

ARTICLE

THE BATTLE OVER RECIPROCAL COMPENSATION: THE FCC'S ONGOING STRUGGLE TO REGULATE INTERCARRIER COMPENSATION FEES FOR ISP-BOUND TRAFFIC

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TABLE OF CONTENTS

I. INTRODUCTION	
II. THE FCC'S FLAWED DECISIONMAKING	
A. <i>The State Commissions Speak First</i>	
B. <i>The FCC Weighs In: The ISP Declaratory Ruling</i>	
C. <i>The D.C. Circuit's Review of the ISP Declaratory Ruling</i>	
D. <i>The FCC Responds: The ISP Remand Order and Intercarrier Compensation NPRM</i>	
E. <i>The D.C. Circuit Remands Again</i>	
III. THE LEGAL BASIS FOR FCC JURISDICTION	
A. <i>The D.C. Circuit Correctly Concluded that the FCC's View of the Act's Reciprocal Compensation Obligations Finds No Legal Support in the 1996 Act</i>	
B. <i>ISP-Bound Calls Are "Local" and Subject to Reciprocal Compensation</i>	
C. <i>The FCC has Jurisdiction to Regulate the Compensation Due for Local Traffic</i>	
D. <i>The Markets, Not Regulation, Should Determine Whether Carriers Move to Bill-and-Keep</i>	
IV. CONCLUSION	

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I. INTRODUCTION

Of the many regulatory battles spawned by the United States' 1996 Telecommunications Act¹ (the "1996 Act" or the "Act"), few have been as financially significant or hotly contested as the ongoing dispute over intercarrier compensation for dial-up Internet traffic. At stake are the billions of dollars² which competitive local exchange carriers ("CLEC's") annually have received from incumbent local exchange carriers ("ILEC's") under the Act's reciprocal compensation provisions for transporting and delivering dial-up Internet calls to ISP's when the calls originate on the ILEC's' local networks.³

At the center of the dispute is the Federal Communications Commission ("FCC" or "Commission"), which has struggled with how to categorize ISP-bound traffic for purposes of intercarrier compensation given the existing patchwork of intercarrier compensation regimes. The historical regulatory distinction in the United States between "local" and "long distance" calls has resulted in the development of two general intercarrier compensation regimes: (1) the *access charge* regime, for long distance calls; and (2) the *reciprocal compensation* regime, for calls that originate and terminate within the same local calling area. The difficulty for the Commission has been that ISP-bound calls are not exactly "long distance" and not exactly "local" and, therefore, do not fit neatly under either regime.

Nonetheless, the Commission has attempted to analyze ISP-bound calls within the confines of the existing intercarrier compensation regimes. In the context of access charges, the Commission's treatment of ISP-bound calls has been relatively consistent and straightforward. Access charges are the payments that long distance carriers (also called interexchange carriers) make to local exchange carriers ("LEC's") for use of the LEC's local telephone

¹ Pub. L. No. 104-104, 110 Stat. 56 (codified as amended at 47 U.S.C. §§ 151 et seq. (2000)). The 1996 Telecommunications Act amended the Communications Act of 1934 (the "1934 Act").

² See *Carriers Battle Over Future Reciprocal Compensation*, COMMUNICATIONS DAILY, Jan. 4, 2001 (stating that at the end of 2000, ILEC's reported to the Federal Communications Commission that the reciprocal compensation they pay annually to competing carriers had risen to over two billion dollars). Approximately 90% of these reciprocal compensation billings is for ISP-bound traffic. See *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, Order on Remand and Report and Order, 16 F.C.C. Rcd. 9151, ¶ 5 (2001) [hereinafter *ISP Remand Order*].

³ In the United States, ISP's are entities that provide mass market access to the Internet. For dial-up (or narrowband) Internet access, an end-user with a standard phone line uses a computer and modem to place a call to an ISP in his local calling area. The end-user typically pays a flat monthly fee to the ISP for Internet access, in addition to the flat monthly fee he already pays to his local exchange carrier for use of the local exchange network. To connect to their dial-in subscribers, ISP's purchase analog and digital business lines from local exchange carriers, which may or may not be the same local exchange carriers that provide originating local access for their subscribers.

network to originate and terminate long distance calls.⁴ Since 1983, the Commission has been clear that enhanced service providers (“ESP’s”), of which ISP’s are a subclass, are not required to pay access charges to LEC’s for their use of local exchange services to access their subscribers.⁵ According to the Commission, policy reasons, namely, its historical “hands-off” approach to regulating information services,⁶ as well as the fact that ESP’s do not use local exchange networks in a manner analogous to long distance carriers, justify continuation of the present access treatment of ESP’s as end-users, rather than as interexchange carriers.⁷

The Commission’s approach with respect to reciprocal compensation has not been nearly as clear-cut. Reciprocal compensation emerged as a second form of intercarrier compensation with Congress’ passage of the landmark

⁴ The United States has a dual system for access charges. Interstate long distance calls are subject to the federal access charge regime, while intrastate long distance calls are subject to the access charges rules imposed by state public utility commissions. For interstate long distance calls, the FCC has established access charge rules pursuant to its jurisdictional authority under § 201 of the Act. *See ISP Remand Order*, 16 F.C.C. Rcd. 9151, ¶ 52; 47 U.S.C. § 201(b) (“All charges, practices, classifications, and regulations for an in connection with such [interstate or foreign] communication service, shall be just and reasonable.”).

⁵ *See In re MTS and WATS Market Structure*, Memorandum Opinion and Order, 97 F.C.C.2d 682, ¶¶ 78-83 (1983); *In re Amendments of Part 69 of the Commission’s Rules Relating to Enhanced Service Providers*, Order, 3 F.C.C. Rcd. 2631, ¶ 14 (1988); *In re Part 69 of the Commission Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture*, Report and Order & Order on Further Reconsideration & Supplemental Notice of Proposed Rulemaking, 6 F.C.C. Rcd. 4524, ¶ 60 (1991); *In re Access Charge Reform*, First Report and Order, 12 F.C.C. Rcd. 15,982, ¶¶ 344-345 (1997) [hereinafter *Access Charge Reform Order*]; *see also ISP Remand Order*, 16 F.C.C. Rcd. 9151, ¶ 11.

⁶ Underlying this policy has been the Commission’s continuing recognition that the industry for information services is highly competitive and lacks any “natural or economic barriers to free entry into the market for [computer] services.” *In re Regulatory and Policy Problems Presented by the Interdependence of Computer and Communication Services and Facilities*, Tentative Decision of the Commission, 28 F.C.C.2d 291, ¶ 18 (1970), *clarified and modified* by 28 F.C.C.2d 267 (1971), *aff’d in part sub. nom. GTE Service Corp. v. FCC*, 474 F.2d 724 (2d Cir. 1973), *decision on remand*, 40 F.C.C.2d 293 (1973). These market conditions have led the Commission to conclude that it is not appropriate to impose common carrier regulation on those information service providers who rely on telecommunications infrastructure for transmission of these services but do not themselves provide telecommunications services to the public. Instead, the Commission has focused almost entirely on ensuring that the common carriers who provided the underlying telecommunications services make these services available on a nondiscriminatory basis and do not themselves leverage their market power into the provision of these complementary information services. As a result, providers of information services generally have been left to grow and develop in an industry free of industry-specific regulation.

⁷ *See Access Charge Reform Order*, 12 F.C.C. Rcd. 15,982, ¶ 345; *ISP Remand Order*, 16 F.C.C. Rcd. 9151, ¶ 29.

2002]

THE BATTLE OVER RECIPROCAL COMPENSATION

1996 Telecommunications Act.⁸ The Act fundamentally changed telecommunications regulation in the United States by establishing a regulatory framework designed to introduce competition into the market for local telephone services. Significantly, the Act required local telephone companies to open their networks to competitors by, among other means, interconnecting their networks with the networks of competing local telephone companies.

Envisioning that interconnection and growing local competition would result in more than one LEC being involved in the delivery of telecommunications within a local calling area, Congress included in the Act a provision governing how interconnecting LEC's should be compensated when they collaborate to deliver a "local" call. Congress referred to such compensation as "reciprocal compensation," and provided in section 251(b)(5) of the Act that all LEC's have a duty to "establish reciprocal compensation arrangements for the transportation and termination of telecommunications."⁹ Section 252(d)(2) of the Act further provides that for purpose of compliance by an ILEC with section 251(b)(5), a state public utility commission shall not consider the terms and conditions for reciprocal compensation to be just and reasonable unless such terms and conditions both: (1) "provide for the mutual and reciprocal recovery by each carrier of costs associated with the transport and termination of each carrier's network facilities of calls that originate on the network facilities of the other carrier";¹⁰ and (2) "determine such costs on the basis of a reasonable approximation of the additional costs of terminating such calls."¹¹

Section 251(b)(5) on its face appears to require reciprocal compensation for *all* "telecommunications," which the Act defines as "the transmission between or among points specified by the user, of information of the user's choosing, without change in the form or content of the information sent and received."¹² However, such an interpretation does not make sense in the overall regulatory scheme of the Act which, as noted, allows access charges for long distance

⁸ The federal access charge regime is much older. It arose in the early 1980s as a result of the break-up of AT&T, which introduced competition into long distance markets for the first time.

⁹ 47 U.S.C. § 251(b)(5) (2000). In basic terms, reciprocal compensation works as follows. When a customer of Carrier A places a call to a customer of Carrier B located within the same local service area, Carrier A must pay Carrier B for transporting and terminating the call. Conversely, when a customer of Carrier B place a call to a customer of Carrier A located within the same local service area, Carrier B must pay Carrier A. Meanwhile, each local exchange carrier bills its own customers, usually through flat, monthly fees.

¹⁰ *Id.* § 252(d)(2)(i). Nonetheless, carriers may waive their right to mutual recovery by offsetting their reciprocal obligations, including "bill and keep" arrangements, whereby carriers bill only end-users, not other carriers. *Id.* § 252(d)(2)(B)(i).

¹¹ *Id.* § 252(d)(2)(A)(ii). Under current Commission rules, the charges for both transport and termination must be set at forward-looking economic costs. *See* 47 C.F.R. § 51.705 (2001).

¹² 47 U.S.C. § 153(43).

telecommunications. Thus, soon after passage of the Act, the Commission interpreted section 251(b)(5)'s reciprocal compensation obligations only to apply to the transport and termination of "local telecommunications traffic."¹³

This view of section 251(b)(5) formed the basis of the Commission's 1999 declaratory ruling in which the Commission first spoke to the issue of whether reciprocal compensation is due for ISP-bound traffic.¹⁴ The Commission ruled that carriers who deliver calls to ISP's are not entitled to reciprocal compensation under the Act because these calls are predominantly "interstate" rather than "local" in character.¹⁵ The Commission's *ISP Declaratory Ruling* did not withstand judicial scrutiny. In a decision highly critical of the Commission's decisionmaking, the U.S. Court of Appeals for the District of Columbia Circuit vacated the ruling and remanded the case to the Commission for a more adequate explanation of why reciprocal compensation does not apply to ISP-bound traffic.¹⁶

On April 27, 2001, the Commission issued a ruling on remand reaffirming its previous conclusion that the Act's reciprocal compensation obligations do not apply to traffic delivered to an ISP, but adopting a wholly different analysis to reach this result.¹⁷ Apparently unable to respond to the D.C. Circuit's specific concerns about the Commission's analysis in the *ISP Declaratory Ruling*, the Commission reversed course and remarkably concluded that its entire view of reciprocal compensation had been misguided from the beginning – specifically its determination that section 251(b)(5)'s reciprocal compensation obligations only apply to "local" telecommunications traffic, a determination that had formed the basis of not only the Commission's *ISP Declaratory Ruling*, but all state public utility commission and federal court decisions to date on the issue as well.¹⁸

According to the Commission, a more "reasonable reading" of the Act is that Congress intended the traffic listed in section 251(g) – namely, "exchange access, information access, and exchange services for such access" provided to interexchange carriers and information service providers¹⁹ – to be excluded from the telecommunications traffic subject to reciprocal compensation under

¹³ *In re* Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, 11 F.C.C. Rcd. 15,499, ¶ 1034 (1996) [hereinafter *Local Competition Order*] (concluding that section 251(b)(5)'s reciprocal compensation obligations only apply to traffic that "originates and terminates within a local area"); *see also* 47 C.F.R. § 51.701(a) (providing that reciprocal compensation applies for "transport and termination of local telecommunications traffic between LEC's and other telecommunications carriers").

