BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

IN RE: INVESTIGATION INTO APPROPRIATE METHODS TO COMPENSATE CARRIERS FOR EXCHANGE OF TRAFFIC SUBJECT TO SECTION 251 OF THE TELECOMMUNICATIONS ACT OF 1996	)))))	**DOCKET NO. 000075-TP (PHASE II)**

REBUTTAL TESTIMONY

OF

WILLIAM E. TAYLOR, Ph.D.

ON BEHALF OF

BELLSOUTH TELECOMMUNICATIONS, INC.

APRIL 19, 2001

n/e/r/a
Consulting Economists

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

TABLE OF CONTENTS

ON BEHALF OF BELLSOUTH TELECOMMUNICATIONS, INC.

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

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO. 000075-TP (PHASE II)

APRIL 19, 2001

I. INTRODUCTION AND SUMMARY

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

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

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

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

research at Bell Laboratories and Bell Communications Research, Inc.

I have participated in telecommunications regulatory proceedings before several state public service commissions, including the Florida Public Service Commission ("Commission") in Docket Nos. 900633-TL, 920260-TL, 920385-TL, 980000-SP, 980696-TP, 990750-TP, and 000075-TP (Phase I). In addition, I have filed testimony before the Federal Communications Commission ("FCC") and the Canadian Radio-television Telecommunications Commission on matters concerning incentive regulation, price cap regulation, productivity, access charges, local competition, interLATA competition, interconnection and pricing for economic efficiency. Recently, I was chosen by the Mexican Federal Telecommunications Commission and Telefonos de Mexico ("Telmex") to arbitrate the renewal of the Telmex price cap plan in Mexico.

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

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

Q. PLEASE DESCRIBE NERA, YOUR PLACE OF EMPLOYMENT.

A. Founded in 1961, National Economic Research Associates or NERA is an internationally known economic consulting firm. It specializes in devising economic solutions to problems involving competition, regulation, finance, and public policy. Currently, NERA has more than 275 professionals (mostly highly experienced and credentialed economists)

with 10 offices in the U.S. and overseas offices in Europe (London and Madrid) and Sydney, Australia. In addition, NERA has on staff several internationally renowned academic economists as Special Consultants who provide their professional expertise and testimony when called upon.

The Communications Practice, of which I am the head, is a major part of NERA. For over 30 years, it has advised a large number of communications firms both within and outside the U.S. Those include several of the regional Bell companies and their subsidiaries, independent telephone companies, cable companies, and telephone operations abroad (e.g., Canada, Mexico, Europe, Japan and East Asia, Australia, and South America). In addition, this practice has supported a large number of legal firms and the clients they represent, and routinely provided testimony or other input to governmental entities like the FCC, the Department of Justice, the U.S. Congress, several state regulatory commissions, foreign regulatory commissions, and courts of law. Other clients include industry forums like the Unites States Telephone Association. Last year, the Warrington School of Business Administration at the University of Florida presented its International Business Leadership Award to NERA, citing work of the NERA Communications Practice on incentive regulation interconnection, and efficient competition and technological convergence.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I have been asked by BellSouth Telecommunications, Inc. ("BellSouth")—an incumbent local exchange carrier ("ILEC")—to address economic issues raised in the testimonies of witnesses representing alternative local exchange carriers ("ALECs") in this proceeding. I

review and comment on the testimonies of Lee L. Selwyn (representing AT&T Communications of the Southern States, Inc., TCG of South Florida, Global NAPS, Inc., MediaOne Florida Telecommunications, Inc., Time Warner Telecom of Florida, LP, Florida Cable Telecommunications Association, Inc., and Florida Competitive Carriers Association) and Timothy J. Gates (representing Level 3 Communications, LLC).

II. RESPONSE TO INTERVENOR TESTIMONY

Q. WHICH ISSUES DO YOU ADDRESS IN YOUR TESTIMONY?

A. I address Issues 12-15 as outlined by the Commission.

Issue 12: Pursuant to the Act and FCC's Rules and Orders:
(a) Under what condition(s), if any, is an ALEC entitled to be compensated at the ILEC's tandem interconnection rate?
(b) Under either a one-prong test or two-prong test:
(i) What is "similar functionality?"
(ii) What is "comparable geographic area?"

Q. HAVE YOU REVIEWED THE SAME LANGUAGE FROM THE FCC'S LOCAL COMPETITION ORDER THAT DR. SELWYN CITES IN HIS TESTIMONY [AT 5-6]?

