITC^DeltaCom or other carriers, and the creation of any new subsidy would be bad public policy. The 1996 Act clearly intended to eliminate implicit subsidy flows and to extend competition into the local and long distance markets. Competition that depends on a flow of subsidy to survive in a market is inefficient and not worth having, in the sense that Florida customers would not benefit from such competition in terms of price and service quality.

Nonetheless, even if it were (incorrectly) determined that any of the services provided to ALECs should be subsidized, funding that subsidy by a charge proportional to the number of lines served would not be competitively neutral. First, that would assign the bulk of the OSS development costs to BellSouth itself, at least in the early years of local competition when BellSouth would serve the overwhelming majority of local access lines in its service area and when those OSS development costs could be substantial. Second, any assessment on access lines would not be competitively neutral unless all competitors (incumbents and entrants alike) could pass that (per-line) charge through to customers on a flat-rated basis if they so chose. Only such flat-rate recovery would match the recovery of fixed costs and would ensure that all end-users pay the same fixed contribution toward the wholesale subsidy, regardless of the carrier from which they take their local service. Even then, the competitive playing field would not be level because BellSouth's *wholesale* OSS services would still be receiving a subsidy from BellSouth's retail customers, which would give an advantage to those ALECs that use BellSouth's OSS to compete against

[37] A similar view is expressed by Mr. Rozycki, on behalf of ITC^DeltaCom, at page 14 of his testimony.

BellSouth's retail services.

If flat-rate recovery from end-users is also ruled out, then it would be more efficient to assess all carriers in proportion to their OSS *transactions* rather than in proportion to access lines because OSS transactions are more likely to be closely linked to the OSS costs in question. Customers that place no demands on OSS should not—to the extent possible—have to pay for OSS development and use costs.

Q. MR. WOOD WORRIES [AT 10] THAT "EXCESSIVE OR UNNECESSARY NRCs INHERENTLY CONSTITUTE BARRIERS TO COMPETITION." IS HIS WORRY JUSTIFIED IN THE CONTEXT OF THE NRCs FILED BY BELLSOUTH IN THIS PROCEEDING TO RECOVER OSS-RELATED COSTS?

A. No. While as a general proposition, I would agree with Mr. Wood that any "excessive or unnecessary" charge that raised a competitor's cost asymmetrically could constitute a barrier to entry, his application of that proposition to the context described is unjustified. NRCs cannot be a barrier to entry as long as two fundamental principles are observed: (1) the true cost causer is assessed the NRCs for the purpose of recovering costs caused directly by it, and (2) NRCs are set, as I discussed earlier, on the basis of a forward-looking pricing methodology. In the current context, NRCs should be assessed to ITC^DeltaCom and other OSS-requesting carriers on the basis of the forward-looking OSS development and use costs caused by those carriers. Those NRCs would, of course, exclude OSS-related costs arising from BellSouth's own needs for OSS to serve its retail customers.

Q. MR. WOOD TAKES ISSUE [AT 11] WITH BELLSOUTH'S OSS COST STUDY BECAUSE IT ALLEGEDLY REFLECTS BELLSOUTH'S "EXISTING SYSTEMS," WHICH, HE CLAIMS, PROVIDES NO INCENTIVE TO BELLSOUTH TO SUPPLY OSS CAPABILITIES "EFFICIENTLY AND IN A NON-DISCRIMINATORY MANNER." DO YOU AGREE?

A. No. Mr. Wood appears to be advocating the use of a hypothetical network (one BellSouth is never likely to have or build toward) for the purpose of calculating forward-looking OSS-related costs. This is exactly the standard that the FCC rejected in explaining how total element long run incremental cost ("TELRIC")—the forward-looking cost measure for a UNE—should be estimated. First, the FCC noted:

> [f]orward-looking cost methodologies, like TELRIC, are intended to consider the costs that a carrier would incur in the future. Thus, a question arises whether costs should be computed based on the least-cost, most efficient network configuration and technology currently available, or whether forward-looking cost should be computed based on incumbent LECs' existing network infrastructures ... The record indicates three general approaches to this issue. Under the first approach, the forward-looking economic cost for ... unbundled elements would be based on the most efficient network architecture, sizing, technology, and operating decisions that are operationally feasible and currently available to the industry.[38]

The FCC, however, rejected this standard because:

> this approach may ... discourage facilities-based competition by new entrants because new entrants can use the incumbent LEC's existing network based on the cost of a hypothetical least-cost, most efficient network.[39]

Instead, the FCC adopted a third approach that calculates costs using the most efficient technology *actually deployed* in the incumbent carrier's current wire centers:[40]

> prices for ... access to unbundled elements would be developed from a forward-looking economic cost methodology based on the most efficient technology *deployed* in the incumbent LEC's current wire center locations.[41]

The FCC explained its choice of a standard for calculating costs thus:

> [t]his benchmark of forward-looking cost and existing network design most closely represents the incremental costs that incumbents actually expect to incur in making network elements available to new entrants ....[42]

This standard is, in fact, close to the economic standard for setting efficient prices. Thus, costs calculated according to the FCC's meaning for TELRIC should reflect the costs that

[38] Local Competition Order, ¶683.

