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The Honorable W.J. "Billy" Tauzin  
Chairman  
Committee on Energy and Commerce  
United States House of Representatives  
Washington, D.C. 20515

Dear Chairman Tauzin:

WorldCom appreciates the opportunity to contribute to the ongoing public dialogue concerning the payment of reciprocal compensation for the transport and termination of ISP-bound traffic under the Telecommunications Act of 1996. This letter responds to the specific questions posed in your February 15 letter to Mr. Ebbers.

1. Explain in detail the nature of the accounting change WorldCom recently made with respect to revenues from reciprocal compensation, and why WorldCom believes that the new accounting approach better comports with Generally Accepted Accounting Principles than the old manner of accounting for such revenues.

**Answer 1.** – WorldCom now treats reciprocal compensation as an offset to costs of sales; prior to September 30, 2000, WorldCom recorded reciprocal compensation on a gross basis as revenues. Reciprocal compensation represents a reimbursement of certain costs for call termination performed on behalf of other carriers' customers and is determined contractually based on fixed rate per minute charged to those carriers. As such, WorldCom has determined that it is more appropriate to reflect this reimbursement net of cost.

2. State whether WorldCom believes there are costs associated with generating reciprocal compensation revenues, specify the actual costs that are incurred by your company in connection with generating those revenues (i.e., connecting calls from competitor networks), both in absolute terms and as a percentage of such revenues. Provide all supporting documentation for any alleged costs. In responding to this request, please also state:
  - a. whether the cost to connect calls from each entity with which WorldCom has a reciprocal compensation agreement is a fixed cost per entity, a fixed cost per connection, a fixed cost per line, or a cost that varies by length of time of the connection or the ultimate customer destination;
  - b. the manner in which the actual reciprocal compensation agreement with each such entity calculates the amount of such payments to your company; and

- c. whether other charges or fees received by your company pursuant to agreements with ultimate destination customers recoup or offset all or part of these same costs and, if so, the amount of such other revenues and the percentage of costs recouped from them; if not, describe the nature of the costs that these customer charges or fees act to recoup or offset.

**Answer – 2.** WorldCom incurs actual economic costs when transporting and terminating local telephone calls from the incumbent local exchange carriers' (ILECs') networks to WorldCom's end users, including Internet service providers (ISPs). It is important to understand at the outset that WorldCom's local networks are very similar to the ILECs' local networks. Like the incumbents, WorldCom's local networks are comprised of copper and/or fiber optic transmission facilities connected to circuit switches. Like the incumbents, there is an actual cost associated with use of our local networks – including when they are used to terminate traffic that originates on an incumbent's network.<sup>1</sup>

WorldCom is not alone in this view. Other authorities -- including the Telecommunications Act of 1996, the Federal Communications Commission, numerous state public service commissions, and the incumbent local exchange carriers – concur in this assessment. A brief summary of their views is provided below.

### **The Telecommunications Act**

In the Telecommunications Act of 1996, Congress plainly required that carriers be allowed to recover the costs of transporting and terminating telecommunications. For example, Section 251(b)(5) directs that each local exchange carrier "establish reciprocal compensation arrangements for the transport and termination of telecommunications." Section 252(d)(2)(A) states that state commissions "shall not consider the terms and conditions for reciprocal compensation to be just and reasonable" unless they: (1) "provide for the mutual and reciprocal recovery by each carrier of costs associated with the transport and termination on each carrier's network facilities of calls that originate on the network facilities of the other carrier. . .," and (2) "determine such costs on the basis of a reasonable approximation of the additional costs of terminating such calls."

### **The FCC's rules**

The FCC rules implementing Section 251(b)(5) of the Telecommunications Act require that carriers pay each other reciprocal compensation for transporting and terminating local telecommunications. Sections 51.701-51.717 establish the rules for the payment of reciprocal compensation. The only exception to the general reciprocal compensation requirement is contained in Section 51.713, which only allows adoption of a "bill and keep" arrangement where a state commission concludes that traffic between the two local networks is roughly in balance.

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<sup>1</sup> The ILECs have alleged that their competitors have installed less expensive "soft" switches to handle ISP-bound terminating traffic, reducing their costs below those of the ILECs. Those states addressing this type of claim generally have dismissed it outright as unsupported. Moreover, with respect to WorldCom, this allegation simply is not true. Although WorldCom has conducted very limited trials with soft switches, WorldCom's local networks continue to use circuit switches for terminating local traffic.