¹⁴ *In re* Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, Declaratory Ruling in CC Docket No. 96-98 and Notice of Proposed Rulemaking in CC Docket No. 99-68, 14 F.C.C. Rcd. 3689 (1999) [hereinafter *ISP Declaratory Ruling*].

¹⁵ *Id.* ¶ 1.

¹⁶ *See* *Bell Atlantic v. FCC*, 206 F.3d 1 (D.C. Cir. 2000).

¹⁷ *See* *ISP Remand Order*, 16 F.C.C. Rcd. 9151 (2001).

¹⁸ *Id.* ¶ 46.

¹⁹ 47 U.S.C. § 251(g) (2000).

2002] *THE BATTLE OVER RECIPROCAL COMPENSATION*
section 251(b)(5).²⁰ The Commission classified ISP-bound traffic as “information access” and concluded that compensation for this traffic is not governed by the reciprocal compensation provisions of the Act, but instead by any intercarrier compensation rules the Commission may choose to adopt in the future pursuant to its broad jurisdictional authority under section 201 of the Act.²¹

Having established its jurisdiction over ISP-bound calls, the Commission wasted no time developing a new intercarrier compensation scheme to govern them. On the same day it released the *ISP Remand Order*, the Commission began a parallel proceeding to consider implementing a new unified intercarrier compensation scheme, which would apply not only to the costs associated with the delivery of ISP-bound traffic, but also reciprocal compensation payments for transport and termination of local telecommunications traffic and interstate access charges. In a notice of proposed rulemaking, the Commission proposed a “bill-and-keep” intercarrier compensation approach, in which each carrier recovers from its own end-user customers the cost of both the originating traffic that it delivers to other networks and the terminating traffic that it receives from other networks.²² According to the Commission, implementation of a bill-and-keep system is critical to eliminating the regulatory arbitrage opportunities²³ uniquely presented where reciprocal compensation is available for ISP-bound traffic.²⁴

The Commission, nonetheless, recognized that a bill-and-keep system would take years to implement and that, in the interim, some type of compensation scheme for ISP-bound traffic was required to address the “market distortions” created by the prevailing intercarrier compensation regime for exchange of ISP-bound traffic.²⁵ The Commission therefore established a three-year transitional scheme that imposes a gradually declining cap on the amount that carriers may recover from other carriers for transporting and terminating ISP-bound traffic and caps the amount of traffic for which any such compensation is owed.²⁶

The *ISP Remand Order* was appealed to the D.C. Circuit, and, once again, the Commission’s attempted regulation of intercarrier compensation for ISP-bound traffic did not withstand judicial scrutiny. In an opinion dated May 3,

²⁰ *ISP Remand Order*, 16 F.C.C. Rcd. 9151, ¶ 34.

²¹ *Id.* ¶¶ 30, 42.

²² *In re Developing a Unified Intercarrier Compensation Regime*, Notice of Proposed Rulemaking, 16 F.C.C. Rcd. 9610 (2001) [hereinafter *Intercarrier Compensation NPRM*].

²³ According to the Commission, the prevailing “calling-party’s-network-pays” regime for ISP-bound traffic has resulted in some carriers exclusively targeting ISPs as customers merely to take financial benefit of their high volumes of incoming traffic. See *Intercarrier Compensation NPRM*, 16 F.C.C. Rcd. 9610, ¶¶ 2, 68, 70.

²⁴ See *ISP Remand Order*, 16 F.C.C. Rcd. 9151, ¶ 2; *Intercarrier Compensation NPRM*, 16 F.C.C. Rcd. 9610 ¶ 66.

²⁵ See *ISP Remand Order*, 16 F.C.C. Rcd. 9151, ¶ 2.

²⁶ *Id.* ¶¶ 2, 8, 78.

2002, the D.C. Circuit ruled that the Commission's reliance on section 251(g) as the basis for excluding ISP-bound calls from the reciprocal compensation regime was unsupported by the Act and remanded the case to the Commission for further proceedings.²⁷ Significantly, however, the D.C. Circuit decided not to vacate the *ISP Remand Order* or to address the petitioners' attacks on the Commission's interim compensation scheme. According to the court, only a remand is appropriate because of the "non-trivial likelihood" that there are other legal bases to support the Commission's adoption of interim and final intercarrier compensation rules for ISP-bound traffic.²⁸ Thus, the court allowed the Commission's interim compensation scheme to remain in place while the Commission revisits, yet again, the issue of its jurisdiction to implement a compensation scheme for ISP-bound traffic.

This article will review the Commission's *ISP Remand Order* and the D.C. Circuit's May 3, 2002 decision and will analyze the effects that the Commission's proposed bill-and-keep system will have on the Internet industry. The article will argue that, in light of the D.C. Circuit's May 3, 2002 decision and its earlier rejection of the *ISP Declaratory Ruling*, the only reasonable interpretation of the Act's reciprocal compensation obligations is that they apply to "local" calls and that ISP-bound traffic is properly categorized as "local." Therefore, ISP-bound traffic should be subject to the reciprocal compensation provisions of the Act. However, this categorization of ISP-bound traffic does not deprive the Commission of jurisdiction to regulate it. Indeed, the Commission has full authority under the 1996 Act to regulate reciprocal compensation rates just as it regulates other interconnection pricing. Thus, the Commission can require that these rates be based on forward-looking economic costs, which should help alleviate the regulatory arbitrage the Commission identified in the *ISP Remand Order* and the Intercarrier Compensation NPRM as its principal motivation for moving to a bill-and-keep system.

Finally, this article will explain why Commission regulation should not be the vehicle for moving to a bill-and-keep regime for ISP-bound traffic. The 1996 Act fully allows for a bill-and-keep system, and carriers will naturally migrate to implementing bill-and-keep regimes in their interconnection agreements once traffic levels between ILEC's and CLEC's are balanced. However, this will only occur when local markets are truly competitive and reciprocal compensation rates are cost-based.

²⁷ *WorldCom, Inc. v. FCC*, 288 F.3d 429 (D.C. Cir. 2002).

²⁸ *Id.* at 434.

2002]

THE BATTLE OVER RECIPROCAL COMPENSATION
II. THE FCC'S FLAWED DECISIONMAKING

A. *The State Commissions Speak First*

State public utility commissions, in their role as arbiters of interconnection agreements pursuant to section 252 of the Act,²⁹ got the first crack at the reciprocal compensation issue. They examined whether the interconnection agreements under their jurisdiction require ISP-bound traffic to be compensated through reciprocal compensation. Most interconnection agreements tracked the reciprocal compensation requirements of federal law and provided for payment of reciprocal compensation only for "local traffic."

Just prior to the Commission's release of the *ISP Declaratory Ruling* in February 1999, over half of the state public utility commissions in the country had examined the question. All had ruled that a dial-up Internet communication that travels from the end-user to an ISP is a severable local call terminating at the ISP's local modem and, therefore, is "local" and subject to the reciprocal compensation provisions of the interconnection agreements under their jurisdiction.³⁰ The federal courts that reviewed these state commission decisions generally agreed.³¹

B. *The FCC Weighs In: The ISP Declaratory Ruling*

The FCC threw its hat into the ring in February 1999 with the release of its *ISP Declaratory Ruling* and took the opposite view from the state public utility commissions. The Commission concluded that carriers who deliver calls to ISP's are not entitled to reciprocal compensation under the Act because these

²⁹ See 47 U.S.C. § 252(b) (requiring state public utility commission to approve voluntarily-negotiated interconnection agreements and to arbitrate negotiation disputes).

³⁰ See Kasey A. Chappelle, Comment, *The End of the Beginning: Theories and Practical Aspects of Reciprocal Compensation for Internet Traffic*, 7 COMM'LAW CONSPECTUS 393, 398 (1999) (reporting that before the Commission's *ISP Declaratory Ruling*, twenty-nine state public utility commissions had ruled that reciprocal compensation should apply to ISP traffic). In aftermath of the *ISP Declaratory Ruling*, in which the FCC stated that dial-up ISP-bound traffic was "predominantly interstate," state public utility commissions have taken different approaches to setting intercarrier compensation for this traffic. Some have eliminated compensation entirely for ISP-bound traffic, interpreting existing interconnection agreements to exclude ISP-bound traffic from the scope of reciprocal compensation, or determining in arbitration proceedings that no such compensation is warranted. Other state public utility commissions have reduced such compensation to levels that are intended to reflect the CLEC's' actual costs more accurately. Finally, some commissions have refused to budge on the issue and continue to preserve reciprocal compensation at the high rates the parties originally negotiated. See PETER W. HUBER ET AL., *FEDERAL TELECOMMUNICATIONS LAW* 72-73 (2d. ed. Supp. 2001).

³¹ See, e.g., *Southwestern Bell Tel. Co. v. Public Utility Comm'n of Texas*, No. MO-98-CA-43, at 7 (W.D. Tex. June 22, 1998), *aff'd* 208 F.3d 475 (5th Cir. 2000); *Illinois Bell Tel. Co. v. WorldCom Techns., Inc.*, No. 98 C 1925, 1998 WL 419493 (N.D. Ill. July 23, 1998), *aff'd* 179 F.3d 566 (7th Cir. 1999).

calls are “largely interstate” rather than “local” in character.³² Nonetheless, the Commission ruled that in the absence of a federal rule regarding the appropriate intercarrier compensation for this traffic, the parties are bound to their existing interconnection agreement as interpreted by state public utility commissions. Therefore, if the parties had agreed to reciprocal compensation for ISP-bound traffic, or a state public utility commission in the exercise of its authority to arbitrate interconnection disputes had imposed reciprocal compensation obligations for this traffic, ISP-bound traffic would be subject to the reciprocal compensation rates set forth in the agreements.³³

The Commission’s decision in the *ISP Declaratory Ruling* to treat dial-up ISP-bound traffic as “interstate” rather than “local” did not surprise observers. In 1998, the Commission had concluded that an ADSL offering was an interstate service and therefore properly tariffed at the federal level.³⁴ Based on this order, most people expected that the Commission would also view ISP-bound traffic as “interstate” rather than “local.”

The Commission’s analysis in the *ISP Declaratory Ruling* turned out to be almost identical to its earlier analysis in the *GTE ADSL Order*. In both decisions, the Commission cited the same FCC precedent³⁵ in support of its “end-to-end” jurisdictional analysis of the service at issue to determine whether it was “local” or “interstate.” Applying this analysis to GTE’s ADSL service offering, the Commission concluded that an ADSL communication does “not terminate at the ISP’s local server . . . but continue[s] to the ultimate destination or destinations, very often at a distant Web site accessed by the end

³² *ISP Declaratory Ruling*, 14 F.C.C. Rcd. 3689, ¶¶ 1, 26 n.87 (1999).

³³ *Id.* ¶ 1.

³⁴ The Commission repeatedly stated that it was making no determination whether ILEC’s should be required to pay reciprocal compensation when they exchange circuit-switched dial-up Internet traffic with CLEC’s. See *In re GTE Telephone Operating Cos.*, Memorandum Opinion and Order, 13 F.C.C. Rcd. 22,466, ¶¶ 2, 29 (1998) [hereinafter *GTE ADSL Order*].

