

ARBITRATION RESULTS:

THE RUNS, THE HITS, AND THE ERRORS

November 1996

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The first group of negotiations and arbitrations for competitive local interconnection under the Telecommunications Act of 1996 is drawing to a close. Teleport Communications Group Inc. (TCG) sought negotiations with the Regional Bell Operating Companies on February 8, 1996, the same day that President Clinton signed the bill into law. Having failed to reach agreement through bilateral negotiations with a number of RBOCs, TCG's were among the first arbitrations to be conducted under the Act. Under the Act, TCG's arbitrations were required to be concluded by November 8, 1996.

With the process nearing a close, it is time to look at the "box score." What runs were scored -- the results that TCG achieved in its arbitrations. What were the hits -- the arbitration processes that worked well, and why. And what were the errors -- the arbitration processes that did not work well, and why. Finally, based on this experience, where do we go from here?

TCG is the largest Competitive Local Exchange Company (CLEC) in the nation, having deployed over 6,000 miles of fiber optic cable and 22 digital telephone switches to serve 55 MSAs across the country with a full range of switched and dedicated local telecommunication services. TCG is a facilities-based CLEC, with no interests other than the development of competitive local telecommunication services.

With its negotiations and arbitrations covering 30 states and the District of Columbia nearly complete, TCG is now in a position to provide answers to many of these questions. These answers are important because interconnection arbitrations are not an end in themselves but only a means to the end of creating effective local exchange competition. The arbitrated results recently announced by the State Commissions represent elements that must be included in interconnection agreements that must still be finalized, filed and approved by the State commissions. Thus we are not at the end of the process, but, at most, at the end of the beginning of vigorous local telephone competition. Moreover, there will be many more arbitrations in the future over new and different issues, and TCG's experience with these first arbitrations lends important insights for those future endeavors. Some key questions, and TCG's answers, follow.

What is the most positive result from the arbitrations? The statute, and its tight deadlines, stopped the gaming of the regulatory process by the ILECs. The State Commissions stepped up to the plate and conducted these difficult proceedings to meet the nine month deadlines imposed by the statute. Without the statute, its deadlines, and the State Commissions' vigorous efforts, TCG has no doubt that it would still be embroiled in difficult and time consuming disputes over interconnection with the ILECs. So clearly, these arbitrations have helped advance the course of local competition.

Has the process achieved the pro-competitive results that Congress intended?

It is, frankly, premature to ask about results at this time -- results can only be addressed in the future by looking at actual performance in the marketplace. The answer will depend not on paper promises but on concrete performance by the Incumbent Local Exchange Carriers (ILECs).

Performance, not promises, is important because it does no good to reach an arbitrated result that gives TCG a reasonable price for an unbundled loop if the ILEC cannot (or will not) deliver that service to TCG at least as quickly as it provides retail services to its own customers, and at a quality that is at least equal to that which its own retail customers actually receive. It does no good for TCG to obtain reasonable "Transport and Termination" reciprocal compensation arrangements if the ILEC does not stand ready to provide sufficient trunks to carry TCG's traffic, or if it "conveniently" forgets to program its switches to route TCG's traffic properly. The ILECs' performance must live up to the ILECs' promises.

It is also impossible to answer this question today because virtually all of the arbitrations that have been concluded by TCG and other CLECs include "interim" rates for the key elements, most of which will be changed in a few months. Until the

permanent rates have been proposed, reviewed and approved it is impossible to judge how vigorous or ubiquitous local exchange competition can be.

In short, the question of whether these initial arbitrations are conducive to a fair and reasonable competitive environment can only be answered in the light of experience -- after a reasonable period of *actually interconnecting* under *permanent rates* and seeing whether the ILECs fulfill their obligation to provide high quality, fairly priced and non-discriminatory interconnection.

What types of arbitration processes were used? The arbitration processes were so varied that, in essence, each State's procedure was unique. Some States consolidated the arbitration requests of TCG and other parties into a large and complex proceeding. Other states conducted the arbitrations as a two-party proceeding, limited to TCG and the ILEC. Different states chose different arbitrators to hear the cases, including full Commissions, Administrative Law Judges, Commission staff members, or outside arbitrators. In TCG's experience the Commission - based arbitrators had the best expertise to handle these matters. The procedures that were used ranged from formal, rate case-style evidentiary proceedings with witnesses, cross examination, evidentiary submissions, briefs, and oral arguments, to simple "baseball-style" arbitrations, where the arbitrator simply picked the most reasonable "final offer"

presented by each party. In some cases initial arbitration decisions were first announced by arbitrators subject to party comment and final Commission modifications, while other decisions were first released by the Commission after private consideration of the arbitration record.