A. Yes. I have reviewed paragraph 1090 of the Local Competition Order.[1] I have also reviewed the surrounding paragraphs 1085-1093, which offer additional insight into the FCC's intent.

Q. DO PARAGRAPHS 1085-1093 OF THE LOCAL COMPETITION ORDER

[1] FCC, *In the Matter of Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-
(continued...)

SUPPORT DR. SELWYN'S ARGUMENTS [AT 5-13]?

A. No, the FCC's intent simply does not support the position that Dr. Selwyn and the ALECs have taken in this proceeding. Dr. Selwyn and the ALECs in this proceeding have argued that carriers should receive inter-carrier compensation at the tandem rate based solely on the geographic area served by the terminating carrier's switch. If implemented, this approach would fail to produce a cost-based rate (which the FCC has required for inter-carrier compensation) and, consequently, fail to be economically efficient. An inter-carrier compensation rate that does not reflect the termination cost of the carrier receiving local exchange traffic from another carrier would open the door to inefficient competitive entry and, in many cases, undesirable arbitrage. The availability of inter-carrier compensation in excess of actual cost has already caused a proliferation of entry by ALECs nationally with the sole or primary purpose of receiving and switching Internet-bound traffic to Internet service providers ("ISPs"). Recognizing the enormous scope for arbitrage by ISP-specializing CLECs or CLEC-ISP alliances, some states (led by Massachusetts and Colorado) have taken steps to end inter-carrier compensation in its present form for such traffic.

Q. ON WHAT BASIS DO YOU CONCLUDE THAT THE FCC INTENDED TO ESTABLISH COST-BASED RATES FOR INTER-CARRIER COMPENSATION?

A. One need only look at the Telecommunications Act of 1996 ("the Act"). Section 252(d)(2)

(...continued)

98, First Report and Order ("Local Competition Order"), released August 19, 1996.

of the Act requires that inter-carrier compensation be paid "on the basis of a reasonable approximation of the additional costs of terminating such calls." Indeed, the FCC cites this provision from the Act when it concludes that the ILEC's cost of transport can be used as a proxy for the costs incurred by interconnecting carriers.

Q. WHY WOULD DR. SELWYN'S APPROACH RESULT IN RATES NOT BASED ON COST?

A. Any inter-carrier compensation received by an ALEC at a rate that does not reflect "a reasonable approximation of the additional costs of terminating traffic" would fail to be cost-based. To best convey the error in Dr. Selwyn's position, consider two Scenarios, A and B. In Scenario A, an ALEC receives compensation at the tandem rate, yet only incurs the costs of end office termination (end office switching). In scenario B , an ALEC receives compensation at the tandem rate, and incurs the costs of tandem termination (tandem switching + transport + end office switching). I expect that Dr. Selwyn would argue that both scenarios are appropriate for compensation at the tandem rate as long as the geographic area served by the ALEC's switch at its point of interconnection ("POI") is comparable to the geographic area served by BellSouth's tandem. However, Dr. Selwyn's position would result in a rate for Scenario A that is not truly cost-based. Recall that in Scenario A, the ALEC receives compensation at the *tandem rate*, yet *only incurs the costs of end office termination.* This outcome is clearly at odds with both the provisions of the Act and the policies adopted by the FCC in this regard.

Q. WHAT IS WRONG WITH INTER-CARRIER COMPENSATION RATES THAT

ARE BASED SOLELY ON GEOGRAPHY AND NOT ON COST?

A. First, as I noted above, that would conflict with both the Act and the FCC's own regulations to implement the Act. For that reason alone, the Commission should ensure that only cost-based rates are used for inter-carrier compensation.

Second, if the Commission were to determine that inter-carrier compensation rates should be based solely on the size of a carrier's service area rather than also on a measure of the carrier's termination costs, then the Commission would first have to resolve a number of problematic issues. Specifically, the Commission would have to determine what constitutes the geographic serving area of a tandem. Which tandem, and whose tandem, should the Commission measure for that purpose? How should the serving area itself be measured: on the basis of geography alone or with reference to the number of access lines served?

Third, as is already evident with Internet-bound traffic, compensation rates that are not cost-based create opportunities for arbitrage that tends to enrich the terminating carrier. Moreover, because the arbitrage is triggered by a flaw in a regulatory policy, it is not likely to be self-healing, i.e., the arbitrage will not itself be temporary and cure the distortion that generates it in the first place.