³⁵ See *Petition for Emergency Relief and Declaratory Ruling Filed by BellSouth Corporation*, 7 F.C.C. Rcd. 1619 (1992) (considering the jurisdictional nature of traffic that consisted of an incoming interstate transmission call to the switch serving a voice mail subscriber and an intrastate transmission of that message from that switch to the voice mail apparatus, and concluding that the entire transmission constituted one interstate call because “there is a continuous path of communications across state lines between the caller and the voice mail service”); *Teleconnect Co. v. Bell Telephone Co. of Penn.*, E-88-83, 10 F.C.C. Rcd. 1626 (1995), *aff’d sub nom.* *Southwestern Bell Tel. Co. v. FCC*, 116 F.3d 593 (D.C. Cir. 1997) (considering whether a nationwide 800 travel long distance service is a single, interstate, end-to-end call and concluding that the 800 call used to connect to the interexchange carrier’s switch was not a separate and distinct call from the call that was placed from that switch); *In re Southwestern Bell Tel. Co.*, Order Designating Issues for Investigation, 3 F.C.C. Rcd. 2339, 2341 (1988) (concluding that a credit card call should be treated as one and not two calls because switching at the credit card switch “is an intermediate step in a single end-to-end communications”).

2002] *THE BATTLE OVER RECIPROCAL COMPENSATION*
user.”³⁶ Similarly, in the *ISP Declaratory Ruling*, the Commission analyzed dial-up ISP-bound traffic from “inception to its completion”³⁷ and concluded that the communications do not terminate at the ISP’s local server but continue to distant Web sites that are often located in other states.³⁸ As a result, the Commission concluded that a “substantial portion” of dial-up ISP-bound traffic is interstate.³⁹

In both the *ISP Declaratory Ruling* and *GTE ADSL Order*, the Commission rejected the argument of a number of CLEC’s and ISP’s that, for jurisdictional purposes, an end-to-end Internet communication must be separated into two components. For example, for a dial-up Internet communications, these CLEC’s and ISP’s argued that the communications can be separated into (1) an intrastate (*i.e.*, “local”) telecommunications service, provided in this instance by one or more LEC’s, and (2) an interstate information service provided by the ISP.⁴⁰ They further argued that because section 251(b)(5) of the Act refers to the duty to establish reciprocal compensation arrangements for the “transport and termination of *telecommunications*,”⁴¹ and because ISPs provide “information services” rather than “telecommunications services,” the “telecommunications” component of dial-up Internet traffic must terminate at the ISP’s local server.⁴² In rejecting this argument, the Commission referred to the Act’s definition for “information services” – “the offering of a capability for generating, acquiring, storing, transforming, processing, retrieving, utilizing, or making available information *via telecommunications*”⁴³ – and stated that such definition recognizes that the information service and the

³⁶ *GTE ADSL Order*, 13 F.C.C. Rcd. 22,466, ¶¶ 17, 19 (noting that “the Commission traditionally has determined the jurisdictional nature of communications by the end points of the communication and consistently has rejected attempts to divide communications at any intermediate points of switching or exchange between carriers”).

³⁷ *ISP Declaratory Ruling*, 14 F.C.C. Rcd. 3689, ¶ 11 (1999).

³⁸ *Id.* ¶ 12.

³⁹ *Id.* ¶¶ 18, 20. The Commission did acknowledge that some Internet websites accessed by an end-user might be located within the same local exchange area as the end-user. However, the Commission concluded that “a substantial portion of Internet traffic involves accessing interstate or foreign websites.” *Id.* ¶ 18.

⁴⁰ *Id.* ¶ 13. The Commission rejected the identical argument in the *GTE ADSL Order*. *GTE ADSL Order*, 13 F.C.C. Rcd. 22,466, ¶ 20.

⁴¹ 47 U.S.C. § 251(b)(5) (2000) (emphasis added).

⁴² *ISP Declaratory Ruling*, 14 F.C.C. Rcd. 3689, ¶ 13. In further support of this position, certain CLEC’s highlighted that in previous decisions the Commission had concluded that ISP’s do not appear to offer “telecommunications service” and thus are not “telecommunications carriers” that must contribute to universal service. *See id.* ¶ 13 & n.44; *see also In re Federal-State Joint Board on Universal Service, Report and Order*, 12 F.C.C. Rcd. 8776, ¶¶ 788-789 (1997) [hereinafter *Universal Service Order*]. According to the Commission, it never concluded in those decisions that “telecommunications” end where “enhanced” service begin or that any “transmission” or “traffic” terminated or originated at any intermediate point. *ISP Declaratory Ruling*, 14 F.C.C. Rcd. 3689, ¶ 13 n.44.

⁴³ 47 U.S.C. § 153(20) (emphasis added).

underlying telecommunications cannot be separated for purposes of jurisdictional analysis.⁴⁴ Therefore, the Commission analyzed ISP-bound traffic for jurisdictional purposes as a continuous telecommunications transmission from the end-user to a distant Web site.

The Commission also was not persuaded by two other arguments raised by a number of CLEC's, which they claimed proved that ISP-bound traffic must be deemed to terminate at the ISP. First, these CLEC's pointed to the Commission's consistent treatment of ISP's as end-users, and ISP-bound traffic as "local," in other contexts and argued that this established that a dial-up Internet call must terminate at the ISP's point of presence.⁴⁵ In particular, these CLEC's cited to the Commission decisions "exempting" ISP's from paying interexchange carrier-type access charges and permitting them instead to pay local business rates for their access to the local switched network, just like any other end-user.⁴⁶ The CLEC's also reminded the Commission that it has permitted ISP's to pay the special access surcharge when purchasing special access line under the same conditions as those applicable to end-users⁴⁷ and has extended its treatment of calls to ISP's as local traffic to the regulatory accounting area, where the F.C.C. treats costs incurred to carry calls to ISP's as local and permits LEC's to recoup them under charges set by state public utility commissions.⁴⁸

Despite this precedent, the Commission refused to categorize ISP's as end-users or ISP-bound traffic as "local," for purposes of reciprocal compensation. In particular, the Commission stated that the fact that it "exempted" ISP's from access charges indicates its understanding that ISP's in fact use interstate access services, and, therefore, the Commission retains jurisdiction over this traffic and may treat it as interstate for purposes of reciprocal compensation.⁴⁹

The Commission also brushed aside a statutory argument made by a number of CLEC's that was premised on the fact that "telephone exchange service" and "exchange access" are the only two services defined by the 1996 Act and that a "local exchange carrier," by definition, can only engage in the provision of telephone exchange service or exchange access.⁵⁰ According to these

⁴⁴ *ISP Declaratory Ruling*, 14 F.C.C. Rcd. 3689, ¶ 13.

⁴⁵ *Id.* ¶ 15.

⁴⁶ *Id.* ¶ 16.

⁴⁷ *See id.* ¶ 5; *see also GTE ADSL Order*, 13 F.C.C. Rcd. 22,466, ¶ 7 (1998).

⁴⁸ *ISP Declaratory Ruling*, 14 F.C.C. Rcd. 3689, ¶ 5; *see also In re* Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture, Notice of Proposed Rulemaking, 4 F.C.C.R. 3983, ¶ 47 (1989). The system of allocating costs between the interstate and intrastate jurisdictions is known as the separations process. Expenses that are intrastate are included in a carrier's "rate base" – the expenses it seeks to recoup through local charges.

⁴⁹ *ISP Declaratory Ruling*, 14 F.C.C. Rcd. 3689, ¶ 16. The Commission rejected the same argument in the GTE ADSL Order. *See GTE ADSL Order*, 13 F.C.C. Rcd. 22,466, ¶ 21.

⁵⁰ *See* 47 U.S.C. § 153(26) (2000). Consistent with this understanding that LEC's provide only these two types of services, the Act imposes on ILECs the duty to interconnect "for the

2002]

THE BATTLE OVER RECIPROCAL COMPENSATION

CLEC's, this demonstrates that, under the Act, the traffic they deliver to ISP's must be deemed either "telephone exchange service" or "exchange access." Therefore, because ISP-bound traffic cannot be "exchange access" since neither LEC's nor CLEC's assess toll charges for the traffic,⁵¹ it therefore must be "telephone exchange service," which is a form of local telecommunications for which reciprocal compensation is due.⁵² The Commission rejected this argument, simply stating that it was "unpersuaded" that ISP-bound traffic is "telephone exchange service" based on its consistent characterization of providers of information services as "users of access service."⁵³

C. The D.C. Circuit's Review Of The ISP Declaratory Ruling

The Commission's *ISP Declaratory Ruling* was challenged from both sides. The ILEC's generally were satisfied with the Commission's determination that ISP-bound traffic was beyond the scope of the Act's reciprocal compensation requirements but were unhappy about the Commission's decision to leave the ultimate determination whether ISP-bound traffic was subject to reciprocal compensation to the state public utility commissions. They challenged the Commission's conclusion that, in the absence of federal regulation, state public utility commissions have the power to require the payment of reciprocal compensation in arbitration proceedings. CLEC's, on the other hand, generally were happy with this aspect of the *ISP Declaratory Ruling*, given that the majority of state public utility commissions had already ruled in their favor, but challenged the Commission's conclusion that the Act's reciprocal compensation requirements do not apply to ISP-bound traffic.

In a critical opinion dated March 24, 2000, the D.C. Circuit vacated the *ISP Declaratory Ruling* and remanded the case to the Commission for a more adequate explanation of its conclusion that reciprocal compensation does not apply to ISP-bound traffic.⁵⁴ The court began its review with the observation that "the issue at the heart of this case is whether a call to an ISP is local or long-distance" and "[n]either category fits clearly."⁵⁵ According to the court, calls to ISP's are not quite local because "there is some communication taking place between the ISP and out-of-state websites," and not quite long-distance because the communication from the ISP server to the distant websites "is not really a continuation, in the conventional sense, of the initial call to the ISP."⁵⁶

transmission and routing of telephone exchange service and exchange access." *Id.* § 251(c)(2).

⁵¹ The Act defines "exchange access" to mean "offering of access to telephone exchange services or facilities for the purpose of the origination or termination of telephone *toll* services." *Id.* § 153(16) (emphasis added).

⁵² *ISP Declaratory Ruling*, 14 F.C.C. Rcd. 3689, ¶ 17.

⁵³ *Id.* ¶ 17.

⁵⁴ See *Bell Atlantic v. FCC*, 206 F.3d 1 (D.C. Cir. 2000).

⁵⁵ *Id.* at 5.

⁵⁶ *Id.*

The court analyzed the Commission's reliance on an end-to-end jurisdictional analysis for purposes of determining whether ISP-bound traffic is local and concluded that the Commission had not provided an adequate explanation why this type of analysis, which has historically been used to determine whether a particular communication is jurisdictionally interstate, is appropriate for determining whether a call to an ISP traffic is local or long distance for purposes of reciprocal compensation.⁵⁷ The court seemed more inclined to believe that the call is appropriately characterized as *local* because "an ISP appears . . . no different from many businesses, such as pizza delivery firms, travel reservation agencies, credit card verification firms, or taxicab companies, which use a variety of communication services to provide their goods or services to their customers."⁵⁸ The court explained that ISP's are more analogous to these types of businesses than to long distance providers because they are not telecommunications providers (as are long distance providers) and simply use telecommunications to provide their products or services (in this case information services) to their customers.⁵⁹ For this reason, the court found the precedent cited by the Commission in support of using an end-to-end jurisdictional analysis, all of which involved interexchange carriers rather than ISP's, to be distinguishable.⁶⁰

The court was equally unimpressed with the Commission's responses to the arguments advanced by CLEC's in support of their position that ISP-bound traffic is "local." First, the court dismissed the Commission's position that telecommunications cannot be said to "terminate" at an ISP because, although a call from an ISP to an out-of-state website may be an information service for the end-user, it is telecommunication from the perspective of the ISP.⁶¹ The court disagreed, stating that, "the mere fact that the ISP originates further telecommunications does not imply that the original telecommunications does not 'terminate' at the ISP."⁶²

The court also considered the Commission's policy of treating ISPs as end-users for purposes of exempting them from access charges, but not for purposes of reciprocal compensation. The court declared that this contradictory policy was "something of an embarrassment,"⁶³ and concluded that the Commission's argument that the fact that ISPs are *exempted* from access charges simply confirms that calls to ISPs are like long-distance calls as "not very compelling."⁶⁴

Lastly, the court was not satisfied with the Commission's explanation of why traffic to ISPs is "exchange access" rather than "telephone exchange

⁵⁷ Id.