[39] *Id.*

[40] In ¶684 of the Local Competition Order, the FCC considered and rejected embedded costs as another possible measure of cost for a UNE.

[41] Local Competition Order, ¶685. Emphasis added.

[42] *Id.*

efficiently-functioning ILECs actually expect to incur on a going forward basis. In particular, according to the FCC's implementation of TELRIC, costs for OSS should be based on the technology actually being deployed by BellSouth, not upon technologies that are—or may become—available but are not deployed. From that standpoint, BellSouth's cost study rests on an assumption of a forward-looking network configured with technology actually deployed by BellSouth that is consistent with the FCC's stated TELRIC methodology. As for Mr. Wood's contention that nothing short of a hypothetical network configured with technology that BellSouth may never deploy can induce efficient behavior or produce efficient NRCs, the burden remains on Mr. Wood and ITC^DeltaCom to demonstrate that such a claim is indeed true. That demonstration must, in addition, pay heed to the FCC's explicit instructions (discussed above) about what to assume in a TELRIC-estimation exercise.

Q. AS A GENERAL MATTER, WOULD ACCESS TO OSS PROVIDED BY BELLSOUTH TO ALECs LIKE ITC^DELTACOM BE LESS EXPENSIVE IF BELLSOUTH WERE TO DEPLOY NEW TECHNOLOGY REGARDLESS OF ITS EXISTING NETWORK OR WERE TO BUILD THOSE OSS FROM SCRATCH?

A. Not necessarily. The fact that BellSouth plans to serve ALEC demand with access to its existing OSS implies that the costs associated with such access are the costs that should be used to set prices. Moreover, the sum of one-time and transactional costs for a new OSS built from scratch would far exceed that of adding customized interfaces to the existing OSS.

Of course, whatever method is used to supply OSS functions in the future, consistency requires that we calculate both OSS development and OSS use costs *using the same method*. Mr. Wood suggests [at 11] calculating OSS use costs in a Total Network Management-compliant network but ignores the one-time OSS development costs of constructing that platform. In light of the economic trade-off between OSS development costs and OSS use costs, there is danger in such selectivity. As I explained earlier, ALECs and other OSS-requesting carriers exempted from paying for OSS development costs will then have an incentive to demand gold-plated OSS. In the process, those ALECs could end up minimizing their own OSS use costs, without regard to the excessive OSS development cost burden that would be shifted to BellSouth. Once the OSS development costs are taken into account, the *total* cost of OSS may be greater than it need be and the burden of recovering it would fall disproportionately on BellSouth because of that shifting of costs.

Q. DO YOU BELIEVE THAT BELLSOUTH HAS ANY INCENTIVE TO USE NRCs FOR OSS TO RAISE BARRIERS TO ENTRY?

A. No, it would make little or no economic sense for BellSouth to do so. BellSouth Corporation, the Regional Holding Company of which BellSouth is the local telecommunications arm, has a keen economic interest in being able to participate in the interLATA long distance market and to offer competing bundles of local, long distance, and other services to its customers. With long distance and other carriers allowed entry into the local exchange market, the borders between local and other markets are being erased. BellSouth Corporation and other Regional Holding Companies can ill afford to ignore this market and competitive reality. Therefore, BellSouth Corporation must do what is required of it by the law of the land (specifically, Sections 271—particularly, the "competitive checklist"—and 272 of the 1996 Act) to acquire the right to participate in markets from which it is currently barred. As such, a central requirement is that BellSouth provide non-discriminatory access to its network elements (which, according to the FCC, include OSS), databases, and other systems that competitors need to provide telecommunications services. BellSouth must not only provide such access but, once it gains Section 271 approval, must also remain in compliance with the applicable requirements (Section 271(d)(6) of the 1996 Act) in order to keep its authority to offer long distance services. Therefore, any attempt to raise barriers to entry through excessive or unjustified NRCs for OSS would be completely antithetical to BellSouth's and BellSouth Corporation's own long-term economic interests. That is why the following statement by Mr. Wood [at 13] and others like it make absolutely no sense at all:

> ILECs such as BellSouth have tremendous incentives to delay the implementation of such systems and to overstate their costs in order to raise the

costs of potential competitors.[43]

In any event, BellSouth should hardly be expected to provide access to its OSS without being able to recover at least the additional cost that is caused by other carriers requesting such access. For reasons explained earlier, not allowing such recovery would be neither competitively neutral nor economically efficient.