Q. DR. SELWYN ARGUES [AT 13] THAT "IT IS A GOOD THING" FOR AN ALEC TO BE ABLE TO RECEIVE A HIGHER TANDEM RATE EVEN WHEN ITS COSTS OF TERMINATION ARE BELOW THOSE OF AN ILEC THAT PERFORMS SIMILAR FUNCTIONS. DO YOU AGREE?

A. Absolutely not. This is a familiar argument, a variant of which Dr. Selwyn and others have

employed to justify inter-carrier compensation of ALECs at rates that exceed their true cost to deliver Internet-bound traffic to ISPs. It is true that the FCC established the so-called symmetry rule, which ties the inter-carrier compensation rate available to both the ILEC and the ALEC to the ILEC's termination cost, regardless of the ALEC's own termination cost. The FCC justified that rule by reasoning that symmetry in rates would force symmetry in costs as well, i.e., induce ILECs to become more efficient and lower their termination costs to at least the level of the ALEC's costs. However, at a practical level, the Commission would find it almost impossible to enforce that rule to the satisfaction of all parties, including itself.

First, the kind of symmetry in costs that the FCC hoped to induce cannot be considered a certainty in a market in which one party (the ILEC) is regulated and subject to franchise obligations while the other party (the ALEC) is essentially free to operate in any manner it chooses, including regarding whom it serves and where and what services it provides. The ILEC's costs are, in large part, driven by its regulatory circumstances, but the ALEC's are not.[2] The ILEC cannot pick and choose customers to serve, or serve only customers that receive more traffic than they originate. In contrast, the ALEC has all of these options.

Second, an ALEC can construct a network that specializes in terminating (i.e., receiving incoming) traffic. This network can be configured differently than that of the ILEC and avoids costs that a network providing several different services and features must

[2] For example, one reason why ILECs have more hierarchical architectures for switching than CLECs is because ILECs must serve low-density geographic areas and provide network access to many customers who generate
(continued...)

take on. The proliferation throughout the nation of ALECs that serve only ISPs demonstrates this possibility. An ALEC network specialized in this manner may have a lower unit termination cost to which even the most efficient ILEC could not aspire. Unlike the specializing ALEC, the ILEC provides the call termination function as only one among several other functions. For the ILEC to become "more efficient" with respect to any one function is an ambiguous goal. It could conceivably do so by reallocating resources and production priorities but that could happen, at least in the short run, at the expense of its other services and functions. Alternatively, it could try to lower its costs in the long run by adopting more efficient technologies, redesigning the network, and utilizing its human and other resources differently. However, costs of a multi-service network are the outcomes of a large number of complex interactions. Also, such a network has neither the luxury to re-design its network from scratch (something to which new entrants could aspire), nor the ability to upgrade to new technologies or network architectures in a continuous and seamless manner.

Third, the asymmetry of the circumstances of the ILEC and the ALEC virtually ensures that the ALEC would be able to take full advantage of any policy that guarantees the ALEC a higher rate of compensation than the cost it incurs. The arbitrage that this asymmetry makes possible can only lead to an endless transfer of revenues from the ILEC to the ALEC with virtually no prospect of its reversal or of the arbitrage opportunity itself disappearing. Despite its well-intentioned goals, the outcomes of this public policy cannot

(...continued)

very small amounts of local and toll traffic. CLECs generally do not seek out such customers.

be those expected by Dr. Selwyn.

Finally, in view of that asymmetry, the compensation each carrier receives should not be allowed to differ significantly from *its* unit termination cost. Until that asymmetry disappears, the effects of the policy advocated by Dr. Selwyn can never be beneficial to society. Ironically, if a policy of symmetric compensation rates absolutely must be retained, then it would be better to set the inter-carrier compensation rate at the level not of the ILEC's (potentially higher) unit termination cost, but that of the ALEC's (potentially lower) unit termination cost. This would still encourage the regulated entity (the ILEC) to lower its unit termination cost (an outcome that Dr. Selwyn desires) while eliminating the possibility of any arbitrage by the unregulated and unconstrained entity (the ALEC). Although I do not necessarily advocate such a policy, it would at least have the salutary effect of removing the arbitrage carrot and encouraging ALECs to become full service providers, i.e., to compete with the ILEC for the full spectrum of local exchange services.

Issue 13: How should a "local calling area" be defined, for purposes of determining the applicability of reciprocal compensation?