⁵⁸ Id. at 7.

⁵⁹ Id. at 6-7.

⁶⁰ Id. at 6.

⁶¹ Id. at 7.

⁶² Id.

⁶³ Id. at 8.

⁶⁴ Id.

2002] *THE BATTLE OVER RECIPROCAL COMPENSATION*
service.”⁶⁵ The court noted that the Commission, in its brief, conceded that “exchange access” and “telephone exchange access” constitute the only possibilities for this type of traffic,⁶⁶ and concluded that the nature of the services that ISPs provide precludes a conclusion they connect to the local network “for the purpose of the origination or termination of telephone toll services” (the definition of “exchange access”).⁶⁷

D. The FCC Responds: The ISP Remand Order and Intercarrier Compensation NPRM

It took more than a year for the Commission to respond to the D.C. Circuit’s opinion. The Commission released its *ISP Remand Order* on April 27, 2001, which reaffirmed its previous conclusion that the Act’s reciprocal compensation obligations do not apply to traffic delivered to an ISP, but adopted a completely new statutory analysis to support this outcome.⁶⁸ On the same day, the Commission also issued its *Intercarrier Compensation NPRM*, which sought comments on the Commission’s proposed plan to implement a unified bill-and-keep intercarrier compensation scheme for all currently regulated forms of intercarrier compensation, including for ISP-bound traffic.⁶⁹

Although it surprised few observers that the Commission reaffirmed its earlier conclusion that ISP-bound traffic is not subject to reciprocal compensation and that the Commission has jurisdiction to implement a new compensation scheme for this traffic,⁷⁰ the Commission’s decision to entirely revamp its interpretation of the Act’s reciprocal compensation obligations was unexpected. The Commission concluded in the *ISP Remand Order* that its interpretation of section 251(b)(5) as applying only to “local” telecommunications – an interpretation that was fundamental to the Commission’s *ISP Declaratory Ruling* and every state public utility commission and federal court decision on the ISP reciprocal compensation

⁶⁵ Id.

⁶⁶ Id.

⁶⁷ Id. at 9. The D.C. Circuit has vacated and remanded an FCC order that classified DSL-based advanced services as either “telephone exchange service” or “exchange access” for purposes of concluding that DSL-based advanced services are subject to the interconnection, unbundling and resale obligations of section 251(c) of the Act. *WorldCom, Inc. v. FCC*, 246 F.3d 690 (D.C. Cir. 2001). The court explained in support of that decision that the Commission’s interpretation of “telephone exchange service” and “exchange access” in that order was essentially the same as in the *ISP Declaratory Ruling*, which the court had vacated and remanded. See *id.*

⁶⁸ See *ISP Remand Order*, 16 F.C.C. Rcd. 9151 (2001).

⁶⁹ See *Intercarrier Compensation NPRM*, 16 F.C.C. Rcd. 9610 (2001). For example, the Commission also proposed that a bill-and-keep approach was appropriate for the reciprocal compensation payments governed by section 251(b)(5) of the Act and interstate access charges regulated under section 201. See *id.*

⁷⁰ See Strickling Believes FCC Can Justify Recip Comp Ruling In Face of Remand, *TR DAILY*, March 24, 2000.

issue to date – was a mistake and should be discarded.⁷¹ According to the Commission, whether ISP-bound traffic is local or long distance, or telephone exchange service or exchange access, is wholly irrelevant to its interpretation of section 251(b)(5).⁷² Rather, Congress intended all along that section 251(g) provides a limitation on the scope of “telecommunications” embraced by section 251(b)(5).⁷³ In other words, the telecommunications that are the subject of section 251(b)(5) are all the telecommunications not specifically excluded by section 251(g) – namely, “exchange access, information access, and exchange services for such access” provided by interexchange carriers and information service providers.⁷⁴ The Commission concluded that ISP-bound traffic, “at a minimum,” constitutes “information access” under section 251(g) and, therefore, is excluded from section 251(b)(5).⁷⁵

Conveniently, this new statutory approach to interpreting the scope of section 251(b)(5) eliminated any need for the Commission to explain, as the D.C. Circuit had requested, why extension of its end-to-end jurisdictional analysis to reciprocal compensation “made sense in terms of the statute or the Commission’s own regulations.”⁷⁶ Nonetheless, this jurisdictional analysis still played an important role in the Commission’s final decision. After finding that ISP-bound traffic is excluded from section 251(b)(5) by section 251(g), the Commission used the jurisdictional analysis to reaffirm its conclusion that ISP-bound traffic is predominantly interstate and, therefore, within the Commission’s section 201 jurisdiction under the Act. Only in this way was the Commission able to assert the legal authority to establish an appropriate cost recovery mechanism for ISP-bound traffic.⁷⁷

Clearly anticipating that its use of the end-to-end jurisdictional analysis would draw heavy criticism in light of the D.C. Circuit’s decision, the Commission explained that the court had only questioned the logical connection between this jurisdictional analysis and the construction of section 251(b)(5).⁷⁸ The Commission argued that it was no longer using the end-to-end analysis to construe section 251(b)(5), but rather relying on section 251(g) to limit the reach of section 251(b)(5). Therefore, it was only using the end-to-end analysis to determine the scope of its jurisdiction under section 201 of the Act, which is something it historically has done.⁷⁹

Having found that it has jurisdiction over ISP-bound traffic under section 201 of the Act, the Commission offered its opinion that a bill-and-keep system appears to be the preferable cost recovery mechanism for ISP-bound traffic and

⁷¹ *ISP Remand Order*, 16 F.C.C. Rcd. 9151, ¶ 46.

⁷² *See id.* ¶¶ 26, 30.

⁷³ *See id.* ¶ 42.

⁷⁴ *Id.* ¶¶ 23, 30, 34, 46.

⁷⁵ *Id.* ¶¶ 30, 42.

⁷⁶ *Bell Atlantic v. FCC*, 206 F.3d 1, 3 (D.C. Cir. 2000).

⁷⁷ *See ISP Remand Order*, 16 F.C.C. Rcd. 9151, ¶¶ 4, 52 (2001).

⁷⁸ *See id.* ¶ 53.

⁷⁹ *See id.* ¶¶ 53-54.

2002]

THE BATTLE OVER RECIPROCAL COMPENSATION

initiated a new rulemaking proceeding to implement a bill-and-keep system for all regulated forms of intercarrier compensation.⁸⁰ In the Commission's view, a bill-and-keep approach would substantially eliminate the existing opportunities for regulatory arbitrage that the prevailing intercarrier compensation scheme for ISP-bound traffic makes available.⁸¹ According to the Commission, the existing "calling-party's-network-pays" ("CPNP") scheme for ISP-bound traffic, in which the originating carrier pays the carrier that serves the ISP, "appears to have distorted the development of competition in the local exchange market."⁸²

In particular, the exchange of reciprocal compensation payments for ISP-bound traffic has undermined the operation of competitive markets by "creat[ing] opportunities for regulating arbitrage and distort[ing] the economic incentives related to competitive entry into the local exchange and exchange access markets."⁸³ The Commission noted, for example, that "ISPs do not receive accurate price signals from carriers that compete, not on the basis of the quality and efficiency of the services they provide, but on the basis of their ability to shift costs to other carriers."⁸⁴ The Commission also claimed that these regulatory arbitrage opportunities have had the effect of creating incentives for CLEC's to target ISP's as customers merely to take advantage of their high volume of incoming traffic that generates high reciprocal compensation rates.⁸⁵ The Commission stated that, in some instances, these opportunities have allowed CLEC's serving ISP's to pay ISPs' to use their services, driving ISP rates for consumers to uneconomical low levels.⁸⁶

Nevertheless, the Commission acknowledged in the *ISP Remand Order* that a bill-and-keep system will take months, if not years, to implement and that, in the meantime, an interim compensation mechanism is needed for the exchange of ISP-bound traffic to limit these regulatory arbitrage opportunities.⁸⁷ The Commission, therefore, imposed a "hybrid mechanism," which establishes relatively low per minute rates with a cap on the total volume of traffic entitled to such compensation.⁸⁸ According to the Commission, this three-year interim

⁸⁰ *Id.* ¶ 6; *Inter-carrier Compensation NPRM*, 16 F.C.C. Rcd. 9610, ¶ 66 (2001).

⁸¹ *See ISP Remand Order*, 16 F.C.C. Rcd. 9151, ¶¶ 4, 6, 67, 7; *Inter-carrier Compensation NPRM*, 16 F.C.C. Rcd. 9610, ¶ 4.

⁸² *Inter-carrier Compensation NPRM*, 16 F.C.C. Rcd. 9610, ¶ 66.

⁸³ *ISP Remand Order*, 16 F.C.C. Rcd. 9151, ¶ 2.

⁸⁴ *Id.* ¶ 71.

⁸⁵ *See id.* ¶¶ 2, 68, 70. The Commission explained that there is nothing inherently wrong with carriers targeting specific types of customers for business reasons but that there is something wrong when such decisions are driven by regulatory opportunities that disconnect costs from end-user market decisions. *See id.* ¶ 5.

⁸⁶ *See id.* ¶ 21.

⁸⁷ *Id.* ¶ 66.

⁸⁸ This interim compensation scheme only applies as carriers re-negotiate expired or expiring interconnection agreements. It does not alter existing contractual obligations, except to the extent parties are entitled to invoke contractual change-of-law provisions. It also does not pre-empt any state public utility commission decision regarding ISP-bound

compensation scheme for ISP-bound traffic will “move[] aggressively to eliminate the arbitrage opportunities presented by the existing recovery mechanism for ISP-bound [traffic]” and will produce more accurate price signals and “substantially reduce current market distortions.”⁸⁹

Specifically, the Commission capped intercarrier compensation rates for ISP-bound traffic as follows:

- \$0.0015/minute-of-use (“mou”), beginning from the effective date of the *ISP Remand Order* and continuing for six months;
- \$0.0010/mou, starting in the seventh month and continuing for 18 months;
- \$0.007/mou, starting in the 25th month and continuing through the 36th month or until further Commission action, whichever is later.⁹⁰

The Commission stated that these rate caps will have no effect to the extent that state public utility commission have ordered LEC’s to charge lower rates or on a bill-and-keep basis.⁹¹ Moreover, the rate caps apply only if the ILEC’s offer to exchange *all* traffic subject to section 251(b)(5) at these rates. This will ensure that ILEC’s will pay the same rates for ISP-bound traffic that they receive for section 251(b)(5) traffic, which, according to the Commission, is reasonable given that there are no inherent cost differences between a delivering a voice call to a local end-user and a data call to an ISP.⁹²

With respect to traffic caps, the Commission imposed the following caps on the total ISP-bound minutes for which an LEC may receive compensation:

- For 2001, an LEC may receive compensation for ISP-bound minutes up to a ceiling equal to, on an annualized basis, the number of ISP-bound minutes for which that LEC was entitled to compensation under its interconnection agreement during the first quarter of 2001, plus another 10% growth factor;
- For 2002, an LEC may receive compensation for ISP-bound minutes up to a ceiling equal to the minutes for which it was entitled to compensation in 2001, plus another 10% growth factor;
- For 2003, a LEC may receive compensation for ISP-bound minutes up to a ceiling equal to the 2002 ceiling.⁹³

The Commission further adopted a rebuttable presumption that the traffic exchange between LEC’s that exceeds a three to one ratio of terminating to originating ISP-bound traffic is subject to the interim compensation mechanism set forth in the *ISP Remand Order*. The Commission stated that this presumption may be rebutted by showing that traffic above the ratio is not

traffic compensation for the period prior to the effective date of the interim regime. *Id.* ¶ 82.