IV. PERFORMANCE BENCHMARKS, PARITY, AND PENALTIES

Q. WHAT HAS ITC^DELTACOM PROPOSED FOR ENSURING COMPLIANCE BY BELLSOUTH WITH PERFORMANCE TARGETS EMBODIED IN ITC'S INTERCONNECTION AGREEMENT WITH BELLSOUTH?

A. Even though penalties or liquidated damages are not required by the 1996 Act to ensure that an ILEC complies with performance standards, ITC^DeltaCom has proposed a "three-tiered performance guarantee system" that is based on such penalties (Rozycki, at 8-9; ITC^DeltaCom Petition, Exhibit A, Attachment 10). This system identifies a set of 45 performance benchmarks, each accompanied by a specific performance guarantee. This set of benchmarks, however, is ITC^DeltaCom's own compilation.

ITC^DeltaCom's proposed performance guarantee system is supposed to work at three levels. At the first level, failure to meet any of the performance benchmarks would, in many instances, trigger refunds by BellSouth of NRCs charged to ITC^DeltaCom. At the second level, BellSouth's failure to comply with a single performance benchmark for two consecutive months or twice within a quarter would be declared a "Specified Performance Breach" and trigger a payment by BellSouth *directly to ITC^DeltaCom* of $25,000 per breach. At the third—and most punitive—level, a "Breach of Contract" would be declared upon BellSouth's failure to meet any specific performance benchmark five times within a six-month period. The penalty for such a breach would be a payment by BellSouth—*again, directly to ITC^DeltaCom*—of $100,000 per breach.

[43] Paradoxically, Mr. Wood also recognizes that the opposite is true when he states [at 16, fn. 5]: "Thus, the 1996 Act provides a compensating incentive for BellSouth to open its markets to competition, i.e., in-region, inter-LATA entry."

Q. DO YOU AGREE THAT SUCH A PENALTY-BASED SYSTEM IS NECESSARY TO ENSURE BELLSOUTH'S COMPLIANCE AND TO SECURE COMPETITIVE PARITY?

A. No. As Mr. Varner's testimony explains, enforcement measures based on penalties or liquidated damages are completely unnecessary and inappropriate. Apart from the fact that legal and other remedies are already available, ITC^DeltaCom's proposed performance guarantee system suffers from an important incentive problem known in economics as *moral hazard*. From the economic standpoint, therefore, ITC^DeltaCom's proposal cannot be justified.

Q. WHAT IS MORAL HAZARD AND WHY DOES IT CREATE AN INCENTIVE PROBLEM?

A. Moral hazard is a form of gaming by which one party to a contract may resort to actions—within the framework of the existing contract—that create an unanticipated competitive or financial advantage for that party *at the expense of the other party* to the contract. This type of behavior usually arises when one of two parties to a contract possesses special information that the other does not.[44] There is then an incentive for the better-informed party to act in ways that raise the risk of default by—or loss to—the other party. Such behavior may be illustrated by the following simple examples:

1. A homeowner that insures his home against accidental fire damage may actually raise the risk of such damage by failing to take precautions or to maintain the pre-insurance level of vigilance against accidental fires.
2. A customer that purchases an appliance or automobile under a comprehensive warranty may actually raise the risk of needing repairs by failing to accord the level of care that would have been given without the warranty.

Q. HOW CAN THE MORAL HAZARD PROBLEM BE PREVENTED IN INTER-CARRIER RELATIONSHIPS?

A. The total prevention of moral hazard may require an extraordinary level of monitoring and

~~[44] For an extensive discussion of moral hazard, see Jean Tirole, *The Theory of Industrial Organization*, Cambridge, MA: The MIT Press, 1993.~~

policing of the private conduct of all parties to a contract. For that reason, it may never be possible to completely eliminate all opportunities for moral hazard-based behavior. It is important, however, that all parties to a contract realize that their private *individual* conduct may have both positive and negative consequences for *all*. This would be particularly true when the contracting parties are engaged in a supplier-customer relationship *within* the contract and as competitors *outside* the contract.

Q. PLEASE EXPLAIN WHY YOU BELIEVE THAT ITC^DELTACOM'S PROPOSED PERFORMANCE GUARANTEE SYSTEM CREATES AN INCENTIVE FOR MORAL HAZARD LEADING TO AN UNDUE ADVANTAGE FOR ITC.

A. Mr. Rozycki attempts to justify [at 10] the penalties involved in the ITC^DeltaCom-proposed performance guarantee system by pointing to (1) BellSouth's size and relative (current) market position and (2) BellSouth's ability to afford penalty payments of the magnitude proposed.

There are a number of critical defects in Mr. Rozycki's—and ITC^DeltaCom's—proposal and claims. First, ITC^DeltaCom is unilaterally pushing a set of performance measures that BellSouth may or may not be able to meet and, therefore, may or may not agree to in an explicit interconnection agreement. BellSouth has developed a comprehensive set of service quality measurements ("SQMs") for use in interconnection agreements generally. It is not feasible for BellSouth to design, negotiate, and implement a separate set of SQMs for every ALEC that interconnects with it. With ALECs free to impose their own particular set of performance measures, BellSouth would face the impossible task of trying to meet those varying standards by, in effect, setting performance goals and operating—for purposes of interconnection—like several different carriers.

