

1 **Q. Let's turn to the final topic of your testimony, local interconnection rates.**
2 **Should carriers reimburse each other for termination of local traffic on the**
3 **basis of switched access rates?**

4 A. No. During the transition to a competitive market, the Commission should regulate all
5 intercarrier compensation arrangements, to ensure that carriers do not use their market
6 power to block entry into the market, or to gain a competitive advantage over other
7 carriers. For instance, the dominant carrier should not be allowed to demand exorbitant
8 payments from its smaller competitors for terminating their traffic, nor should the
9 dominant carrier be allowed to refuse to make a fair payment to its smaller competitors
10 for termination of traffic which is originated by customers of the dominant carrier and
11 destined for customers of the smaller carrier.

12 In the absence of regulatory intervention, the dominant carrier would be in a
13 position to demand asymmetric compensation arrangements -- or even to refuse to
14 interconnect on any reasonable terms, as the Bell companies once did, prior to the
15 Kingsbury Commitment earlier in this century. As long as it controls the vast majority of
16 the traffic, the dominant carrier will have the necessary market power to impose its
17 preferences on smaller carriers. In so doing, it will not only benefit its own stockholders
18 to the detriment of its competitors', but it will also create a very substantial barrier to
19 entry. Without mandatory interconnection on reciprocal terms, the newer competitors
20 will operate at the mercy of the dominant carrier, and the prospects for effective
21 competition will be bleak.

22 Historically, carriers have maintained a sharp distinction between local and toll
23 compensation rates. It is sometimes argued that this distinction is arbitrary, or that it will
24 be hard to maintain and police such differences in an increasingly competitive
25 environment, because different competitors will offer different local calling areas and
26 different service packages. I reject this view. The distinction is neither arbitrary nor
27 artificial. A distinction has been maintained between local and long-distance traffic for
28 this entire century, and it is both feasible and appropriate to continue this distinction

1 during the transition to competition. It is feasible because separate treatment can be
2 accomplished by mandatory reporting requirements, whereby each carrier reports its
3 traffic mix, (and is subject to auditing by the other carrier). This is very similar to the
4 procedures which are already used to distinguish interstate and intrastate toll traffic. To
5 some degree, the mix of local and toll calls can also be verified through the use of inter-
6 switch communication linkages, such as SS7, which can often pass along the originating
7 phone number.

8 Maintaining the local/long-distance distinction is also appropriate. Granted,
9 from a cost standpoint, the place of origination is largely irrelevant to the terminating
10 local carrier. However, in terms of value, there is a significant difference between local
11 and long distance traffic. Due to customer perceptions, as well as longstanding historic
12 pricing patterns, long-distance traffic generates significantly more revenue per minute
13 than local traffic. In turn, this suggests that the termination of local traffic is not as
14 valuable, and should not be priced as high, as the termination of long-distance traffic.

15 This difference in value, or relative strength of demand for local and long
16 distance call termination services is particularly significant since both local and long
17 distance calls are originated and terminated over the same loop. As I previously
18 testified, the loop is economically similar to cattle feed. When feed is increased, the
19 possible output of both hamburger and leather increases. Like cattle feed, the jointly
20 used loops are part of the intermediate, rather than final, stage of production. Telephone
21 subscribers are primarily interested in placing long-distance and local calls, rather than
22 in "consuming" access lines; thus, the access line is an intermediate input necessary for
23 the final joint products, local and toll calling (Likewise, most people are interested in
24 buying hamburger or leather coats instead of a cow.)

25 Given the joint nature of the subscriber loop facilities, and since these joint costs
26 are not caused by increases and decreases in traffic volumes, a pure usage factor has
27 little or nothing to do with the level of loop costs. Accordingly, there is no reason why
28 the loop costs should be recovered in uniform proportion to traffic volume.

1 In competitive markets, joint costs are recovered in a manner which recognizes
2 the relative strength of demand for the joint products that make use of the joint element
3 of production. In those markets, purchasers of each of the joint products bear some
4 share of the joint costs, with the relative shares being determined by the relative strength
5 of demand in the various markets, considering the value of the final product, the
6 availability of substitutes for that product, or alternative means of producing that
7 product, and the like. In essence, cattle producers will tend to price raw meat and hides
8 in a manner that ensures that each product provides the maximum feasible contribution
9 to the joint costs of cattle feeding within the market constraints imposed by each
10 product's demand.

11 For instance, in the classic example of beef and hides, purchasers of leather
12 goods will bear a relatively large share of the joint costs of feeding the cattle if the
13 demand for leather products is strong and the demand for meat is weak. But leather
14 coat buyers will obviously not be required to shoulder 100% of the feed costs and
15 consumers of beef none of them, as there is also a considerable demand for beef.

16 While relative usage is one measure of relative strength of demand (since
17 heavier users tend to derive greater value from the network), all minutes are not
18 equivalent. In a competitive market, costs would not be recovered based upon a
19 uniform per-minute approach, since that would not adequately recognize the relevant
20 factors that influence the value of each product or service, and thus the relative strength
21 of demand for that item. While not a perfect analogy, consider the example of dairy
22 products. Cream does not carry the same price per fluid ounce as whole milk, while
23 skim milk will have still a different price. The relative prices of the various dairy
24 products depends upon market conditions, and more specifically the relative strength of
25 demand for each of the various products.

26 Analogously, it would not be appropriate to levy the same per-minute access
27 charges for toll and local calls, because this would fail to acknowledge the great
28 differences in perceived value, and market demand, that distinguish toll usage from local

1 usage. Stated another way, if an incumbent LEC is allowed to charge a smaller local
2 exchange competitor as much per minute to complete a call that originated down the
3 block as it charges AT&T to complete a call that originated in California, the LEC
4 would be completely ignoring the underlying differences in value, as well as the
5 associated differences in revenues per minute (and resulting differences in their
6 respective ability to pay). Such an illogical pricing policy may be sustainable in the short
7 run, if the LEC has the market power to force the new carriers to pay whatever it
8 demands. Nevertheless, such a pricing policy would not be logical, nor would it be
9 consistent with the pattern of prices which would emerge in a truly competitive market.
10 To the contrary, in a competitive market one would expect to see higher prices per
11 minute for originating or terminating toll calls than for originating or terminating local
12 calls, because the former service is inherently more valuable than the latter service.
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