⁸⁹ *Id.* ¶¶ 7, 77.

⁹⁰ *See id.* ¶¶ 8, 78.

⁹¹ *See id.* ¶¶ 8, 80.

⁹² *See id.* ¶¶ 89-90.

⁹³ *See id.* ¶¶ 8, 78. The Commission stated that these traffic caps are consistent with projections of growth of dial-up Internet access for the first two years of the transition. *See id.* ¶ 8.

2002]

THE BATTLE OVER RECIPROCAL COMPENSATION

ISP-bound traffic or conversely that traffic below the ratio is ISP-bound traffic.⁹⁴

E. *The D.C. Circuit Remands Again*

The Commission's *ISP Remand Order* was challenged in the D.C. Circuit by two sets of petitioners. One group, headed by WorldCom, consisted of CLEC's that deliver calls to ISP's and thus were at risk of losing reciprocal compensation payments. These companies argued that the Commission erred in finding that section 251(g) takes ISP-bound calls out of section 251(b)(5)'s reciprocal compensation obligation and that, in any event, the interim compensation rules adopted by the Commission were not a product of reasoned decisionmaking and are contrary to the Act's terms. The other group of petitioners was composed of several states and state regulatory commissions that complained that the *ISP Remand Order* unlawfully preempted their authority to determine the compensation of ISP-serving CLEC's.

The D.C. Circuit issued its decision on May 3, 2002 and ruled that the Commission's reliance on section 251(g) to "carve out" ISP-bound calls from the reciprocal compensation obligations of section 251(b)(5) found no support under the provisions of the Act or its legislative history.⁹⁵ According to the court, "[b]ecause that section [251(g)] is worded simply as a transitional device, preserving various LEC duties that antedated the 1996 Act until such time as the Commission should adopt new rules pursuant to the Act, we find the Commission's reliance on 251(g) precluded."⁹⁶

Nevertheless, the court declined to vacate the Commission's *ISP Remand Order* or address the petitioners' arguments on the interim compensation provisions devised by the Commission "because there may well be other legal bases for adopting the rules chosen by the Commission for compensation between the originating and terminating LECs in calls to ISPs."⁹⁷ According to the court, "[b]ecause we can't yet know the legal basis for the Commission's ultimate rules, or even what those rules may prove to be, we have no meaningful context in which to assess these explicitly transitional measures."⁹⁸ The court stated, nonetheless, that there is "a non-trivial likelihood" that the Commission has statutory authority to devise interim compensation rules for ISP-bound traffic, as well as a bill-and-keep system, under sections 251(b)(5) and 252(d)(B)(i) of the Act.⁹⁹ The court, however, declined to decide this jurisdictional issue and remanded the case to the Commission for further proceedings.

⁹⁴ *Id.* ¶¶ 8, 79.

⁹⁵ *WorldCom, Inc. v. FCC*, 288 F.3d 429 (D.C. Cir. 2002).

⁹⁶ *Id.* at 430.

⁹⁷ *Id.*

⁹⁸ *Id.* at 434.

⁹⁹ *Id.*

The ISP reciprocal compensation dispute offers a glaring example of technology outpacing regulation. The Act's reciprocal compensation provisions, as well as the entire regulatory structure of the Act in general, are premised on the architecture and characteristics of a public, circuit-switched, telephone network, which was designed and optimized based on the assumption that the majority of traffic carried will be narrowband, point-to-point voice communications between individuals.

But the nature and character of communications have changed over time, and the Internet has given rise to new forms of communications, such as e-mail, instant messaging, and other forms of digital, IP-based services. These types of digital communications are most efficiently carried over data networks that incorporate "packet switching." Instead of maintaining an end-to-end channel of communications for the length of the information transfer, packet switching breaks the information up into small packets that are transmitted separately over the most efficient route available, and then reassembled later at their destination.¹⁰⁰ Packet-switched communications, and particularly Internet usage, have distorted the traditional regulatory assumptions of per-minute pricing and two-way flowing traffic and have created acute regulatory challenges for the Commission, particularly in the area of reciprocal compensation, in which identification of the communication as either "local" or "long distance" is so important.

Adding to the Commission's difficulty in resolving the ISP reciprocal compensation dispute has been the Commission's apparent predisposition to a particular outcome, regardless of whether that outcome is legally supportable. Throughout the ISP reciprocal compensation proceedings, the Commission has not wavered in its view that the Act's reciprocal compensation obligations do not apply to ISP-bound traffic and that the sole authority rests with the Commission to determine what compensation, if any, is due. But the 1996 Act and existing FCC regulations and orders provide little justification for this result, and the Commission has been forced to develop innovative, but legally tenuous, arguments in support of this outcome.

The Commission's latest foray into the ISP reciprocal compensation dispute provided the most shaky legal justification to date. As confirmed by the D.C. Circuit in its May 3, 2002 remand of the *ISP Remand Order*, the Commission's conclusion that section 251(g) provides the boundaries of section 251(b)(5) contravenes the plain meaning of the Act and finds no support in either the Act's legislative history or Commission precedent. This is not surprising because the scope of section 251(b)(5) is readily apparent from the overall regulatory structure of the Act. Reciprocal compensation applies to "local" traffic while access charges apply to all "non-local," or long distance, communications. Of course, this view of section 251(b)(5) returns the burden on the Commission to determine whether ISP-bound traffic is "local" or "long

¹⁰⁰ See *Packet-switched*, WHATIS?COM, at http://searchnetworking.techtarget.com/sDefinition/0,,sid7_gci212737,00.html (last visited Aug. 2, 2002).

2002]

THE BATTLE OVER RECIPROCAL COMPENSATION

distance.” The Commission clearly attempted to avoid this question in the *ISP Remand Order*, particularly in light of the D.C. Circuit’s rejection of the use of an end-to-end jurisdictional analysis for purposes of section 251(b)(5) and its statement that ISP-bound traffic appears more akin to local telecommunications traffic than long distance traffic.¹⁰¹

The Commission consistently has failed to recognize, however, that categorizing ISP-bound traffic as local and concluding that it is subject to reciprocal compensation under the Act does not deprive the Commission of jurisdiction to regulate it. Indeed, just as the Commission has jurisdiction to regulate other interconnection pricing under section 252 of the Act, the Commission has full authority to regulate reciprocal compensation rates. It, therefore, can reduce reciprocal compensation for ISP-bound traffic from its currently artificially high level to forward-looking costs. As the Commission concedes in promoting its interim price cap scheme, lowering reciprocal compensation rates should have the effect of alleviating the regulatory arbitrage opportunities the Commission has identified and has said are the principal reasons for moving to a bill-and-keep compensation regime. Once these regulatory arbitrage opportunities disappear, and as local markets become more competitive, carriers will naturally migrate to a bill-and-keep system, negating any need for the Commission to impose one prematurely through regulation.

A. *The D.C. Circuit Correctly Concluded that the FCC’s View of the Act’s Reciprocal Compensation Obligations Finds No Legal Support in the 1996 Act*

Former FCC Commissioner Furchtgott-Roth, in his dissent accompanying the *ISP Remand Order*, described the Commission’s conclusion that section 251(g) expressly limits the reach of section 251(b)(5)¹⁰² as a “twisted interpretation of the law” and “fraught with legal difficulties.”¹⁰³ The D.C. Circuit agreed with Furchtgott-Roth’s assessment in its May 3, 2002 decision remanding the *ISP Remand Order*, where it flatly rejected the Commission’s reading of section 251(g).¹⁰⁴

Section 251(g) is titled “Continued Enforcement of Exchange Access and Interconnection Requirements” and provides that:

On or after the date of enactment of the Telecommunications Act of 1996, each local exchange carrier . . . shall provide exchange access, information access, and exchange services for such access to interexchange carriers and information service providers in accordance with the same equal access and nondiscriminatory interconnection restrictions and obligations (including receipt of compensation) *that apply*

¹⁰¹ See *Bell Atlantic v. FCC*, 206 F.3d 1 (D.C. Cir. 2000).

¹⁰² *ISP Remand Order*, 16 F.C.C. Rcd. 9151, ¶¶ 8, 79 (2001).

¹⁰³ *Id.* (Furchtgott-Roth, dissenting).

¹⁰⁴ *WorldCom, Inc. v. FCC*, 2002 U.S. App. LEXIS 8542, at *9.

to such carrier on the date immediately preceding the date of enactment of the Telecommunications Act of 1996 under any court order, consent decree, or regulation, order, or policy of the Commission, until such restrictions and obligations are explicitly superseded by regulations prescribed by the Commission after such date of enactment.¹⁰⁵

Obviously, section 251(g) makes no reference to section 251(b)(5), and neither its language nor legislative history provide any indication that one of its purposes is to exclude certain categories of services from the “telecommunications” referred to in section 251(b)(5). This is not surprising in light of the fact that section 251(g) was intended as a mere transition enforcement mechanism between pre-1996 Act regulation of local exchange carriers and any regulations that the Commission might impose pursuant to the local competition provisions of the 1996 Act. As stated by the D.C. Circuit, section 251(g) on its face “appears to provide simply for the ‘continued enforcement’ of certain pre-Act regulatory ‘interconnection restrictions and obligations,’ including the ones contained in the consent decree that broke up the Bell System, until they are explicitly superseded by Commission action implementing the Act.”¹⁰⁶

Section 251(g) itself, and the Act in general, support this interpretation. Section 251(g) explicitly preserves the equal access and nondiscriminatory interconnection restrictions and obligations that applied to LEC’s “*on the date immediately preceding the date of enactment*” of the 1996 Act “under any court order, consent decree, or regulation, order, or policy of the Commission.”¹⁰⁷ This provision was required because the Act expressly provides that the 1982 AT&T Divestiture Decree and GTE Consent Decree, which required the Bell Operating Companies (“BOC’s”) and GTE to provide equal access and nondiscriminatory interconnection to competitors, are superseded by the 1996 Act on a prospective basis.¹⁰⁸ Consequently, as the legislative history makes clear, Congress included section 251(g) in order to codify these obligations that applied to LEC’s *before* passage of the 1996 Act, and ensure that they would continue after passage of the 1996 Act, until such time as the Commission explicitly replaces or eliminates them through new regulations.¹⁰⁹

The Commission also endorsed this understanding of section 251(g) in numerous decisions prior to the *ISP Remand Order*. For example, as the D.C. Circuit noted in its decision, the Commission stated in a 1999 order that

¹⁰⁵ 47 U.S.C. § 251(g) (2000) (emphasis added).

¹⁰⁶ *WorldCom, Inc. v. FCC*, 2002 U.S. App. LEXIS 8542, at *9.

¹⁰⁷ 47 U.S.C. § 251(g) (emphasis added).

¹⁰⁸ See 47 U.S.C. § 152 notes (quoting Act of Feb. 8, 1996, P.L. 104-104, Title VI, § 601, 110 Stat. 143).

¹⁰⁹ See Conf. Report 104-458 on S. 652, at 123 (Jan. 31, 1996) (stating that “the substance of this new statutory duty shall be the equal access and nondiscrimination restrictions and obligations, including receipt of compensation that applied to local exchange carriers immediately *prior* to the date of enactment, regardless of the source”) (emphasis added).

2002]

THE BATTLE OVER RECIPROCAL COMPENSATION

section 251(g) is “a transitional enforcement mechanism that obligates the *incumbent* LECs to continue to abide by equal access and nondiscriminatory interconnection requirements of the MFJ [Modified Final Judgment, *i.e.*, the 1982 AT&T Divestiture Decree] . . . until superseded by subsequent regulations of the Commission.”¹¹⁰ Likewise, in another 1999 order, the Commission interpreted section 251(g) as “preserv[ing] the LECs’ existing equal access obligations, originally imposed by the MFJ.”¹¹¹

This persuasive evidence of the meaning of section 251(g) undermines the Commission’s interpretation of section 251(g) as limiting the scope of section 251(b)(5). Indeed, one would assume that if Congress intended for section 251(g) to have another purpose in the overall regulatory scheme of the Act, specifically one as important as limiting the scope of the Act’s reciprocal compensation obligations, it either would have made this clear in the Act itself or somewhere in its lengthy legislative history. It is particularly telling that even the Commission failed to grasp this “intention” of Congress for nearly five years following passage of the Act.