Q. DO YOU AGREE WITH DR. SELWYN [AT 19] AND MR. GATES [AT 8-9] THAT IT IS APPROPRIATE FOR ALECs TO ADOPT LOCAL CALLING AREA DEFINITIONS THAT DIFFER FROM THOSE OF THE ILEC?

A. Yes. In fact, I would expect ALECs to offer their customers local calling areas that differ from the incumbent's local calling areas. Competition is expected to produce new service options for customers. How an ALEC defines its local calling area for its own customers is certainly one means of differentiating itself in the market.

Q. SHOULD AN ALEC'S LOCAL CALLING AREA AFFECT HOW "LOCAL CALLING AREA" IS DEFINED FOR PURPOSES OF RECIPROCAL COMPENSATION?

A. No. The local calling area for retailing purposes is entirely different from the local calling area for interconnection purposes. The issue in this proceeding is how to define the local calling area *for interconnection purposes*. While each ALEC should be permitted to establish local calling areas for its own customers, the definition of a local calling area for the purposes of paying reciprocal compensation is a different matter entirely. The most appropriate mechanism by which to determine the local interconnection calling area for compensation purposes is the use of negotiations between interconnecting carriers. Interconnecting parties themselves are in the best position to negotiate where and how interconnection should occur between their respective networks and whether local interconnection or access charges should be the basis for inter-carrier compensation.

Q. WHAT WOULD BE THE ECONOMIC CONSEQUENCES IF ILECs WERE REQUIRED TO MATCH EACH ALEC'S CLAIMED LOCAL EXCHANGE AREAS FOR RECIPROCAL COMPENSATION PURPOSES?

A. Chaos. If inter-carrier compensation depended solely on the definition of the local exchange area of the originating carrier, each terminating LEC would need to be able to rate each call for reciprocal compensation according to its local exchange area definition and of every other LEC in Florida. Today, each LEC switch uses a routing table that references originating and terminating NPA-NXXs to classify calls as local or toll according to the LEC's own definitions. If inter-carrier compensation were determined by

the local calling area of the originating LEC, each LEC would require routing tables for every other LEC, and the classification process would become unwieldy.

In addition, the definitions of local calling areas for individual LECs are frequently ambiguous and change over time. LECs should be free to define local calling areas for their retail services in any way they choose. Thus, for each LEC, calls between particular NPA-NXX pairs could be local in some retail packages and toll under other circumstances, depending on the LEC's perceptions of its customers' needs.

LECs should, therefore, be free to negotiate to determine whether particular NPA-NXX pairs represent local or toll calls for the purpose of reciprocal compensation. Moreover, the classification for inter-carrier compensation purposes need bear no relationship with the retail packaging process, so that LECs can change their retail offerings without negotiating new rules for inter-carrier compensation.

Issue 14:
(a) What are the responsibilities of an originating local carrier to transport its traffic to another local carrier?
(b) For each responsibility identified in part (a), what form of compensation, if any, should apply?

Q. DO YOU AGREE WITH DR. SELWYN [AT 37] THAT AN ALEC NEED ESTABLISH ONLY ONE POINT OF INTERCONNECTION WITH AN ILEC ANYWHERE IN EACH LATA?

A. Yes. It is consistent with both the Act and the FCC's implementing rules for each ALEC to be allowed to establish only one POI in each LATA for collecting local exchange traffic headed to its network. Doing so allows competitors entering the market to build their

networks slowly, thus allowing them to expand their networks with growth in their customer bases. Requiring ALECs to replicate the ILEC's network as a condition of entry can be burdensome enough to become a barrier to entry.

Q. SHOULD, AS DR. SELWYN SUGGESTS [AT 42], THE ORIGINATING CARRIER BE REQUIRED TO CARRY *WITHOUT COMPENSATION* LOCAL EXCHANGE TRAFFIC TO A TERMINATING CARRIER'S POI REGARDLESS OF WHERE IT IS PHYSICALLY LOCATED IN THE LATA?

A. No. This is where I disagree with Dr. Selwyn. ALECs have been granted an opportunity to expand their facilities-based networks gradually with growth in their own customer bases. However, this opportunity granted to ALECs by Congress and the FCC should not become a "free ride" for them . Allowing ALECs to use one POI for interconnection is simply recognition by regulators that replicating the ILEC's network for interconnection purposes could be prohibitively costly and an entry barrier for potential competitors. A more cost-effective strategy for these entrants is to purchase transport (that it cannot provide itself) from other sources. Instead of ALECs building switches themselves in each local calling area, ALECs have the opportunity to purchase transport from other carriers who may already have a presence in those areas. The transport market is well established and stands ready to offer ALECs these services.