In addition, the Commission's local competition rules establishing federal rates for transport and switching confirm that actual economic costs are incurred when carriers transport and terminate telecommunications. Sections 51.505-51.515 of the FCC's Rules (some vacated) established pricing rules for unbundled network elements, including switching and shared transport, and set up interim proxy rates. In particular, the Local Competition Order set the total element long-run incremental cost (TELRIC)-based per-minute proxy rate for unbundled local switching at between 0.2 cents and 0.4 cents, while rejecting USTA's proposed per-minute rate of 1.3 cents (paras. 811-813). The Commission concluded that a price within this proxy range "should allow carriers the opportunity to recover fully their additional cost of terminating a call..." (para. 815). The Commission also found that the TELRIC-based per-minute proxy rate for tandem switching should be an additional 0.15 cents (para. 824).

### The FCC's decisions

In the Local Competition Order, the FCC concluded that "reciprocal compensation for transport and termination of calls is intended for a situation in which two carriers collaborate to complete a call." (para. 1034). The Commission determined that reciprocal compensation should include cost-based rates to recover the costs incurred by carriers in transporting and terminating calls (paras. 1056-1068). The FCC explained that "In general, we find that carriers incur costs in terminating traffic that are not *de minimis*, and consequently, bill-and-keep arrangements that lack any provisions for compensation do not provide for recovery of costs." (para. 1112). Similarly, in the ISP Reciprocal Compensation Order, the FCC acknowledged that "no matter what the payment arrangement, LECs [including CLECs] incur a cost when delivering traffic to an ISP that originates on another LEC's network." (para. 29).

The Commission long has recognized that the ILECs incur actual economic costs for originating, transporting, and terminating traffic on behalf of interexchange carriers. In the Local Competition Order, the FCC concluded that telephone exchange providers and exchange access providers "us[e] essentially the same equipment to transmit and route traffic..." (para. 185). In fact, "the facilities used to provide exchange access services are the same as those used to provide local exchange services." (para. 363). As the Commission put it:

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 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. (para. 1033).

Similarly, the Commission has acknowledged that the ILECs incur actual economic costs for originating, transporting, and terminating traffic on behalf of their own end user customers. In the Local Competition Order, the Commission found that "transport of traffic for termination on a competing carrier's network is, therefore, largely indistinguishable from transport of termination of calls on a carrier's own network." (para. 1054).

## The state commissions

Numerous state commissions have determined that CLECs incur legitimate economic costs when they terminate ISP-bound traffic on behalf of the incumbents. For example:

- The New York Public Service Commission upheld and modified its reciprocal compensation scheme over bill and keep, stating that “to deny all compensation for ISP termination would be to unfairly ignore the indisputable fact that CLECs completing these calls incur costs in doing so.” Opinion and Order Concerning Reciprocal Compensation, Case 99-C-0529, Opinion No. 99-10 (August 26, 1999), p. 61.
- The Texas Public Utility Commission found that because carriers incur costs to transport and terminate traffic, “current volumes of traffic between carriers do not support adoption of the bill-and-keep method.” Proceeding to Examine Reciprocal Compensation, Arbitration Award, Docket No. 21982 (July 13, 2000), p. 35.
- The Alabama Public Service Commission determined that “it is undeniable that [a CLEC] will incur costs in terminating traffic to its ISP customers which originates from [ILEC] customers. It would be entirely inconsistent with the competitive principles underlying the Act not to provide [the CLEC] with some mechanism to recover those costs as they are incurred.” ICG Telecom Group, Docket 27069 (November 10, 1999).
- The Ohio Public Utilities Commission concluded that “there is no question [a CLEC] incurs costs when it delivers ISP-bound traffic that has originated from an [ILEC] customer. Once an ISP call is handed off by [the ILEC], these calls are transported and switched by [the CLEC] and delivered to the ISP. Any carrier would incur some costs in performing this transport and switching function.” ICG Telecom Group, Case No. 99-1153-TP-ARB (January 11, 2000).
- The Florida Public Utilities Commission indicated that “the evidence is also clear that a cost is involved in the delivery of this traffic, including traffic to ISPs.” GlobalNAPs, Inc., Docket No. 991267-TP (April 24, 2000).
- The Illinois Commerce Commission found that “[the ILEC’s] local exchange competitors are obligated by law to terminate calls made by [the ILEC’s] customers, they incur costs in order to do so, and they are entitled to be compensated for the use of their equipment and facilities.” Teleport Comm., 97-0404 (March 11, 1998).
- The California Public Utilities Commission (ALJ Recommendation) concluded that bill and keep does not provide “an equitable alternative” to recip comp for ISP calls, and thus is “unacceptable.” Because the ISP is the called party like any other business end user, and the ILEC customer is the calling party, the originating ILEC must “pay for the costs of terminating the call, on behalf of the call originator who causes the costs to be incurred.” The Proposed Decision of ALJ Pulsifer to the Public Utilities Commission of the State of California (11/3/00, pages 82, 84-85).