The D.C. Circuit further pointed out that the Commission’s interpretation of section 251(g) as expressly limiting the reach of section 251(b)(5) to exclude reciprocal compensation for ISP-bound traffic delivered by CLEC’s is also negated by the language of section 251(g) that limits its scope to those LEC’s who were subject to equal access and nondiscriminatory interconnection restrictions and obligations “on the date immediately preceding the date of enactment” of the 1996 Act.¹¹² Prior to the 1996 Act, there were few, if any, carriers competing with the BOC’s and GTE in local markets. Thus, the majority of CLEC’s who today provide information access services to ISP’s did not have restrictions or obligations imposed on them as “carriers” prior to the 1996 Act and are, therefore, outside the scope of section 251(g).

Although not addressed by the D.C. Circuit, equally unpersuasive is the Commission’s conclusion in the *ISP Remand Order* that the services provided

¹¹⁰ *In re* Deployment of Wireline Services Offering, Order on Remand, 15 F.C.C. Rcd. 385, ¶ 47 (1999) [hereinafter *Advanced Services Remand Order*] (quoted in *WorldCom, Inc. v. FCC*, 2002 U.S. App. LEXIS 8542, at *10).

¹¹¹ *In re* Operator Communications, Inc., Memorandum Opinion and Order, 14 F.C.C. Rcd. 12,506, ¶ 2 n.5 (1999); *see also In re* Application for Review and Petition for Reconsideration or Clarification of Declaratory Ruling Regarding U S West Petitions to Consolidate Latas in Minnesota and Arizona, Memorandum Opinion and Order, 14 F.C.C. Rcd. 14,392, ¶ 17 (1999) (“In section 251(g), Congress delegated to the Commission sole authority to administer the ‘equal access and nondiscriminatory interconnection restrictions and obligations’ that applied under the AT&T Consent Decree.”); *In re* AT&T Corporation, Memorandum Opinion and Order, 13 F.C.C. Rcd. 21,438, ¶ 5 (1998) (“[S]ection 251(g) requires the BOCs, both pre- and post-entry, to treat all interexchange carriers in accordance with their preexisting equal access and nondiscrimination obligations, and thereby neutralize the potential anticompetitive impact they could have on the long distance market until such time as the Commission finds it reasonable to revise or eliminate those obligations.”).

¹¹² *WorldCom, Inc. v. FCC*, 2002 U.S. App. LEXIS 8542, at *12-13 (D.C. Cir., May 3, 2002).

by LEC's to deliver traffic to ISP's constitute "information access" under section 251(g) and, therefore, compensation for this service is not governed by section 251(b)(5).¹¹³ As noted by the D.C. Circuit in its opinion vacating and remanding the Commission's *ISP Declaratory Ruling*, the Commission has acknowledged that "exchange access" and "telephone exchange service" constitute the only possibilities for ISP-bound traffic under the Act. The D.C. Circuit, therefore, expressed strong doubt about the Commission's conclusion that ISP-bound traffic was "exchange access" rather than "telephone exchange service."¹¹⁴ Yet, in the *ISP Remand Order*, the Commission declined to justify its position that ISP-bound traffic is akin to "exchange access," and instead concluded that regardless of whether ISP-bound traffic falls under the rubric of "exchange access," it at a minimum is "information access."¹¹⁵ Thus, the Commission takes the unprecedented step of concluding that the Act recognizes a third service category, albeit one that is not defined by the 1996 Act and mentioned only twice in transitional provisions.¹¹⁶

Tellingly, the Commission itself specifically rejected the argument that "information access" is a third service category less than two years earlier. In the *Advanced Services Remand Order*, the Commission rejected the ILEC argument that xDSL traffic is exempt from the Act's interconnection, unbundling and resale obligations because it is an "information service" as opposed to "exchange access" or a "telephone exchange access" service, which by definition LEC's provide.¹¹⁷ The Commission disagreed, concluding that "information access" service is not a distinct and mutually exclusive statutory category from both "exchange access" and "telephone exchange access" service, and noted that the term "information access" is not defined by the Act, is referenced only twice in the Act, and is included in section 251(g) solely "for the purpose of transitioning from the MFJ."¹¹⁸ The Commission further

¹¹³ *ISP Remand Order*, 16 F.C.C. Rcd. 9151, ¶¶ 30, 42 (2001).

¹¹⁴ See *Bell Atlantic v. FCC*, 206 F.3d 1, 8-9 (D.C. Cir. 2000).

¹¹⁵ *ISP Remand Order*, 16 F.C.C. Rcd. 9151, ¶ 42. The term "information access" is also reference in section 274(h)(2)(A) of the Act, which the Commission says is another transitional provision merely reconciling certain aspects of the MFJ with the 1996 Act. *Id.* ¶ 48; 47 U.S.C. § 274(h)(2)(A) (2000).

¹¹⁶ In addition to section 251(g), the term "information access" is also referenced in section 274(h)(2)(A) of the Act, which the Commission identifies as another transitional provision "merely reconciling certain aspects of the MFJ" with the 1996 Act. *ISP Remand Order*, 16 F.C.C. Rcd. 9151, ¶ 42.

¹¹⁷ *Advanced Services Remand Order*, 15 F.C.C. Rcd. 385, ¶¶ 46-49 (1999). The Commission concluded that xDSL-based advanced services are either "telephone exchange service" or "exchange access," depending on how the technology is used, and therefore subject to the Act's interconnection, unbundling and resale requirements. *Id.* ¶ 3. This order was recently vacated and remanded by the D.C. Circuit in light of the Commission's reliance in that order on its interpretation of "telephone exchange service" and "exchange access" in the *ISP Declaratory Ruling*, which the court vacated and remanded a few months later. *WorldCom, Inc. v. FCC*, 246 F.3d 690, 693, 696 (D.C. Cir. 2001).

¹¹⁸ *Advanced Services Remand Order*, 15 F.C.C. Rcd. 385, ¶ 47.

2002]

THE BATTLE OVER RECIPROCAL COMPENSATION

surmised that because the modified final judgment defines “information access” as “the provision of specialized exchange telecommunications services by a BOC in an exchange area in connection with the origination, termination, transmission, switching, forwarding or routing of telecommunications traffic to or from the facilities of a provider of information services,”¹¹⁹ it was more likely merely “a subcategory of a broader category of services.”¹²⁰

Although the Commission did not further elaborate in the *Advanced Services Remand Order* about the category of which services “information access” is a subcategory, the only reasonable conclusion is that it is a subcategory of “telephone exchange service.” The “information access” classification in the modified final judgment clearly identifies “information access” as an “exchange telecommunications service,” which arguably is a subcategory of “telephone exchange services” as opposed to “exchange access services.” Moreover, as mentioned previously, “information access” must be a “telephone exchange service” by process of elimination since “exchange access” is defined by the Act as being associated with the origination or termination of telephone toll services, and “telephone toll service” is explicitly distinguished from “information services” by the Act and defined as a “telephone service” for which there is “a separate charge not included in contracts with subscribers for exchange service.”¹²¹ By definition, therefore, information access cannot be a subcategory of “exchange access services” but must be a subcategory of “telephone exchange services.”¹²²

For all of these reasons, the D.C. Circuit correctly concluded in its decision remanding the *ISP Remand Order* that the Commission’s conclusion that section 251(g) limits the boundaries of section 251(b)(5)’s reciprocal compensation obligations finds absolutely no support in either the Act, its legislative history, or Commission precedent. This is not surprising given that the only reasonable interpretation of section 251(b)(5) is the one long-held by the Commission – that it applies to “local” telecommunications traffic. Although section 251(b)(5) refers generally to “telecommunications” rather than explicitly to “local” telecommunications, Congress clearly recognized a legal distinction between the transport and termination of local traffic and access services for long distance communications. At the time of passage of the 1996 Act, an elaborate intercarrier compensation scheme already existed at both the federal and state levels for the situation in which an originating LEC, an interexchange carrier, and a terminating LEC collaborated to complete a

¹¹⁹ Modified Final Judgment § IV(I), *reprinted in* United States v. AT&T Co., 552 F. Supp. 131, 229 (D.D.C. 1982).

¹²⁰ *Advanced Services Remand Order*, 15 F.C.C. Rcd. 385, ¶ 47 n.99.

¹²¹ 47 U.S.C. § 153(48) (2000).

¹²² The Commission further argued in the *ISP Remand Order* that because the pre-1996 Act relationships between carriers predominantly involved access services, all of the services specified in section 251(g) must be access services, or services associated with access. *ISP Remand Order*, 16 F.C.C. Rcd. 9151, ¶ 37 (2001). This argument, however, finds support in neither the Act nor the modified final judgment.

long distance call. The 1996 Act did not supersede or replace these access charge regimes, and they continue today. Thus, the only reasonable conclusion is that Congress included the reciprocal compensation obligations in the 1996 Act to cover those situations in which access charges do not apply – namely, where two carriers collaborate to complete a call that originates and terminates within the same local exchange area.

It is particularly telling that the Commission never wavered from this view of section 251(b)(5) until the D.C. Circuit vacated and remanded the *ISP Declaratory Ruling* and forced the Commission to develop a new legal analysis to support its desired result. Once the D.C. Circuit held that the Commission's application of an end-to-end jurisdictional analysis was inappropriate for determining whether a telecommunications is "local" or "long distance" for purposes of section 251(b)(5), the Commission was unable to refute CLEC's argument that dial-up Internet calls terminate at an ISP and, therefore, must be considered "local" calls. As a result, the Commission's only option was to search for a new legal analysis to support its conclusion that ISP-bound traffic is excluded from the "telecommunications" subject to reciprocal compensation. The Commission found its exclusion in section 251(g). However, for this analysis to have any semblance of credibility, the Commission was forced to fully repudiate its earlier analysis and conclusion that section 251(b)(5) applies to local telecommunications traffic. The only conclusion that can reasonably be drawn from this sudden reversal of sound policy is that the Commission's motivation for modifying its interpretation of section 251(b)(5) at this time was the expediency of doing so under the circumstances.

B. ISP-Bound Calls Are "Local" And Subject To Reciprocal Compensation

With the D.C. Circuit's decision that section 251(g) does not specifically exclude ISP-bound traffic from section 251(b)(5)'s reciprocal compensation obligations, the issue whether ISP-bound traffic is "local" or "long distance" again becomes significant. As noted, the D.C. Circuit has expressed serious reservation as to whether the use of an end-to-end jurisdictional analysis to determine whether ISP-bound traffic is local or long distance. Therefore, other methods will have to be employed by the Commission on remand to make this determination.