Second, I note Dr. Selwyn's concern [at 41] with allowing an ILEC to dictate where ALECs with which it interconnects should place their POIs or, as he puts it, allowing that ILEC to "shift financial responsibility for some or all of the transport costs incurred on its side of the POI to the ALEC." On this point, Dr. Selwyn offers the following "principle:"

> ... a local carrier should be responsible for the costs of transport from the point at which the call originates on its network to the POI. This principle must apply whether or not the transport will extend beyond the originating caller's local calling area.

Ironically, Dr. Selwyn expresses no concern for the possibility that this principle could shift financial responsibility for transport back to the ILEC. Consider how such strategic behavior could arise. Suppose the arrangement is for the originating carrier to pay for all transport from its customer up to the POI and for the terminating carrier to absorb the cost of transport from that POI to the called customer. The decision to locate the POI is itself asymmetric: it is entirely the ALEC's call and the ILEC has no say (for reasons discussed above). Now suppose the volume of traffic flowing from some of the ILEC's local calling areas to the ALEC's network is disproportionately larger than the reverse flow of traffic. That is, relatively little traffic is returned by the ALEC to those ILEC local calling areas. Next, suppose that precisely the opposite is true for traffic flowing back and forth between the rest of the ILEC's local calling areas and the ALEC's network. An ALEC that is free to locate its POI would obviously seek to minimize its own costs of transport. This it could easily do, in Dr. Selwyn's scheme of things, by locating its POI very close to the ILEC local calling areas to which it *sends* a lot more traffic than it receives, and as far away as possible from the other ILEC local calling areas from which it *receives* a lot more traffic than it sends.[3] While this perfectly rational cost-minimizing strategy would serve the ALEC's interest, it would also maximize the shift of transport cost to the ILEC—a fact that Dr. Selwyn simply chooses to ignore. The transport costs of the two carriers are a zero-

[3] In some cases, the ALEC may even consider locating its POI *within* a local calling area to which it sends the most (continued...)

sum game. What one carrier saves on transport cost by locating its POI in a particular place becomes extra transport cost for the other. Therefore, while the ALEC should be free to locate its POI anywhere in the LATA, it should not be absolved of all responsibility for the manner in which it can shift the greatest "financial responsibility" for transport costs on to the ILEC.

Third, both Dr. Selwyn [at 41-42] and Mr. Gates [at 22-23] argue that ALECs should not be required to incur transport costs even if they choose to locate their POIs outside of the local calling area in which the call originates. This principle mis-interprets FCC policy which, in my reading, only requires the ILEC to deliver traffic to the ALEC's POI within the local service area in which the call originates. Moreover, the principle would violate the economic foundation of reciprocal compensation for local exchange traffic in which it is supposed that the costs incurred by the originating carrier are recovered from its local exchange customers. If the ILEC is required to haul traffic outside its local calling area to an ALEC POI, there is no possibility that local exchange rates recover the transport costs of that call.

(...continued)

traffic, or even collocating at an ILEC switch in that local calling area.

Issue 15:
(a) Under what conditions, if any, should carriers be permitted to assign NPA/NXX codes to end users outside the rate center in which the NPA/NXX is homed?
(b) Should the intercarrier compensation mechanism for calls to these NPA/NXXs be based upon the physical location of the customer, the rate center to which the NPA/NXX is homed, or some other criterion?

Q. DR. SELWYN ASSERTS [AT 44] THAT "CARRIERS...SHOULD BE ALLOWED TO DEFINE BOTH THEIR OUTWARD AND INWARD LOCAL CALLING AREAS..." DO YOU AGREE?

A. Yes. For retail purposes, all carriers should be free to bundle and price local exchange services in whatever manner they perceive their customers want. However, those definitions of local calling areas for retail purposes should not necessarily be the definition of local calling area for the purpose of determining whether the method of inter-carrier compensation for interconnection is carrier access charges (for toll calls) or reciprocal compensation (for local calls).

Q. DO YOU AGREE WITH MR. GATES [AT 26-29] THAT ALECs SHOULD BE PERMITTED TO ASSIGN NXX CODES TO CUSTOMERS OUTSIDE THE LOCAL CALLING AREA?