### The ILECs' own words

In 1996, the ILECs fought against the imposition of bill-and-keep arrangements for transporting and terminating traffic, arguing (among other things) that mandatory bill-and-keep would fail to adequately compensate carriers for costs incurred, and violate the 5<sup>th</sup> Amendment of the Constitution as a taking through uncompensated use of ILEC property. (Local Competition Order, paras. 1099-1105). One ILEC even derided the concept as "bilk and keep."

In early 1997, the ILECs filed comments in the FCC's inquiry into the ISPs' use of the public switched networks. The ILECs uniformly complained about the network congestion caused by ISP traffic on their networks, and that this alleged congestion was being caused by heavy ISP traffic on the ILECs' terminating local switches. For example, Bell Atlantic argued that the Commission needed to address the growing congestion in the ILECs' central office switches and facilities, and interoffice trunk facilities, serving ISPs. (Bell Atlantic/NYNEX Comments, CC Docket No. 96-263, filed March 24, 1997, at i, 1-6).

In early 1998, several ILECs filed petitions pursuant to Section 706 of the Telecom Act. Again, the ILECs complained about network congestion caused by ISP traffic. For example, Bell Atlantic admitted that the growth of the Internet "has caused some traffic congestion in certain Bell Atlantic switches, especially those located near major ISP points of presence." (Bell Atlantic Petition, CC Docket No. 98-11, filed April 6, 1998 (attached White Paper, at 15). Ameritech acknowledged that increasing Internet usage brings "significant network congestion" on its circuit-switched networks. (Ameritech Petition, CC Docket No. 98-32, filed March 5, 1998, at 6-7). These types of statements point up the inarguable observation that local carriers incur significant costs when terminating ISP-bound traffic.

In several FCC proceedings in 1996 and 1997, the ILECs argued for the imposition of federal access charges on ISPs precisely because, they claimed, the cost burdens imposed by the ILECs' residential customers when they call ISPs far exceeded the revenues the ILECs derived from serving the ISPs as local customers. For example, "information derived from our network engineers can be used to generally illustrate the conclusion that current revenues derived from local services provided to ISPs do not come close to recovering the cost of providing service." Bell Atlantic Ex Parte Letter to Jim Schlichting, CC Docket No. 96-262 (June 28, 1996), at 14. Additionally, "the low, flat rates that the ISPs pay are not covering the massive costs that they are imposing on the telephone network to avoid network congestion that would degrade service to other customers. . . . [T]here is no justification for allowing ISPs to pay below-cost rates for their access." Bell Atlantic/NYNEX Ex Parte Letter, CC Docket No. 96-262 (March 24, 1997), at 3, 5. Further, Bell Atlantic argued, increased Internet usage has "driven the monthly cost of delivering this traffic over a business line to an Internet provider to at least \$75 and an ISDN line to about \$50. Yet the revenues from that line remains at \$16-30 per month. . . ." Id. at p. 7.

Finally, in the current remand proceeding on reciprocal compensation, the ILECs have all but admitted that CLECs incur economic costs when they terminate traffic sent to them by the ILECs. In a recent ex parte letter, for example, counsel for BellSouth argues for a

relatively low compensation rate due, in part, to “rapidly declining costs of network facilities used by the CLECs to route Internet calls to ISP modem banks.” Letter from Robert T. Blau, BellSouth, to Dorothy Attwood, FCC, CC Docket No. 99-68, February 1, 2001, at 1.

### The ILECs’ actions

As noted above, the ILECs’ own words reveal their belief that actual costs are incurred when carriers transport and terminate telecommunications. Their words further demonstrate the ILECs’ apparent inability or unwillingness in the mid-1990s to deploy sufficient local facilities at the terminating end of their networks, and their obvious desire to be rid of this traffic. Not surprisingly, when competitive alternatives began to appear in 1996 and 1997, many ISPs looked to CLECs to terminate traffic from their customers. As a result, CLECs are removing actual economic costs from the ILECs’ networks because CLECs are terminating traffic that the ILECs otherwise would be forced to terminate themselves. Of course, the ILECs now want to wash their hands of any obligation to compensate CLECs for the very real value they are providing – relieving the ILECs of the very real costs of terminating ISP-bound traffic.