The Commission is in the minority in its view that calls to ISP's do not terminate at the ISP. There is an abundance of legal precedent supporting the conclusion that calls to ISP's appear to terminate locally at the ISP and are subject to reciprocal compensation. For example, the overwhelming majority of state public utility commissions that have looked at the issue have expressly recognized that ISP-bound traffic terminates at the ISP and therefore should be categorized as "local." Moreover, the D.C. Circuit, in its decision vacating and remanding the *ISP Declaratory Ruling*, determined that the Commission's regulatory definition of termination – "the switching of local telecommunications traffic at the terminating carrier's end office switch, or equivalent facility, and the delivery of such traffic to the called party's

2002]

THE BATTLE OVER RECIPROCAL COMPENSATION

premises”¹²³ – supports the conclusion that calls to ISP’s terminate for reciprocal compensation purposes at the ISP’s premises.¹²⁴ The U.S. Court of Appeals for the Fifth Circuit has likewise found that under the Commission’s definition, “‘termination’ occurs when [the ISP’s carrier] switches the call at its facility and delivers the call to ‘the called party’s premises,’ which is the ISP’s local facility. Under this usage, the call indeed ‘terminates’ at the ISP’s premises.”¹²⁵

The D.C. Circuit and other federal courts have also indicated that ISP-bound traffic must terminate at the ISP due to the statutory and regulatory distinction between telecommunications and information services. As noted, the Commission has recognized that telecommunications and information services are mutually exclusive categories of service under the 1996 Act and that ISP’s provide information services, not telecommunications services. The D.C. Circuit in its decision vacating and remanding the *ISP Declaratory Ruling* recognized the importance of the distinction between telecommunication and information services for purposes of determining where ISP calls terminate and held:

ISPs . . . are “information service providers,” . . . which upon receiving a call originate further communications to deliver and retrieve information to and from distant websites. . . . Although ISPs use telecommunications to provide information service, they are not themselves telecommunications providers (as are long-distance carriers).¹²⁶

In this regard, the D.C. Circuit equated ISP’s to businesses such as “pizza delivery firms, travel reservation agencies, credit card verification firms, or taxicab companies” which simply use a variety of communication services to sell goods or services to their customers.¹²⁷ In a similar context, the U.S. Court of Appeals for the Ninth Circuit has also viewed conventional dial-up Internet access as consisting of two separate services, the telephone service linking the user and the ISP, which falls within the “telecommunications” category, and the information services provided by the ISP.¹²⁸

In addition to the precedent supporting the view that calls to ISP’s terminate at the ISP, a high level examination of the way an ILEC customer might make a dial-up call to connect to the Internet illustrates that the call terminates at the ISP’s premises and not somewhere on the Internet. In a typical situation, the ILEC customer clicks on a dial-up icon on his computer and this initiates the computer’s modem to dial the ISP’s access number, which is usually a local

¹²³ 47 C.F.R. §§ 51.701(d) (2001); *Local Competition Order*, 11 F.C.C. Rcd. 15,499, ¶ 1040 (1996).

¹²⁴ *Bell Atlantic v. FCC*, 206 F.3d 1, 6 (D.C. Cir. 2000) (“[T]he traffic is switched by the ILEC whose customer is the ISP and then delivered to the ISP, which is clearly the ‘called party.’”).

¹²⁵ *Southwestern Bell Tel. Co. v. Pub. Utils. Comm’n*, 208 F.3d 475, 483 (5th Cir. 2000).

¹²⁶ *Bell Atlantic*, 206 F.3d at 6-7.

¹²⁷ *Id.* at 7.

¹²⁸ *See AT&T Corp. v. City of Portland*, 216 F.3d 871, 877 (9th Cir. 2000).

phone number. Just like a local voice call, the call is routed through the ILEC's switch to an local interconnection trunk between the ILEC and the CLEC that serves the ISP. The call then travels through the CLEC's local switch to the ISP's premises, where the call is answered by the ISP's server. When the call is delivered, the CLEC provides the ILEC with a signaling message notifying the ILEC that the call was answered. This operation fits squarely within the Commission's definition of "termination" for reciprocal compensation purposes: "the switching of traffic . . . at the terminating carrier's end office switch, or equivalent facility, and delivery of that traffic from that switch to the called party's premises."¹²⁹ Thus, for this reason as well, ISP-bound calls must be viewed as terminating at the ISP and are therefore local calls subject to reciprocal compensation.

Two final reasons for subjecting ISP-bound traffic to reciprocal compensation are: (1) the long-standing Commission precedent treating ISP's as end-users of telecommunications services for purposes of access charges and (2) the fact that ISP-bound traffic cannot be "exchange access" as defined by the 1996 Act and therefore must be "telephone exchange service." As noted, the Commission has historically exempted ISP's from access charges by treating calls to ISP's as local calls made to end-users within a local calling area. As a result, ISP's have been allowed to pay lower intrastate charges for their local telephone links like other local customers. The Commission has extended this consistent treatment of calls to ISP's as local traffic to the regulatory accounting area, treating costs incurred in carrying calls to ISP's as local and permitting LEC's to recoup them under charges set by state public utility commissions. The Commission also has permitted ISP's to pay the special access surcharge when purchasing special access line under the same conditions as those applicable to end-users.

Moreover, ISP-bound traffic must be considered "local" traffic because, under the 1996 Act, ISP-bound traffic must be either "telephone exchange service" or "exchange access," and, by definition, ISP-bound traffic cannot be "exchange access" because ISP's do not connect to the local network "for the purpose of the origination or termination of telephone toll service." Rather, ISP's connect for the purpose of providing "information services," which the Act, by definition, explicitly distinguishes from "telephone toll services." To be sure, these information services travel over telecommunications, which are provided by an LEC. But neither the subscriber nor the ISP are subject to separate "toll" charges for these local calls, as is required by the definition of an "exchange access." Therefore, by process of elimination, ISP-bound traffic must be considered "telephone exchange service," which is a form of local telecommunications for which reciprocal compensation is due.

C. The FCC Has Jurisdiction to Regulate the Compensation Due for Local Traffic

In expending so much energy in the *ISP Declaratory Ruling* and the *ISP*

¹²⁹ 47 C.F.R. §§ 51.701(d) (2001).

2002]

THE BATTLE OVER RECIPROCAL COMPENSATION

Remand Order focusing on the jurisdictional nature of ISP-bound calls, the Commission completely overlooked that the 1996 Act plainly grants it jurisdiction to regulate the interconnection pricing of calls to ISP's, regardless of whether it labels these calls as "local" or "long distance." Indeed, the nature and extent of the Commission's jurisdiction over local and interexchange traffic are wholly irrelevant to the question whether local calls to ISP's are subject to reciprocal compensation under the Act.

The regulatory scheme that existed prior to passage of the 1996 Act made a clear distinction between local and long distance calls for jurisdictional purposes, with local calls (or more specifically intrastate local calls) subject to state regulation and long distance calls (or more specifically interstate long distance calls) subject to federal regulation by the FCC. The 1996 Act fundamentally altered this framework and expanded the FCC's jurisdiction to certain historically intrastate issues.¹³⁰ Specifically, section 251(d)(1) of the Act directs that the Commission should "establish regulations to implement the requirements" of section 251, which, together with section 252, would govern all aspects of interconnection between competing local exchange carriers.¹³¹ The Commission has interpreted this directive as a broad grant of authority from Congress to establish national regulations for the various aspects of interconnection, including resale and access to unbundled network elements.¹³² Accordingly, the Commission has moved forward and established uniform national rules addressing every conceivable local interconnection issue and declared those rules "binding on the states, even with respect to intrastate issues."¹³³

The Commission's jurisdiction under sections 251 and 252 to regulate interconnection of local telecommunications traffic includes the authority to regulate interconnection pricing under section 251(b)(5). In fact, the Commission has already determined that it may regulate the interconnection pricing of local traffic under section 251(b)(5). In the *Local Competition Order*, the Commission devoted significant portions of the order to determining issues related to the scope of section 251(b)(5) and the mechanisms by which reciprocal compensation for the exchange of local

¹³⁰ *Local Competition Order*, 11 F.C.C. Rcd. 15,499, ¶¶ 24, 83 (1996).

¹³¹ 47 U.S.C. § 251(d)(1) (2000).

¹³² *Local Competition Order*, 11 FCC Rcd. 15,499, ¶ 24. The United States Supreme Court has confirmed that the Commission has jurisdiction under sections 251 and 252 to regulate local telecommunications that were historically regulated by the states. See *AT&T, Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999). In *Iowa Utilities Board*, the Court held that the FCC "has rulemaking authority to carry out the provisions of . . . §§ 251 and 252," including the jurisdiction to design a pricing methodology for matters addressed in section 251. *Iowa Utils. Bd.*, 525 U.S. at 378, 384. In its review of the *ISP Declaratory Ruling*, the D.C. Circuit agreed that the Commission "has jurisdiction to implement such provisions as § 251, even if they are within the traditional domain of the states." *Bell Atlantic v. FCC*, 206 F.3d 1, 6 (D.C. Cir. 2000).

¹³³ *Local Competition Order*, 11 F.C.C. Rcd. 15,499, ¶ 101.

B.U. J. SCI. & TECH. L.

[Vol. 8:2

traffic ought to be set by state public utility commissions.¹³⁴ Specifically relevant to this discussion, the Commission concluded that the “additional cost” standard of section 252(d)(2) – which provides that the reciprocal compensation rates for transport and termination shall be based on “a reasonable approximation of the additional costs of terminating such calls” – permits the use of the forward-looking, economic cost-based pricing standard that the Commission established for interconnection and unbundled elements pursuant to section 252(d)(1) of the Act.¹³⁵ According to the Commission, transport of traffic for termination on a competing carrier’s network is “largely indistinguishable” from transport for termination of calls on a carrier’s own network and therefore should be based on same cost-based standard.¹³⁶

The Commission then stated that state public utility commissions have three options for establishing reciprocal compensation rate levels: (1) They may conduct a thorough review of economic studies prepared using the Commission’s TELRIC¹³⁷ costing methodology outlined in the *Local Competition Order* for the pricing of interconnection and unbundled network elements; (2) they may adopt a default price pursuant to default proxies adopted by the Commission; or (3) in some circumstances, order a bill-and-keep arrangement (under which no money changes hands).¹³⁸ The Commission further stated that regardless of whether reciprocal compensation rates are set using a TELRIC-based economic cost study or a default proxy, the rates should be symmetrical in nature.¹³⁹ In other words, reciprocal compensation rates should be the same as the ILEC’s forward-looking costs for transport and termination of local exchange traffic.¹⁴⁰ According to the Commission, symmetrical rates based on the ILEC’s forward-looking costs have specific pro-competitive advantages, including reducing the ILEC’s ability to use its superior bargaining position to negotiate excessively high termination charges that CLEC’s would pay the ILEC and excessively low termination rates that the ILEC would pay interconnecting carriers.¹⁴¹

Moreover, the Commission concluded that in lieu of adopting actual

¹³⁴ *Id.* ¶¶ 1027-1118.

¹³⁵ *Id.* ¶ 1054.

¹³⁶ *Id.*

¹³⁷ TELRIC is the acronym for Total Element Long Run Incremental Cost.

¹³⁸ *Local Competition Order*, 11 F.C.C. Rcd. 15,499, ¶ 1055; *see also* 47 C.F.R. § 51.705 (2001).

¹³⁹ *Local Competition Order*, 11 F.C.C. Rcd. 15,499, ¶ 1085; 47 C.F.R. § 51.711.

¹⁴⁰ *Local Competition Order*, 11 F.C.C. Rcd. 15,499, ¶¶ 1085-1090. The Commission did authorize state public utility commissions to depart from symmetrical rates if a CLEC submits a forward-looking economic cost study establishing that its cost will be greater than that of the ILEC for transport and termination. *Id.* ¶ 1089. Moreover, the Commission stated that state public utility commissions may establish reciprocal compensation rates that vary according to whether the traffic is routed through a tandem switch or directly to the end-office switch, because the “additional costs” in these two instances will likely vary. *Id.* ¶ 1090.

¹⁴¹ *Id.* ¶ 1087.