A. Yes. ALECs and ILECs should be free to offer foreign exchange-like services ("virtual NXX service" in Mr. Gates' terminology). However, assigning an NPA/NXX code to a customer outside the rate center in which the NPA/NXX is homed does not change the basic nature of the call. If the call originates and terminates in different local calling areas, the call is a toll call and not subject to reciprocal compensation.

Q. DR. SELWYN ARGUES AT LENGTH [AT 44-52, INCLUDING FIGURES 1-4]

THAT THE ILEC'S *COSTS* ARE NOT AFFECTED BY THE LOCATION AT WHICH THE ALEC DELIVERS TRAFFIC TO ITS CUSTOMERS. MR. GATES MAKES THE SAME POINT [AT 33]. DO YOU AGREE WITH THIS CONCLUSION?

A. In general, yes. The ILEC's costs are unaffected by the location of the ALEC's customer.

Q. BOTH DR. SELWYN AND MR. GATES CONCLUDE FROM THIS FACT THAT RECIPROCAL COMPENSATION, NOT ACCESS CHARGES, SHOULD BE PAID FOR THIS VIRTUAL FX TRAFFIC. DO YOU AGREE?

A. No, not at all. The originating carrier pays reciprocal compensation on local traffic while it receives carrier access charges on toll traffic. Irrespective of costs, a virtual FX call is not a local call; it originates in one local calling area and terminates in another, which makes it a toll call.

The situation is identical to a toll call, where the LEC carries the call from its end office to the interexchange carrier's point of presence ("POP"). When the POP is in the local calling area of the originating end user, that call is functionally similar to a local call, from the perspective of the LEC. However, such calls are not classified as local calls but as carrier access calls. Carrier access rates rather than local usage rates are applied to those calls, and the rates are set so that the LEC recovers its economic costs plus contribution (in an amount determined by the regulator). While interexchange carriers would prefer to classify switched access calls as local exchange calls—thereby avoiding access charges—regulators do not permit it, recognizing that prices for other services (e.g., basic exchange service) are set with the expectation of contribution from switched access service.

Q. MR. GATES CLAIMS [AT 36] THAT LECs RECOVER THE COST OF CARRYING VIRTUAL FX TRAFFIC FROM THEIR OWN CUSTOMERS. DO YOU AGREE?

A. No. First, virtual FX calls are not local calls, so they are not included in the count of calls used to determine local usage costs for flat-rated local exchange service. In that sense, local exchange rates were not set to recover these costs. Second, Mr. Gates distorts the quotation from the FCC's TSR Order he purports to explain. That Order, as cited by Mr. Gates [at 35-36], clearly reads

> The originating carrier recovers the costs of these facilities through the rates it charges its own customers *for making calls*. [Emphasis added]

Thus, the TSR Order is *not* talking about recovering traffic-sensitive costs of originating local traffic from "subscriber line charges, vertical services..., universal service surcharges, extended area service charges and contribution from access charges for intraLATA and interLATA toll" as suggested by Mr. Gates [at 36]. Indeed, Mr. Gates appears to argue that so long as sufficient sources of contribution exist to fund a subsidy to virtual FX traffic, the LEC can be said to "recover its costs" of providing the service. Such an interpretation does obvious violence to the intention of the Act which explicitly sought to remove implicit subsidies from telecommunications prices.

Q. DR. SELWYN CLAIMS [AT 53] THAT THE ONLY IMPACT ON THE ILEC OF AN ALEC VIRTUAL FX SERVICE IS IN THE NATURE OF "A COMPETITIVE LOSS." DO YOU AGREE?

A. No. Reclassifying a virtual FX call from toll to local would represent a regulatory anomaly or loophole, not a competitive loss. When the ILEC responds to customer demand for toll-

free calling, it offers FX service, in which callers dial toll-free numbers and the ILEC recovers the cost of the service from the FX subscriber. As the call is classified as a toll call, no reciprocal compensation is paid when an ALEC subscriber dials the FX number. In contrast, the virtual FX service described by Dr. Selwyn is free to both the callers and the FX subscriber, and, in addition, the ALECs that wish to provide it want to receive reciprocal compensation from the ILEC when its customers dial the virtual FX number. While both the ILEC and the ALEC are free to offer FX-like services under any pricing structure they want, it is important that both ALEC and ILEC services be subject to the same regulatory treatment. Since the call originates and terminates in different local calling areas, it is not a local call and neither ALEC nor ILEC should pay reciprocal compensation when its subscriber dials such a number.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.