

F. Intercarrier Arrangements

It is imperative that the Commission regulate intercarrier compensation arrangements and ensure that they apply on a reciprocal basis. In other words, the dominant carrier should not be allowed to demand exorbitant payments from its smaller competitors for terminating their traffic, nor should the dominant carrier be allowed to refuse to make a fair payment to its smaller competitors for termination of traffic which is originated by customers of the dominant carrier and destined for customers of the smaller carrier.

In the absence of regulatory intervention, the dominant carrier would be in a position to demand asymmetric compensation arrangements -- or even to refuse to interconnect on any terms. As long as it controls the vast majority of the traffic, the dominant carrier will have the necessary market power to impose its preferences on smaller carriers. In so doing, it will not only benefit its own stockholders to the detriment of its competitors', but it will also create a very substantial barrier to entry. Without mandatory interconnection on reciprocal terms, the newer competitors will operate at the mercy of the dominant carrier, and the prospects for effective competition will be bleak.

Staff's proposed rules regarding intercarrier arrangements are partly based upon the assumption that the distinction between local and toll calling is arbitrary. With regard to bill and keep, staff states that "it perpetuates the existing difference between local and toll compensation rates, which is arbitrary, and it will be hard to maintain and police such artificial differences in a competitive environment, where different competitors provide different local calling areas and different service packages". (Appendix A, p. 5). We reject this view, believing that the distinction is neither arbitrary nor artificial. To the contrary, maintaining a distinction between local and long-distance traffic is both feasible and appropriate. It is feasible because separate treatment can be accomplished by mandatory reporting requirements, whereby each carrier reports its traffic mix, (and is subject to auditing by the other carrier). To some degree, the mix of local and toll calls can also be determined (or verified) through the use of inter-switch communication linkages, such as SS7, which can often pass along the originating phone number (much like caller ID service).

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

As an example of this concept of value, consider the following. The cost of a typical local loop (which is connected to a central office) is not the direct cost of any particular service. Instead, it is a joint cost that is attributable to the provision of several services. Joint costs are incurred when production facilities simultaneously serve two or more markets in fixed proportions. When joint production processes are used, the firm cannot increase or decrease the amount of output for one market without changing in the same proportion and direction the output or capacity available for another market. As a result, joint costs do not vary in proportion to the total output or sale of any one of the final products; they vary only in proportion to the total available output of the joint production processes.

A classic example of joint costs is the cost of feed used to produce the joint products beef and hides. Another is the cost of growing cotton and cottonseed. In both cases, joint costs are involved in the intermediate stages of production, and additional direct costs are required to produce the final products (e.g., hamburger, leather coats, cotton sheets, cottonseed oil). Moreover, increased capacity yields joint benefits: more cattle feed increases the available output of both hamburger and leather; more fertilizer results in more cotton cloth and more cottonseed oil.

This definition also applies to the costs of the typical subscriber loop, which is used to supply local, toll, and switched access services. The installation of a subscriber loop and drop to provide any of these services automatically provides loop capacity for the other two at no additional cost, since the same loop is used for all three services. For example, LEC's cannot increase the loop capacity available for completing local calls without also enlarging the available capacity for originating and terminating toll calls.

Thus, the loop is like cattle feed, which when increased expands the possible output of both hamburger and leather. And like cattle feed, the jointly used loops are part of the intermediate, rather than final, stage of production. Telephone subscribers are primarily interested in placing long-distance and local calls, rather than in "consuming" access lines; thus, the access line is an intermediate input necessary for the final joint products, local and toll calling. (Likewise, most people are interested in buying hamburger or leather coats instead of a cow.)

Given the joint nature of the subscriber loop facilities, they should be treated in a manner similar to common costs. Since the costs are not caused by increases and decreases in traffic volumes, a pure usage factor has little or nothing to do with the level of loop costs. Unfortunately, the factors that do determine the cost level (geographic characteristics of the service territory, customer density patterns, zoning requirements, technological changes, etc.) cannot be closely linked to the various customer classes or service categories. As a result, there is no certain method available for allocating the loop costs to any particular service, or determining the most appropriate recovery of those costs.

Ideally, joint costs should be recovered in a manner which recognizes the relative strength of demand for the joint products that make use of the loop. This pattern of value-related cost recovery is consistent with the method by which joint costs are recovered in competitive markets. In those markets, purchasers of each of the joint products bear some share of the joint costs, with the relative shares being determined by the relative strength of demand in the various markets. In other words, each product is priced to maximize its contribution to the joint costs, within the market constraints imposed by the product's demand.

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

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

Analogously, it would not be appropriate to levy the same per-minute access charges for toll and local calls, because this would fail to acknowledge the great differences in perceived value, and market demand, that distinguish toll usage from local usage. Stated another way, if an LEC is allowed to charge an NEC as much per minute to complete a call which originated down the block as it charges AT&T to complete a call which originated in California, the LEC would be completely ignoring the underlying differences in value, as well as the associated differences in revenues per minute (and resulting differences in their respective ability to pay). Such an illogical pricing policy may be sustainable in the short run, because the LEC has the market power to force NECs to pay whatever it demands, but such a pricing policy would not be logical, nor would it be consistent with the pattern of prices which would emerge in a truly competitive market. To the contrary, in a competitive market one would expect to see higher prices per minute for originating or terminating toll calls than for originating or terminating local calls, because the former service is inherently more valuable than the latter service.