TCG's arbitrations -- which involved largely the same issues and same evidence presented consistently across the country -- provided what amounts to a "controlled experiment" about how the process worked from state to state. TCG experienced some arbitrations that were needlessly "regulatory" -- too expensive, too time consuming, and too complicated. Other proceedings were "de-regulatory" -- streamlined and efficient procedures more in keeping with Congress' objectives.

Frankly, there was little correlation between the outcome and the process -- TCG obtained very favorable results in some states under very imperfect processes, while in other cases ideal processes led to less satisfactory results.

What was the most difficult arbitration process used? From the standpoint of process, and irrespective of outcome, TCG has no doubt as to what arbitration wins this distinction: its arbitration with Southwestern Bell in Texas. The Texas proceeding was difficult for several reasons. First, five arbitration proceedings involving TCG, MCI, AT&T, ACSI, and MFS, each of which had different requirements because each

has different circumstances and goals, were consolidated into one proceeding. Thus, instead of a limited two-party arbitration hearing to adjudicate only the unresolved issues between two companies, all parties had to participate in three weeks of hearings that covered every interconnection issue. An additional factor adding to the complexity of the proceeding was SWB's so-called TELRIC cost studies. These cost studies were so flawed and so complicated that SWB continually updated, changed and modified them from day to day, leaving parties with a target that changed continually. Additionally, because of the statutory deadlines, the Texas Commission was forced to condense the time that parties were allowed to question witnesses. Finally, the Texas proceeding was made more difficult because SWB -- more so than other ILECs -- adhered to truly extreme positions. One example of this was SWB's insistence on being paid \$500,000 or more in up-front payments for collocation arrangements that other ILECs offer for a tenth of that amount or less, and to charge an annual rent of \$55,000 for 100 square feet of collocation space, a rental that makes Trump Tower look like a low rent district.

The combination of a complex, consolidated proceeding and an intransigent ILEC exhausted all parties, including the Commission itself, which devoted considerable time, talent and resources to the effort. TCG spent almost as much money conducting the Texas arbitration alone as it spent in all of its other arbitrations put together. If

such a costly process is used in the future, it may discourage entry by smaller competitors by substantially raising the costs of achieving interconnection and it may encourage ILECs to continue to "game" the regulatory process. While the Texas arbitration was exhausting to all involved, the outcome was favorable to TCG in many respects: the Commission adopted bill and keep, rejected SWB's outlandish collocation costs, and reached a number of other pro-competitive conclusions.

What was the easiest arbitration process used? Again, without regard to outcome, TCG believes that the "baseball-style" arbitrations conducted in a few states were the cleanest, simplest, and least expensive arbitration proceedings it encountered -- they were the "hits" of the arbitration games. These were also the proceedings that most closely approximated the intent of Congress to have a new and less "regulatory" approach. In "baseball-style arbitration," the arbitrator picks the most reasonable, fair and pro-competitive "best and final" offer of one party or the other. This forces parties to moderate their positions and seek to come closer together, since a party that doggedly holds on to an extreme position is likely to lose to a more reasonable alternative proposed by the other party.

In Pennsylvania, the Administrative Law Judge required each party to present and explain its position, which took less than a day, without resorting to the time

consuming and expensive evidentiary processes followed in other states. The arbitrator's answer was delivered quickly -- TCG's initial Pennsylvania arbitration was the first decision released in the country, at a time when other states were still wrestling with contentious discovery and rate case procedural issues.

How successful was TCG in its arbitrations? TCG arbitrated a variety of issues across the country, with the particular issues being raised varying from RBOC to RBOC. The three common issues that TCG arbitrated in almost all states were (1) Transport and Termination rates; (2) the appropriate division of switched access revenues for jointly provided services; and (3) performance standards, comparative performance reporting, and performance penalties.

Transport and termination. TCG's first preference was for "bill and keep," with a second-best alternative being a rate at the lower end of the FCC's proxy range. TCG was successful in obtaining bill and keep in its arbitrations in nine states. In most of the remaining states TCG obtained a rate in the lower portion of the FCC's default range.

Division of revenues for jointly provided switched access. TCG sought a fair apportionment of the switched access revenues where TCG provides tandem switching

and transport from the IXC to the ILEC end office, and the ILEC provides end office switching. The results on this aspect of TCG's arbitrations were mixed. Seven states decided to grant TCG some relief on this issue. In the other states where this issue was raised, the Commissions generally declined to address the issue. While many of the Commissions agreed with TCG that the ILEC's proposals for the division of switched access revenues were harmful or unfair to TCG, they concluded that this is a problem that the FCC created and should fix as part of "access charge reform."