2002]

THE BATTLE OVER RECIPROCAL COMPENSATION

reciprocal compensation rates, state public utility commissions may impose bill-and-keep arrangements “if traffic is roughly balanced in the two directions and neither carrier has rebutted the presumption of symmetrical rates.”¹⁴² As mentioned, the Act explicitly states that the definition of what may be considered “just and reasonable” terms and conditions for reciprocal compensation “shall not be construed to preclude arrangements that afford mutual recovery (such as bill-and-keep arrangements).”¹⁴³ According to the Commission, bill-and-keep is appropriate where traffic is roughly equal because the payments from one carrier to the other can be expected to be offset by payments in the opposite direction.¹⁴⁴ Thus, where traffic flows are balanced, a bill-and-keep system does not prevent recovery of costs for transport and termination, as required by the Act. However, if traffic is not equal, a bill-and-keep system would deprive LEC’s of the real costs for the termination of traffic that they incur, in violation of the Act.¹⁴⁵ It would also have the detrimental effect of distorting carrier incentives by encouraging them to seek customers that primarily originate traffic and thereby overuse competing carriers’ termination facilities.¹⁴⁶

Consequently, it is fully within the authority of the Commission to ensure that reciprocal compensation rates are based on the forward-looking, cost-based rates of the ILEC’s, and are symmetrical in nature. The Commission can require state public utility commissions to use forward-looking costs as the basis for rates set within a particular jurisdiction and require that those rates be symmetrical. Such action should help alleviate the regulatory arbitrage, which the Commission identified in the *ISP Remand Order* and the *Intercarrier Compensation NPRM* as particularly acute for ISP-bound traffic and which was the Commission’s principal motivation for moving to a bill-and-keep system. Indeed, the Commission adopted the interim rate cap scheme specifically to lower existing rates for ISP-bound traffic and “produce more accurate price signals,” which the Commission says should “substantially reduce current market distortions.”¹⁴⁷ It is puzzling that the Commission makes such a statement in one breath and then in the next argues that reducing reciprocal compensation rates to forward-looking costs will not solve the problem.

The Commission blames the regulatory arbitrage on the existing compensation mechanism for ISP-bound traffic, in which the calling party’s carrier pays the carrier transporting and terminating the traffic to the ISP. But this is not entirely accurate. The distortions, to the extent they exist, are actually the result of the high, above-cost rates which the ILEC’s themselves negotiated in the original interconnection agreements soon after passage of the

¹⁴² *Id.* ¶ 1112; *see also* 47 C.F.R. § 51.713.

¹⁴³ 47 U.S.C. § 252(d)(2)(B)(i) (2000).

¹⁴⁴ *Local Competition Order*, 11 F.C.C. Rcd. 15,499, ¶ 1112.

¹⁴⁵ *See id.*

¹⁴⁶ *See id.*

¹⁴⁷ *ISP Remand Order*, 16 F.C.C. Rcd. 9151, ¶ 77 (2001).

1996 Act.¹⁴⁸ Ironically enough, during these first negotiations, it was the CLEC's who requested "bill-and-keep" reciprocal compensation arrangements, in which each carrier would recover from its own end-user customers the cost of both originating calls that it delivers to other networks and terminating calls that it receives from other networks. The ILEC's rejected these requests and, instead, insisted on reciprocal compensation arrangements where the calling party's carrier would compensate the called party's carrier on a per-minute basis for terminating calls (*i.e.*, "CPNP" system). In most instances, either through negotiations or arbitrations before state public utility commissions, the ILEC's were successful in having CPNP reciprocal compensation arrangements included in the interconnection agreements and were even able to negotiate high per-minute compensation rates.¹⁴⁹

The ILEC's' insistence on a CPNP rather than a bill-and-keep reciprocal compensation arrangement was designed to take full financial advantage of their dominant positions in local markets. They expected that, as a result of their huge local customer base, they would end up benefiting from a minute-of-use compensation arrangement. The ILEC's' expectation was a reasonable one. With a 97% share of the local exchange market in 1997,¹⁵⁰ the ILEC's had every reason to believe that traffic originating on competitors' networks and terminating on ILEC networks would be many times greater than the traffic originating on ILEC networks and terminating on CLEC networks.

But CLEC's proved to be smarter in the long run. They foresaw the explosion of Internet usage and realized that dial-up Internet calls last considerably longer than an average voice wireline call¹⁵¹ and that ISP's do not make many outbound calls. Thus, CLEC's began aggressively recruiting ISP's as their customers and demanding reciprocal compensation payments from ILEC's for ISP-bound traffic. CLEC's were soon terminating many more minutes of "local" calls from ILEC networks than vice-versa, and ILEC's found themselves paying out reciprocal compensation at the artificially high rates they had negotiated.¹⁵² It was only then that the ILEC's protested to the

¹⁴⁸ Section 251(c)(1) of the Act requires ILEC's to negotiate, in good faith, interconnection agreements with their competitors. *See* 47 U.S.C. § 251(c)(1). Because of section 251(b)(5), which requires all LEC's to establish reciprocal compensation arrangements, reciprocal compensation was an important issue during these negotiations.

¹⁴⁹ Under this complicated scheme, each LEC would keep a record of terminating calls and would pay a balance at the end of each month.

¹⁵⁰ *See In re* 1998 Biennial Regulatory Review – Review of Depreciation Requirements for Incumbent Local Exchange Carriers, 15 FCC Rcd. 242, ¶ 54 (1999). For basic phone service, ILEC's still control all but 3% of the market today. *See FCC Sitting Out Telecom War*, WASH. POST, May 3, 2001, at E1, E9.

¹⁵¹ Estimates are that a typical dial-up call to an ISP lasts on average more than three times as long as a typical voice wireline call. *See* K. WERBACH, DIGITAL TORNADO: THE INTERNET AND TELECOMMUNICATIONS POLICY 48, 58-59 (OPP Working Paper No. 29, March 1997) (stating that whereas voice calls typically last only 3 to 5 minutes, the average Internet call lasts seventeen to twenty minutes).

¹⁵² Comments in the *ISP Remand Ruling* proceedings indicated that CLEC's, on average,

2002]

THE BATTLE OVER RECIPROCAL COMPENSATION

FCC and state public utility commissions that ISP-bound traffic should not be subject to reciprocal compensation.

It is for this reason, plus the fact that ILEC's have resisted opening their local markets to competition, that CLEC's became niche providers. Had these rates been cost-based from the start, the arbitrage opportunities and resulting wind-falls would never have been available. Indeed, if reciprocal compensation rates had been truly cost-based, they would simply have compensated the CLEC's for the cost of transporting and terminating the traffic, which are legitimate, real costs.

Nevertheless, in the *ISP Remand Order*, the Commission dismissed the argument that the market distortions caused by applying a CPNP regime to ISP-bound traffic can be cured by regulators simply attempting to "get the rate right."¹⁵³ The Commission contended that because rates are determined on the basis of the ILEC's average costs of transport and termination and demand projections, they do not reflect the costs incurred by any particular carrier for providing service to a particular customer, and it would be impossible for regulators to set different intercarrier compensation rates for each individual carrier. But this argument ignores that a LEC's costs for transporting and terminating voice and data traffic is virtually the same. Moreover, this cost can never represent the actual cost of serving every customer. No rate structure can ever be sufficiently deaveraged such that the actual cost of serving each individual customer is determined. But so long as this cost represents the average cost of serving like customers, then for some customers the carrier will be slightly over-compensated and for others slightly under-compensated, balancing each other out. The Commission provided no support for its concern that carriers will prefer customers who are on average more costly to serve.

Thus, if compensation rates for ISP-bound traffic were cost-based, and local markets were truly competitive such that CLEC's could compete for residential customers, the arbitrage opportunities the Commission complained about would quickly disappear. This is demonstrated by the fact that negotiated reciprocal compensation rates have continued to decline as ILEC's and CLEC's negotiate new interconnection agreements. The Commission admitted as much in the *ISP Remand Order*, stating that the evidence suggests that technological developments, including next generation switches, are reducing the costs incurred by carriers in handling all sorts of traffic, including ISP-bound traffic, which in turn have reduced negotiated reciprocal compensation rates in new interconnection agreements.¹⁵⁴

terminate eighteen times more traffic than they originate, resulting in annual CLEC reciprocal compensation billings of approximately two billion dollars, ninety percent of which is for ISP-bound traffic. *ISP Remand Order*, 16 F.C.C. Rcd. 9151, ¶ 5.

¹⁵³ *Id.* ¶ 76.

¹⁵⁴ *Id.* ¶¶ 84, 87.

D. *The Markets, Not Regulation, Should Determine Whether Carriers Move to Bill-and-Keep*

In pushing for a bill-and-keep system for ISP-bound traffic in the *ISP Remand Order*, the Commission reversed its position in the *Local Competition Order* that a bill-and-keep system is only economically efficient when the flow of traffic between interconnected carriers is roughly balanced and is expected to remain so.¹⁵⁵ The Commission said that its previous “concerns about economic inefficiencies associated with bill and keep missed the mark” because it wrongly assumed that the “calling party was the sole cost causer of the call” and it “may have overstated any incentives that a bill and keep regime creates to target customers that primarily originate traffic.”¹⁵⁶ According to the Commission:

A carrier must provide originating switching functions and must recover the costs of those functions from the originating end-user, not from other carriers. Originating traffic thus lacks the same opportunity for cost-shifting that reciprocal compensation provides with respect to serving customers with disproportionately incoming traffic.¹⁵⁷

Regardless of whether a bill-and-keep system distorts carrier incentives in this way, the Commission’s argument ignores the provisions of the Act that require the recovery of costs for transport and termination. A bill-and-keep system where the traffic is not equal prevents this from happening and, therefore, contravenes the Act.

In any event, premature implementation of a bill-and-keep system for ISP-bound traffic will have a detrimental, as opposed to beneficial, effect on the Internet industry. Because CLEC’s will be unable to collect the costs of transporting and terminating dial-up Internet calls from the originating carriers, they will be forced to collect these costs from the ISP’s themselves. This likely will translate into higher ISP fees for customers for dial-up Internet services, which is the predominant type of service for residential customers. Moreover, it will provide ILEC’s with a windfall because existing rates to their customers are set to recover the costs of both originating and terminating calls, and a move to bill-and-keep would enable them to avoid these costs.

Rather than impose bill-and-keep through regulation, the Commission should allow the markets to dictate when carriers move to a bill-and-keep system. The Commission should concentrate its efforts on working to ensure that ILEC’s comply with the local competition provisions of the 1996 Act and truly open their local markets to competitors. Once local markets are competitive and reciprocal compensation rates are cost-based, CLEC’s will have incentives to serve the entire market, rather than just ISP’s. This will reduce the traffic discrepancies that currently exist. Moreover, with rising demand among residential consumers for broadband access to the Internet

¹⁵⁵ *Local Competition Order*, 11 F.C.C. Rcd. 15,499, ¶ 1112 (1996).

¹⁵⁶ *ISP Remand Order*, 16 F.C.C. Rcd. 9151, ¶ 73.

¹⁵⁷ *Id.*

2002]

THE BATTLE OVER RECIPROCAL COMPENSATION

(particularly, via xDSL and cable networks), for which reciprocal compensation is not due, more and more customers are moving away from dial-up Internet access, thereby reducing the number of minutes terminated by CLEC's to ISP's and bringing traffic levels more in line with the ILEC's. This will also reduce the market distortions that the Commission identified. Once traffic is balanced and rates are cost-based, CLEC's and ILEC's will have a natural incentive to negotiate bill-and-keep mechanisms.

IV. CONCLUSION

For all of its flawed decisionmaking with respect to reciprocal compensation for ISP-bound traffic, the Commission is correct in one regard: Bill-and-keep is the ideal intercarrier compensation scheme for the exchange of all types of traffic between carriers. A bill-and-keep scheme adds a high degree of certainty and simplicity to what otherwise is an extremely complicated and burdensome system of compensation between carriers.

Nevertheless, the Commission should resist the temptation to quickly "fix the system" through regulation. Such a solution is inconsistent with the 1996 Act and will have a detrimental effect on the Internet industry as well as create a windfall for the ILEC's. This point does not appear to be entirely lost on the Commission. Rather than immediately impose a bill-and-keep system, it has proposed to implement a three-year transition scheme.

However, a more appropriate approach, and one that is consistent with the 1996 Act, would be to regulate reciprocal compensation rates and force state public utility commissions to reduce them from their current artificially high levels to true forward-looking costs. Such reductions would help alleviate the regulatory arbitrage the Commission identified in the *ISP Remand Order* and would allow carriers, rather than regulators, to decide when market conditions can support a bill-and-keep system.