Second, Mr. Rozycki can hardly expect an enthusiastic response from BellSouth when his proposed three-tiered system of performance guarantees is so obviously skewed toward enriching ITC^DeltaCom. Whether or not the *size* of the proposed penalty at each level is appropriate—the reasons provided to justify them appear capricious to begin with—the real sticking point is the *manner* in which ITC^DeltaCom proposes to exercise the proposed penalties. As currently structured, penalties at all three levels would be directly a source of unearned income for ITC^DeltaCom. While the refund of NRCs (at the first level) may still be acceptable if circumstances warrant it because that represents a return of charges already paid by ITC^DeltaCom to BellSouth for services requested, ITC^DeltaCom provides no insight whatsoever into the level of economic "harm" that it might suffer from second and third level breaches. In other words, ITC^DeltaCom makes no attempt to link the size of the penalty at either of those levels to the actual financial loss or damage it would supposedly suffer. Without such an accounting, it is impossible to determine whether ITC^DeltaCom has proposed fair compensation or created a lucrative non-market unearned revenue opportunity for itself.

If it is the latter, then the problem of moral hazard is clearly manifest in ITC^DeltaCom's proposal of penalties or liquidated damages. ITC^DeltaCom's proposed performance guarantee lacks symmetry in two ways: it (1) disproportionately favors ITC^DeltaCom and (2) sets up no system of rewards for superior performance to correspond to the proposed consequences for non-compliance. As a result, ITC^DeltaCom would have every incentive to maximize unearned income through this performance guarantee system by creating conditions that cause BellSouth to be in non-compliance.

Q. WHAT ARE THESE CONDITIONS THAT ITC^DELTACOM (OR OTHER CARRIERS SEEKING INTERCONNECTION AGREEMENTS WITH BELLSOUTH) MAY CREATE AS A RESULT OF MORAL HAZARD?

A. The prospect—or promise—of payments unrelated to the actual size of economic loss or damage could trigger moral hazard-based behavior in at least five directions:

1. *Reward lack of cooperation*. OSS-requesting carriers would have less incentive to report operational problems to BellSouth in a timely manner. By ITC^DeltaCom's proposal, the longer a problem goes uncorrected, the greater the compensation available.
2. *Discourage investment by ALEC*. ITC^DeltaCom's proposal, if implemented, would generate several opportunities for unearned income. Such income could discourage ITC^DeltaCom and other OSS-requesting carriers from investing in their own facilities, especially if such investment were to cause those carriers to lose a lucrative source of income.
3. *Encourage inefficient entry*. Firms that are inefficient relative to BellSouth may

nevertheless see an opportunity to enter the market in the expectation of receiving penalty payments from BellSouth. This would be precisely the same effect as providing a subsidy would have in inducing entry by inefficient firms.

4. *Entrapment by ALEC*. OSS-requesting carriers would have an incentive to force BellSouth into situations of non-compliance. For example, by choosing to provision hard-to-serve end-users, presenting service requests that are calculated to cause bottlenecks and delays in BellSouth's response, or basing service requests on deliberately underestimated service requirements (with a subsequent upward revision in those requests that BellSouth could not possibly fulfill quickly), those carriers could increase the risk of BellSouth non-compliance.

5. *Gold-plating*. If OSS-requesting carriers were excused from paying OSS development costs, then they would have an additional opportunity to earn income from penalties. Without having to pay OSS development charges, those carriers could demand systems of excessive quantity and/or quality and, in the process, raise the risk of BellSouth non-compliance.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

BY MR. ALEXANDER (Continuing):

Q Dr. Taylor, do you have a summary of your testimony?

A Yes, I do.

Q Would you give that, please?

A Sure.

Good evening. My testimony addresses two economic issues in this arbitration: the arrangements for intercarrier compensation for Internet-bound traffic, and charges for development of access to operation support systems.

I'm going to focus my summary on the economics of the ISP issue because the consequences for Florida consumers of a wrong decision on compensation for carrying Internet traffic can be devastating. The sums of money involved are large. And payment of reciprocal compensation for ISP traffic would so or could so distort local exchange competition that it would hardly be worth having.

First, since I'm not a lawyer, let's get rid of the legal questions. The FCC declaratory ruling says that ISP-bound traffic is jurisdictionally interstate. Footnote 87 makes it clear that ISP-bound traffic isn't subject to the Section 251(b)(5) reciprocal compensation obligations, but the ruling says state commissions nonetheless can arbitrate negotiation disputes regarding intercarrier compensation until the FCC puts some federal rule into effect, which is why we're here.