Performance Standards, Comparative Performance Reporting and Performance Penalties. In virtually all cases, the arbitrators agreed with TCG that performance standards are a critical issue and that reasonable levels of ILEC performance should be established for the services and facilities that the ILEC is to provide to TCG. The Commissions also generally agreed that the standards should be tied to the level of service delivered by the ILEC to itself and to its other customers. Most arbitrators also agreed with TCG that periodic, comparative reporting of the actual ILEC performance received by TCG is essential. Some ILECs argued that TCG must be required to pay them for the cost of preparing these comparative reports. Arbitrators generally rejected that claim, recognizing that these reports are public interest obligations of the ILECs needed to show that they are not discriminating against their competitors. Unfortunately, most arbitrators declined to adopt specific performance penalties.

Instead, they noted that TCG had the alternative of seeking relief through Commission complaints or judicial actions.

What was most striking on the issue of performance was the degree of resistance put up by many ILECs over even the idea of addressing performance in an arbitration. In several arbitrations, the ILEC argued flatly that the arbitrator had no legal right to address the issue, notwithstanding the fact that the Telecommunications Act of 1996 expressly demands that ILECs provide interconnection that is "at least equal in quality to that provided by the local exchange carrier to itself or any subsidiary, affiliate, or any other party..." While the arbitrators rejected that contention wherever it was advanced, the fact that any ILEC would seriously maintain that how it performs its interconnection obligations was beyond the scope of an interconnection agreement is an ominous sign for the future implementation of the agreements and the development of local exchange competition.

What effect did the stay of the FCC's interconnection rules have on TCG's arbitrations? Surprisingly little. First, of the three issues most typically litigated by TCG, only Transport and Termination was directly addressed by the FCC's rules. Second, many states that decided Transport and Termination rates after the stay was issued independently set rates that fell within the FCC's range anyway. Third, in

TCG's case, the stay helped TCG reach its preferred outcome of bill and keep because the FCC's rules placed limits on a State's ability to adopt bill and keep. When the stay eliminated those limitations, it actually improved TCG's position in seeking bill and keep. Accordingly, on the key issue of Transport and Termination, the end result of the arbitrations was largely within the ranges specified by the FCC, except that more states adopted the simple and pro-competitive solution of bill and keep than might otherwise been the case had the FCC's rules remained in effect.

What do the arbitrations mean for RBOC entry into the long distance market?

The RBOCs will certainly argue that, with interconnection agreements signed, it is time for their entry into the long distance market. However, such entry must follow, not precede, the delivery of quality, non-discriminatory, and fairly priced local interconnection services to RBOC competitors. That has not yet happened. Today, most of TCG's interconnection arrangements are interim in nature, containing rates that are good for only a few months at most. Until permanent rates are established it is not possible to say that interconnection agreements sufficient for purposes of Section 271 are in place.

And irrespective of the price of interconnection, there is the overriding issue of ILEC performance. The price of an ILEC's interconnection service is of little importance

if it is not delivered on time and at acceptable levels of performance. *Until there is a real and demonstrable history in the marketplace that the RBOCs are living up to their obligations and providing quality interconnection services to their competitors, it is not possible to determine whether the time has come for their entry into the long distance market.*

What are the prospects for the future? TCG's experiences with the arbitration process across the country raise serious concerns as to whether the arbitration procedures that were commonly used in TCG's recent arbitrations are up to the challenges of the future. TCG believes that, as the implementation of local interconnection arrangements moves forward, new issues will arise that will require arbitration when negotiations fail. Multi-party, rate case-style processes are a recipe for a catastrophe, as a fast moving competitive industry is bogged down by regulatory machinery designed for a different place and time. Congress recognized that regulatory delay harms customers and competitors alike, making the need for quick, certain, and inexpensive arbitration processes even more acute.

The "box score" in the arbitration games shows clearly that two-party, "baseball-style" arbitrations can deliver results quickly, fairly, and inexpensively and are the best process to be used to address the needs of this fast-changing industry.

By contrast, traditional rate case processes are ponderous, inflexible and ruinously expensive -- they are designed for an era in which nothing much changed for months or years and there was no need to quickly reach a resolution. These rate cases are the games that the ILECs and RBOCs have played for years, and the "BOC's scores" in these games favor the monopolist, whose resources are immense and whose position is enhanced by delay and uncertainty. These rate case processes are not the way the competition game should be played in the future.

Can the "cost studies game" be avoided? The State Commissions also face the prospect of soon having to deal with a myriad of massive ILEC cost studies. These proceedings will determine the prices of key services and facilities needed by competitors, but the costs of participating in the ponderous and grinding proceedings used to evaluate such cost studies can preclude meaningful participation by smaller local competitors. State Commissions must therefore look for ways to simplify and streamline cost study proceedings so that local competitors can have a realistic opportunity to participate in a constructive and informed manner. But more than that is needed.

