Interconnection and Traffic Termination

Q. Please turn to the first section of your testimony. Would you begin by defining what is meant by interconnection rates?

A. Yes. In this context, *interconnection rates* means the rates charged by one LEC to another for the switching and transport of local calls. Prior to the passage of the 1996 Telecom Act, some incumbent LECs (including Bell Atlantic) advocated charging relatively high rates for this service, similar to those charged interexchange carriers (IXCs) for the switching and transport of long distance calls. However, there is no legal or logical reason why the rates applied to the termination of local calls must be the same as the *carrier access rates* charged by a LEC for the origination and termination of toll calls. The FCC notes as follows:

> 1034. We recognize that transport and termination of traffic, whether it originates locally or from a distant exchange, involves the same network functions. Ultimately, we believe that the rates that local carriers impose for the transport and termination of local traffic and for the transport and termination of long distance traffic should converge. We conclude, however, as a legal matter, that transport and termination of local traffic are different services than access service for long distance telecommunications. Transport and termination of local traffic for purposes of reciprocal compensation are governed by sections 251(b)(5) and 252(d)(2), while access charges for interstate long-distance traffic are governed by sections 201 and 202 of the Act. The Act preserves the legal distinctions between charges for transport and termination of local traffic and interstate and intrastate charges for terminating long-distance traffic.
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> 1035. We conclude that section 251(b)(5) reciprocal compensation obligations should apply only to traffic that originates and terminates within a local area... We find that the reciprocal compensation provisions of section 251(b)(5) for transport and termination of traffic do not apply to the transport or termination of interstate or intrastate interexchange traffic.

FCC, First Report and Order, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, et al.,* Docket No. 96-98 (FCC August 8, 1996) (the Implementation Order).

The pricing rules developed by the FCC in 47 C.F.R. Part 51 have been stayed by the federal Court of Appeals for the 8th Circuit[1], and thus the FCC's conclusions are not currently binding on the Board. Nevertheless, from my perspective as an economist, I believe it is appropriate to distinguish these two concepts (local termination rates and carrier access rates), even if they involve identical network facilities. Maintenance of this distinction between local termination rates and carrier access rates is consistent with longstanding patterns in the market, which are deeply rooted in perceived differences in value.

Most consumers perceive long distance calls as having greater value than most local calls, and prices paid by consumers have historically recognized this difference. Similar pricing distinctions based upon perceived value exist in other markets as well. For instance, the price Federal Express charges to deliver a package from my office in Tallahassee to the Ratepayer Advocate's office in Newark differs greatly, depending upon whether it is delivered by 8 a.m., 10 a.m., or 3 p.m. the next day. Yet the package will likely be flown on the same plane in any case, and the time and effort required to transport it within the Newark area will be very similar. It may be more impressive to deliver a package before 8 am, and if someone is in a rush, this service may be very valuable; but the carrier's cost is likely to be about the same regardless of the delivery time. The differences in delivery price are mostly, if not entirely, based

[1] No. 96-3321, etc.: Iowa Utilities Board, et al, Petitioners v. Federal Communications Commission; United States of America, October 15, 1996.

upon differences in perceived value, rather than differences in the cost of transporting the package. These pricing differences persist because the market perceives different delivery times as distinctly different services, with differing value and demand characteristics.

Similarly, in economic terms, terminating a local call is a distinctly different service from terminating a long distance call, even if the engineering functions involved are the same. The latter function is typically perceived as having greater value and historically has commanded a higher price, even where the cost was roughly the same.

The FCC has indicated (in the section quoted earlier) that it believes that "the rates that local carriers impose for the transport and termination of local traffic and for the transport and termination of long distance traffic should converge" in the future. It isn't clear whether the FCC was expressing an opinion about how prices will evolve under increasingly competitive conditions, or hinting at future changes it plans in regulation of interstate switched access rates. Even if it wants to reduce interstate access rates in the future, it may not be in a position to force a complete convergence to occur, assuming the Court of Appeals concludes that the 1996 Telecom Act does not provide the FCC with the authority to completely control intrastate rates. Most likely, toll access rates (regulated by the FCC in the case of interstate traffic) will continue to be distinct from local interconnection rates (which are the subject of this proceeding) for the indefinite future.

If toll access rates continue to trend downward, they will tend to converge towards the current level of local interconnection rates (which are relatively low in most instances). In my opinion, there is no reason to anticipate an upward trend in local interconnection rates, nor would it be appropriate to price this service at levels which are similar to those applicable to switched access service. While the same facilities may

be used for both types of traffic termination, it is reasonable to set distinctly different rates, with the price charged for terminating local calls being much lower than the price applicable to long distance calls, consistent with historic pricing relationships.

Most customers effectively pay a lower price per minute for local calls than they do for long distance calls. For instance, if a residential customer uses the phone for 480 minutes per month for outgoing local calls, and is paying a flat rate of $12 per month, the effective rate is just 2.5 cents per minute. Similarly, if a business customer uses the phone for 900 minutes of outgoing local calls and pays $28 for this service, the effective rate is just 3.1 cents per minute. This is less than the toll rates paid by most customers. Furthermore, in many markets, local exchange service is priced as a flat amount per month, regardless of the volume of local calls placed and received. This provides consumers with an extremely low, or zero, price signal at the margin. The pricing of local interconnection service has typically been consistent with this pattern of prices in the retail market. Where adjacent LECs send traffic back and forth within a single toll-free local calling area, the financial arrangements have typically not involved substantial net payments by either LEC. In a typical EAS arrangement, for example, a smaller independent LEC serving a suburban community might send far more traffic to the urban areas served by the Bell company than it receives from that area. As a result, the smaller LEC might make a net payment each month to the Bell company, but the amounts involved would typically be relatively small -- less than a penny a minute.