And let's also dispose at the outset of two red herrings in the case. I think everyone, all of the economists, surely agree, first, that both BellSouth and ITC^DeltaCom ought to be compensated for the costs caused when an end user dials the Internet. The questions on which there is disagreement are who pays and, second, if ISP service must be provided at some regulated price below cost, how would the burden of that subsidy be shared between the co-carriers.

And the second red herring on which I think there is agreement is that we all agree that ISP-bound calls and local calls use the same network elements. That fact, however, doesn't imply that reciprocal compensation is the efficient form for intercarrier compensation in both cases.

Remember, long distance calls, IXC-bound calls, use these same network elements and intercarrier compensation is done very differently in the carrier access world.

So, what principles ought we to apply? Well, the ruling, the FCC's ruling, points out in paragraph 26 that there are two models for intercarrier compensation, and that the FCC has never applied either model, either the reciprocal compensation model, which it uses for local traffic, or the access charge model, which it uses for interstate toll traffic. Neither of those have been applied to the situation where two local carriers collaborate to deliver traffic to an ISP. And to decide which of these two approaches make sense, I guess we should start by asking why there are two different compensation mechanisms floating around in the first place.

Let's start with costs and revenues. Suppose I'm a BellSouth subscriber. I'm an AT&T Worldnet ISP customer; I gave up on AOL. My computer dials my ISP. My ISP, let's say, takes service from ITC^DeltaCom. What are the costs?

Well, BellSouth is going to haul my call to the ITC^DeltaCom connection point. DeltaCom will then take that call and haul it to the ISP. The ISP will then perform protocol conversion, send my call out onto the Internet. And costs are incurred by all three carriers in that circumstance.

Where is the money? Where are the revenues? Well, I pay BellSouth for local exchange service. I pay my ISP twenty bucks a month for Internet access. And my ISP pays DeltaCom for access to the public switch network. That cost or that price is subject to the FCC's constraint, the ESP exemption, that limits the price that ISPs can be charged to the ordinary business line rate.

Now, there are three good economic reasons why intercarrier compensation in this circumstance for my interstate ISP-bound call ought to be treated like inter-carrier compensation for long distance and not like intercarrier compensation for local calls. The three reasons are cost causation, and they are the harmful economic consequences of paying reciprocal compensation, and the third is fostering local competition. And I will fly through all three quickly.

Cost causation, simple idea. The party that causes the costs ought to pay the costs, so the cost causer faces the right incentives when he or she chooses how much to buy. When I dial the Internet, I am causing the cost of that call. And I am causing it, I believe, as a customer of my ISP.

Now, why is that? The economic characteristics of the service are determined by the ISP. It designed the service I use. It marketed it. It bills me. Most, important, it's taken my money. It answers my questions. It loses money if I don't pay. I'm acting as its customer because from my perspective as a customer, when I'm choosing what I'm doing, I'm using its service when I place my call. That's just like long distance.

I'm also an AT&T long distance customer. When I make a long distance call, I think I'm using some AT&T service. If you ask me what the price is, I would go to an AT&T advertisement and tell you it's reach out and crush someone, or something.

And it's the same characteristics: AT&T has designed the service. They've marketed it. They have billed it, and have taken my money; all of the same characteristics. And for good economic reasons, when local exchange carriers historically have combined to provide access to AT&T to complete this long distance call, the way that intercarrier compensation works is that AT&T pays carrier access charges to the local exchange carrier that provides it to it, and co-carriers then split those carrier access charges generally in proportion to the costs that they incur.

That's very different. The originating local exchange carrier in our long distance case does not compensate the local exchange carrier that hands the call off to AT&T. This is not at all like a local call across town.

What's going on there? There, I'm using Bellsouth's local exchange service. BellSouth has designed the service. They sold it to me; marketed it to me; they've taken my money. And if DeltaCom's network is necessary to complete a call I want to make across town, then BellSouth, essentially acting as my agent, should take the money that I've given them, pay ITC^DeltaCom, and make sure that my call goes through.

The economic principle here is straight-forward. It's got two parts. The carrier whose customer originates the call, prices the service, and receives the money, ought to charge the full cost of the call to the customer. That's how we get economic efficiency. And, second, ought to compensate out of the money that it's got all of the carriers that have combined to incur costs to complete the call.

It's just like when I buy a car from General Motors, that car has got parts from Ford and Bendix and people like that. General Motors takes my money and goes out and makes sure that all the parts I need for the car are there.

In the ISP and the long distance case, the ISP's customer originates the call, must face a price from that ISP which reflects the full cost that that call causes. The ISP then collects that money and ought to pay DeltaCom, who then should share that revenue with BellSouth to compensate for its costs. And these are the economic principles that underlie the two different arrangements for intercarrier compensation that we use for interstate access on the one hand, local exchange service on the other.