In 1996 and 1997, the ILECs sought -- and to a large extent received -- excessive rates for reciprocal compensation precisely because they anticipated that the flow of traffic would result in the CLECs paying enormous sums of money to the ILECs, with little money going the other way. Of course, the ILECs claimed then that these sums of money were merely for the recovery of actual economic costs, and disputed any notion that they amounted to “regulatory arbitrage” or “subsidies.”

**Answer 2.a.** -- As is evident from the foregoing discussion, all local exchange carriers – whether ILECs or CLECs – incur costs when they transport and terminate telephone calls for each others’ customers. Indeed, WorldCom’s own experience demonstrates that it incurs actual economic costs in connection with transporting and terminating traffic to ISPs.

ISPs utilize the local network in the same way as other local business end users. Other end users of inbound telecommunication services includes call centers, credit card validation centers, travel reservation agencies, home shopping networks, call-in radio shows, ticket outlets, pizza delivery stores, and taxicab companies. In every instance, carriers incur costs in transporting and terminating calls to the end users’ premises.

In keeping with the deregulatory approach set out by Congress in the Telecom Act, federal and state rules generally do not require CLECs to file cost studies measuring and reporting the actual costs incurred in transporting and terminating telecommunications on behalf of other carriers. Instead, the FCC decided that, rather than impose dominant carrier regulatory requirements on the competitive industry, the ILECs’ own cost studies, which are also required for determining the costs of unbundled network elements, would be used as a proxy to determine the costs for all carriers. Because these cost studies were to be based on forward looking economic cost, the FCC determined that the costs developed through these studies would reflect the costs of efficient competitors. Local Competition Order, at paras. 1086-89. The FCC also theorized, however, that the CLECs’ costs would be higher than the forward-looking economic cost of the incumbents because the CLECs lacked the incumbents’ scale and scope. Id.

Every state to address the issue has rejected any notion that CLECs are required to submit their own individual cost studies. Instead, the ILEC's own costs of transporting and terminating traffic -- as evidenced in their cost studies to support the UNE rates for local transport and switching -- have been deemed the only proper proxy for CLEC costs. For example:

- The New York Public Service Commission rejected outright the claim that each CLEC's costs must be examined. "For good reason, the pertinent costs are those of the ILEC, unless the CLEC chooses to come in with a study showing its costs are higher." Opinion and Order Concerning Reciprocal Compensation, Case 99-C-0529, Opinion No. 99-10 (August 26, 1999), p. 58. As a result, the Commission set the rate for reciprocal compensation based on the ILEC's end office and tandem office UNE switching rates. Id., pp. 60. In another proceeding, the Commission reiterated that reciprocal compensation rates applicable to ISP-bound traffic must be consistent with the ILEC's "tariffed access rates for local switching and local transport." Order Resolving Arbitration Issues, Case 99-C-0019 (July 23, 1999), p. 8.
- The Texas Public Utility Commission concluded that a blend of the ILEC's UNE rates for end office and tandem office switching, and interoffice transport, should be used as the basis for the payment of reciprocal compensation for all local traffic, including ISP-bound traffic. Proceeding to Examine Reciprocal Compensation, Arbitration Award, Docket No. 21982 (July 13, 2000), pp. 19, 35-38, 49.
- The California Public Utilities Commission reiterated that "the ILEC's costs are to be used as a proxy for the costs of the competitive local exchange carrier," so that the ILEC's "costs of termination at the end office level [are] a proxy for [the CLEC's] costs of termination." Order Modifying Decision 99-09-069 and Denying Rehearing, Application 99-03-047, Decision 00-05-051 (May 18, 2000), p. 10.
- The North Carolina Utilities Commission has concluded repeatedly that CLECs are entitled to reciprocal compensation for ISP-bound traffic, using the ILEC's tandem office interconnection rates. BellSouth Telecommunications, Inc., Docket No. P-55, Sub 1178 (June 13, 2000), p. 16; ICG Telecom Group, Docket No. P-582, Sub 6 (March 1, 2000), p. 11.
- The Alabama Public Service Commission determined that the CLEC "is entitled to reciprocal compensation at the [ILEC's] tandem interconnection rate, which is comprised of (1) tandem switching; (2) transport between the [ILEC] tandem and its end office switches and (3) end office switching." ICG Telecom Group, Docket 27069 (November 10, 1999), p. 13.
- The Kentucky Public Service Commission found that "the most reasonable method for compensation is at the current rate for [ILEC] local calls." ICG Telecom, Order, Case No. 99-218 (March 2, 2000), p. 3.