TCG believes that State Commissions should look for *structural solutions* that either (1) encourage ILECs to develop fair and honest prices for goods and services or

(2) provide a marketplace alternative to the ILEC rates. Rigorous "imputation" requirements can provide a powerful incentive for ILECs to price competitor inputs fairly, by requiring that the ILEC include the costs it charges its competitors in the prices of competing services that it sells to its own customers. Such imputation requirements provide a structural counterweight to the traditional ILEC incentive to over-price the services used by their competitors. ILEC incentives to overprice can also be overcome by allowing competitors to "self provision" interconnection arrangements. For example, if the ILEC charges too much for a collocation arrangement the interconnector can defeat that anti-competitive strategy by building the arrangement itself for less, provided that state and federal commissions support or encourage that result.

Where do we go from here? As 1996 draws to a close, the telecommunications industry finds itself at the end of the beginning of the implementation of the Telecommunications Act of 1996. It is true that many interconnection agreements have been negotiated or arbitrated. It is also true that most only provide temporary assurances and interim rates, leaving the permanent shape of local exchange competition yet to be determined. TCG believes that this is a process that will occur over time -- it will be more of a gradual evolution than a flash-cut, abrupt change. It

will not be achieved through empty paper promises, but only through the ILEC's delivery of fair and non-discriminatory interconnection to their competitors.

TCG also believes that the State Commissions must evaluate and re-evaluate their practices and procedures in light of the impact of the regulatory process itself on the development of local competition. The Telecommunications Act of 1996 has a clear bias in favor of facilities-based local competition, and that objective should guide state initiatives as well.

Finally, TCG believes that the negotiations and arbitrations it has been involved in have produced, overall, results that will allow it and other facilities-based CLECs to continue the development of a competitive local exchange market. The results are not "perfect" but they are reasonably workable.

TCG now faces the far more difficult task of obtaining fair, non-discriminatory, and high quality *implementation* of these agreements by the ILECs. Until ILECs prove, in the day-to-day marketplace, that they can deliver quality and fairly priced interconnection arrangements, the final score as to whether the Telecommunications Act of 1996 will achieve its pro-competitive objectives will remain unknown.

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TCG'S INTERCONNECTION NEGOTIATIONS AND ARBITRATIONS			
	<i>State</i>	<i>Incumbent Local Exchange Carrier</i>	<i>Type of Process</i>
1	Alabama	BellSouth	Negotiated Agreement
2	Arizona	US West	Arbitration
3	California	Pacific Bell	Negotiated Agreement
4	Colorado	US West	Arbitration
5	Connecticut	SNET	Pending
6	District of Col.	Bell Atlantic	Arbitration
7	Florida	BellSouth	Negotiated Agreement
8	Georgia	BellSouth	Negotiated Agreement
9	Illinois	Ameritech	Arbitration
10	Indiana	Ameritech	Arbitration
11	Kentucky	BellSouth	Negotiated Agreement
12	Louisiana	BellSouth	Negotiated Agreement
13	Massachusetts	NYNEX	Arbitration
14	Maryland	Bell Atlantic	Arbitration
15	Michigan	Ameritech	Arbitration
16	Mississippi	BellSouth	Negotiated Agreement
17	Nebraska	US West	Arbitration
18	New Jersey	Bell Atlantic	Arbitration
19	New York	NYNEX	Negotiated Agreement
20	North Carolina	BellSouth	Negotiated Agreement
21	Ohio	Ameritech	Arbitration
22	Oregon	US West	Arbitration
23	Pennsylvania	Bell Atlantic	Arbitration

TCG'S INTERCONNECTION NEGOTIATIONS AND ARBITRATIONS			
	<i>State</i>	<i>Incumbent Local Exchange Carrier</i>	<i>Type of Process</i>
24	Rhode Island	NYNEX	Arbitration
25	South Carolina	BellSouth	Negotiated Agreement
26	Tennessee	BellSouth	Negotiated Agreement
27	Texas	Southwestern Bell	Arbitration
28	Utah	US West	Arbitration
29	Virginia	Bell Atlantic	Arbitration
30	Washington	US West	Arbitration
31	Wisconsin	Ameritech	Arbitration
<p>Notes: 1) TCG's Interconnection Agreement with BellSouth covers its entire nine-state region; TCG at present is only operating in Florida. 2) TCG also filed arbitration requests with Southwestern Bell in Missouri and with GTE in several states; those arbitrations were withdrawn by mutual agreement and negotiations are continuing.</p>			