My other reasons why this is the right model, when you pay reciprocal compensation, harmful consequences come about. First of all, we have a subsidy to Internet use. Under reciprocal compensation, Internet users don't pay the cost of Internet access. They will be receiving a net, a subsidy, from ordinary telephone subscribers.

Now, if you want to subsidize Internet access, that's a policy decision that someone can make, but, in the spirit of the '96 Act, it probably ought to be done explicitly and the revenue recovered to fund that subsidy in some competitively neutral manner.

The second reason is arbitrage. Because reciprocal compensation payments exceed DeltaCom's or the CLECs costs of handling ISP traffic, the ISPs or the CLECs will have a distorted incentive to generate ISP traffic, as well as an incentive to create sham traffic simply to increase revenue and profits from reciprocal compensation.

Finally, my third problem with reciprocal compensation for intercarrier compensation here is local competition. If you use reciprocal compensation, you're going to screw up local competition in two ways. The first is residential customers. No carrier, either BellSouth or DeltaCom, is going to have the right incentive to go out and market its services to residential end users who are likely to dial up the Internet and generate ISP-bound traffic and generate reciprocal compensation payments.

The cost of reciprocal compensation to either DeltaCom or BellSouth can easily exceed the local exchange revenues that the customer generates. And even if it doesn't, you're still distorting local exchange competition for residential end users.

Second competitive problem is in the ISP end. Suppose you're an ISP and you're out there looking for service. The fact is that almost all -- pick a number -- 95% of your dial-up residential end user customers receive today local exchange service from BellSouth. So, if you sign up as an ISP with DeltaCom, 95% of the calls from your customers are going to generate reciprocal compensation payments, roughly. But if you sign up with BellSouth, only roughly 5% of your calls are going to generate reciprocal compensation payments. This difference obviously distorts the choice that ISPs make in picking their service provider.

Economic solution, ideally, treat ISP-bound calls like long distance calls. The ILEC and the CLEC in the circumstances we're talking about share the access revenues, whatever they get from the ISP, in proportion to the costs they incur in handling the traffic.

If the ESP exemption makes that revenue too small, if it's less than the cost of the call, the ILEC and the CLEC under this plan will contribute proportionately to that subsidy. ISP is going to face the same costs and revenues then irrespective of whether it uses BellSouth or DeltaCom to provide access service. The competitive distortions are removed.

There can be other costs recovery mechanisms the Commission could adopt, but in no case does reciprocal compensation for ISP-bound traffic make sense.

And that concludes my summary.

COMMISSIONER CLARK: Thank you.

Mr. Adelman.

MR. ADELMAN: Thank you.

CROSS EXAMINATION

BY MR. ADELMAN:

Q Good evening, Dr. Taylor. David Adelman, representing ITC^DeltaCom.

A Yes.

Q Dr. Taylor, your summary was exclusively about the ISP issue, but I'm going to ask you some questions about OSS.

A Sure.

Q You agree that access to OSS is a UNE; do you not?

A Absolutely.

Q And the FCC has said as much; there is no dispute over that; correct?

A None from me.

Q You don't expect that change; do you?

A I don't forecast change from the FCC. But there is no disagreement that --

Q Well, you were here. We've had a lot of talk about this dynamic regulatory climate we're in. And I just want to make sure you didn't believe there would be any change to that determination.

A I have no indication that it's going to move in that direction.

Q So, as a UNE, you would agree that the rates charged to ALECs for OSS should be based on cost; correct?

A For access to OSS should be based on TELRIC, yes.

Q And that's Section 252(d), combined with the First Report and Order, give you the requirement that the rates be based on TELRIC; correct?

A Yes.

Q And, generally, TELRIC requires the assumption that the UNE is provided using the least cost, most efficient forward-looking technology; correct?

A No, I don't think that's right. If you -- I mean, if you look at my testimony, I discuss the relevant passages in the First Report and Order, paragraphs 683 through 685, I think, if memory serves, where the FCC lays out three different economic standards for forward-looking costs, rejects the one as number one that you just read, and picked number three instead.

Q All right. Forward-looking; correct?

A I'm happy with forward-looking.

Q Efficient?

A Efficient, sure; that's good.

Q So, it's the forward-looking, most efficient technology?

A You slipped in the word "most." Most, in paragraph 683, which the FCC rejected, they rejected the following language: "Under the first approach, the forward-looking economic costs for" blah, blah, blah, "unbundled elements would be based on the most efficient network architecture, sizing technology, and operating decisions that are operationally feasible and currently available to the industry." That standard was rejected.

Q Do you believe that ALECs should pay only for that OSS which is currently deployed?

A No. I believe it should be based on the most efficient technology deployed in the incumbent LEC's current wire centers, wire center locations, as paragraph 685 explained.

Q Okay. Now, you use the word "most" there. So, it is the most efficient OSS deployed in the incumbent's network; correct?