As a result, WorldCom has never been required to file a cost study with any regulatory authority for its CLEC operations. In general terms, however, the cost of transporting and

terminating local calls to ISPs has two variable components. One component varies with call volume (or the cost per call), and commonly is referred to as "call set-up" cost. The other cost component varies with call duration, and is expressed on a "per minute" basis. Combined, these two components should reflect the long-run incremental costs incurred by local carriers.

Some ILECs claim that per-minute reciprocal compensation rate structures are inherently *inefficient because traffic termination costs are fixed to a certain extent*. However, several state commissions have examined and rejected this viewpoint, while others (notably Texas) have adopted plans which include a call set-up charge and smaller per-minute charges.

**Answer 2.b.** -- The interconnection agreements between WorldCom and the ILECs typically calculate the amount of reciprocal compensation payments based on a fixed rate per minute. These usage-sensitive rates initially were developed largely through the negotiation and arbitration process established by Sections 251 and 252 of the Telecommunications Act. As noted above, the ILECs originally sought the highest possible rates for reciprocal compensation, in the belief that nearly all terminating traffic would originate from the CLECs' local networks. For example, the United States Telephone Association (USTA) argued that rates for reciprocal compensation should be based on existing usage-sensitive interstate access charges. Local Competition Order, at para. 1048. The FCC rejected anything other than a cost standard based on the forward-looking costs of terminating local traffic, however, stating that "only that portion of the forward-looking, economic cost of end-office switching that is recovered on a usage-sensitive basis constitutes an 'additional cost' to be recovered through termination charges." Id., at para. 1057.

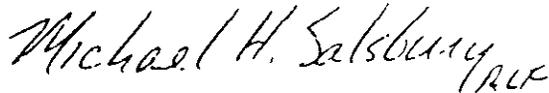
**Answer 2.c.** -- WorldCom does not receive any charges or fees from ISPs that recoup or offset any or all of the costs of transporting and terminating local traffic from the ILEC network to WorldCom's network. Instead, WorldCom receives a monthly fee from its ISP customers to cover other types of costs, including aggregating, concentrating, and delivering traffic from WorldCom's switches and facilities to the local destination: the ISP's modems. In some cases, depending upon the terms of the agreement, WorldCom also will perform various administrative functions on behalf of ISP customers, such as obtaining and assigning local telephone numbers. The services provided to end users by CLECs, and the prices charged, are dictated by the competitive marketplace, which does not allow carriers to recoup any of the LEC-to-LEC telephone transport and termination costs that are covered by reciprocal compensation.

The CLECs' basic service rates generally are not set to recover the costs of inbound terminating switching because these costs are paid by the originating customer through its carrier. This situation is entirely consistent with the fundamental, longstanding regulatory principles of cost causation that have been applied to so-called "sent-paid" local calls. Under this model -- embraced to date by nearly every federal and state regulator -- the calling party is the cost causer, which is responsible for incurring the cost of a call. Thus, the originating carrier must either bear the burden of terminating the calls on its own network or pay a connecting carrier for the costs of terminating the call, on behalf of the call originator who causes the costs to be incurred.

Some ILECs have argued against the "sent-paid" model for ISP calls by attempting to delink the payment obligation from cost causation for local calls. Contrary to their assertions, and as the FCC, numerous state commissions, and several federal courts already have found conclusively: (1) calls between end users, including ISPs, located within a local calling area are local calls; (2) the ISP is the called party, like any other local business end user; and (3) the ILEC end user customer is the calling party, responsible for incurring the cost. Reciprocal compensation is the mechanism recognized by the 1996 Act for allowing carriers to recover from each other the costs of carrying calls to local end users.

Thank you for your interest in ascertaining the facts about the actual costs involved in transporting and terminating local telephone calls to ISPs on behalf of other carriers. Please let me know if there is anything else WorldCom can do to enhance the public record concerning this important public policy issue.

Sincerely,



Michael H. Salisbury

cc: The Honorable John D. Dingell, Ranking Member  
Committee on Energy and Commerce

The Honorable Fred Upton, Chairman  
Subcommittee on Telecommunications and the Internet

The Honorable Ed Markey, Ranking Member  
Subcommittee on Telecommunications and the Internet

✓ The Honorable James Greenwood, Chairman  
Subcommittee on Oversight and Investigations

The Honorable Peter Deutsch, Ranking Member  
Subcommittee on Oversight and Investigations