A Yes, and I didn't use the word "most." I'm quoting -- I'm sorry. I was quoting paragraph 685. And you're asking me what I think the FCC requires. And I think they require --

Q And I want you to refer to the order if you need to. So, it's the most efficient deployed in the network and it's also forward-looking; correct?

A Yes. Oh, and I guess we can add the overview in which the FCC explains that sentence by saying, "This benchmark of forward-looking costs and existing network design most closely represents the incremental costs that incumbents actually expect to incur in making network elements available to new entrants." Again, paragraph 685.

Q Now, I know you're not an expert on OSS, but you are well versed in costs associated with OSS;

correct?

A Versed, yes.

Q You understand that as part of the ordering process, sometimes orders are processed electronically one hundred percent, and some orders fall out? You've heard that terminology; correct?

A Yes.

Q And would you expect as an economist that orders that fall out cause greater costs than orders that are processed fully electronically?

A All else equal, sure.

Q And do you believe that companies that seek to efficiently process -- ALECs that seek to efficiently process their orders, that is, strive to reduce the number of orders that fall out, should be rewarded for such efforts?

A Well, depends on who incurs the costs in doing that. That is, a CLEC that cleans up its orders, makes sure that it's obeying the rules and very carefully submits nothing but correct orders and none of them fall out, ought to be rewarded for that in the sense that it's causing fewer costs to be incurred.

On the other hand, if you're thinking of designing an OSS mechanism which minimizes fallout of orders, then, no, I wouldn't say that at all. You could conceive of building the access to OSS to end all access, the Microsoft access system or something, in which is infinitely complicated, nothing ever falls out, even for special access circuits, for something where you have to design a network which requires lots of individual hand labor, would still do it automatically, it would be nuts to design such a system. It would have zero fallout, but it would be tremendously expensive, and that would not be efficient.

Q And I need to be more precise with my questions. Maybe I'll do it this way. Were you here when Mr. Thomas testified?

A Yes.

Q And do you remember how he stated it is ITC^DeltaCom's goal to process as many orders electronically as possible?

A Yes, that still has the problem that I alluded to. If it's DeltaCom's goal to do that, given the OSS that it's sending its orders into, then that's fine, I have no problem with that.

Q But you understand that some ALECs may make a decision that they would rather fax their orders in or -- I don't know -- mail them in through the U.S. mail. You understand that they could make orders manually or they could make orders electronically?

A Sure.

Q And you understand that ITC^DeltaCom's intention and goal is to, as much as possible, process their orders electronically?

A I believe I heard it stated that that was its intention, sure.

Q Fair enough. Now, assuming Bellsouth's current system and that there is no wasteful spending associated with designing the be-all-end-all OSS, do you agree that where an ALEC spends money to develop its own systems in order to minimize the amount of fallout, it causes less costs for the ILEC than an ALEC that perhaps is not as diligent and does not have as strong a desire to maximize the percentage of its orders that flow through electronically?

A Well, I'm not an expert on OSS costs, but I'm willing to concede that it's certainly possible that OSS orders which come in by fax impose, could impose more costs on the ILEC than OSS orders which go through electronically.

Q And OSS orders that fall out of the electronic system could impose more costs than OSS orders that do not; correct?

A Sure, for reasons in that case that we're not sure sort of who's at fault, whether it's a problem with the gateway itself or whether it's a problem with the way that the CLEC has implemented it.

Q Fair enough. And, generally, as a principle of economics, it is preferred for subsidies, to the extent we must have them, be explicit so we can identify those subsidies; correct?

A As a general matter, sure.

Q And would you accept that if one could identify and segregate costs associated with the manual handling of orders, that is to say those orders that fall out of a system from those that are fully processed electronically, that would be valuable?

A Without looking at the costs of doing that, the answer is yes, it would be valuable. I mean, you're as aware as I of both a regulatory problem and even a characteristic of unregulated markets that even people who impose different costs on a supplier may end up paying the same rate. I mean, from a regulatory perspective, my loop may be ten kilo feet; your loop may be right next to the central office. We pay the same rate because -- not because we impose different costs, but because its either not in the public interest or it costs more than the welfare gains from having exact cost based rates, the cost of actually implementing that exceeds the welfare gains that we might get. And that's the tradeoff that we have here in the OSS circumstance.

Q Okay. Now, let's assume that the ILEC can easily identify those orders that fall out and require manual handling and segregate those types of orders from those that are processed fully electronically. Are you with me?

A Sure.

Q Okay. Would it, as an economist, be economically efficient for the ILEC to isolate the costs associated with those that require manual handling and establish a separate price based on those different costs?

A In principle, if it is costless -- You said easily; I'll leap to costless. If it's costless to discriminate, to set different rates, and to bill CLECs discriminately, depending upon what type of access they, what form of access to OSS they use, then, sure, your prices are getting closer to your costs.

But you can't say as a general matter that the rate structure that is being proposed here is necessarily bad because every transaction isn't priced at its cost and that some are overpriced and some are under priced relative to the average. That just -- That falls afoul of the example of our loops.

Q Okay. Well, but where we can determine which are overpriced and which are under priced, and we can do it without too much transaction costs, too much friction, that would be a valuable exercise and would help send the appropriate price signals to the marketplace; correct?

A Well, again, I have no problem with that hypothetical in principle. I can't say that I know enough about the economics of cost savings from fallout and the costs of segregating and changing, making the rate structure more fine, to say that that's realistic or not.

Q By the way, you use the word "discriminate." And I'm sure you're aware in this context sometimes that carries a negative connotation. You didn't mean it that way; did you?

A No, not at all.

Q So, it would be a positive thing to be able to discriminate, that is, to separate out cost causers, and to directly assign, where possible, the costs to the causers of the costs; correct?

A It would be a fine thing as long as you could show that the gains in economic welfare from more accurate cost-based rates exceed the transactions cost of having a more complex rate structure.

Q So, just to try to bring this together, if BellSouth could efficiently identify orders that fall out and segregate or separate them from orders that flow through and could determine that there are costs different as between those orders, it would be appropriate to have in principle a different rate for orders that fall out from orders that are processed fully electronically?

MR. GOGGIN: I object. Commissioners, I think this question has been asked at least twice, maybe three times. I'm not sure.

COMMISSIONER CLARK: I'll allow the question. I think he's asking him to sum up a series of questions. But beyond that, the questions need to move on, I think.

WITNESS TAYLOR: Well, let me answer, because you did make a subtle change in the question. You said "efficiently separate" and you didn't mean to say that. You meant separate at sufficiently low cost that the welfare gains from the more complex rate structure outweighed those costs. Sure, we can do it efficiently, but in the case of your loop and my loop, even if we have the most efficient billing system in the world, it may not pay to make that distinction.

BY MR. ADELMAN (Continuing):

Q Okay. Let's assume for my example that it can be done in a cost effective way.

A Then, in that case, in principle, with all of the hypothetical you have put there, I would agree that the world would be a better place in the sense that economic welfare would be improved.

Q And you understand that today BellSouth proposes to charge for the OSS UNE the same rate regardless of whether an order falls out or flows through; you understand that?

MR. ALEXANDER: May I just interpose an objection here. Several times Mr. Adelman refers to OSS UNE. Are we talking about access to OSS or are we talking about OSS itself?

BY MR. ADELMAN (Continuing):

Q The UNE is access to OSS; is it not?

A Well, that's my understanding, yes.

MR. ALEXANDER: Thank you.

MR. ADELMAN: I'll -- Can I restate the question, Commissioner?

BY MR. ADELMAN (Continuing):

Q Do you understand that today BellSouth proposes to charge the same rate for access to OSS regardless of whether an order falls out or flows through?

A I believe that's the case, just as they charge the same for a long and a short unbundled loop.

Q Dr. Taylor, do you agree with Mr. Varner that when a BellSouth customer places a call to his or her ISP and the ISP is an ITC^DeltaCom customer, that that call causes costs to ITC^DeltaCom?

A Yes, except that you said a BellSouth customer, and let's be neutral here at least. When a customer who subscribes for telephone service to BellSouth and who takes ISP service from this ISP provider places such a call, I would agree that that call imposes costs on first BellSouth and then on DeltaCom.

Q And those costs were caused as a result of that call; correct?

A Yes.

Q So, if the call is never made, there is no cost; correct?

A Dead right.

Q When you talked about your employment, you indicated that you worked at Bellcore; when were you there?

A In 1983 to 1988.

Q And you call those the good old days?

A No, I called -- No, no; that's post divestiture. I called Bell Laboratories the good old days.

Q So, to you the good old days were before there was any telephone competition?

A No. There was telephone competition in the bad old days. Seems to me MCI was in business in 1978. It was the good old days because Bell Laboratories did basic research in economics funded through the generosity of telephone customers. And it was wonderful to be an economist then.

MR. ADELMAN: Thank you. I have no further questions.

COMMISSIONER CLARK: Let me just indicate that we're not here to ask idle curiosity questions. You can do that on your own time.

With that admonition, Ms. Caldwell, it's your turn.

MS. CALDWELL: With that admonition, I have no questions.

COMMISSIONER CLARK: Okay. Is there any redirect?

MR. ALEXANDER: I believe I'll pass on redirect.

COMMISSIONER CLARK: Thank you.

Thank you, Dr. Taylor. You are excused.

We'll go ahead and take a ten-minute break and we'll return with Ms. Caldwell, the other Ms. Caldwell.

(Recess.)

COMMISSIONER CLARK: We'll go back on the record. I see the other Ms. Caldwell is ready to go.

Mr. Alexander.

MR. ALEXANDER: Yes. Thank you. BellSouth calls Daonne Caldwell.

(Whereupon, the transcript is continued in Volume 7 without omissions.)