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Reciprocal Comp For Internet Traffic--Gravy Train Running Out Of Track

(Part V of Internet Regulation Preview Series)

Summary: In a classic case of what you see is not necessarily what you get, **investors should not expect the current reciprocal compensation arrangement for Internet traffic to continue much past the end of the year.** Given that this issue is probably the single greatest opportunity for arbitrage in the whole sector, over 4,000 percent in some instances, **TPG cautions investors that this extraordinary arbitrage "gravy train" will run out of track--probably this year.** It is simply not sustainable long-term.

Moreover, investors should not be lulled into a false sense of security that 19 consecutive state public utility commissions have ruled (in addition to a recent Federal Court in Texas) that Internet service provider (ISP) traffic passed through a competitive local exchange carrier (CLEC) is classified as a local call. In the coming months, **TPG expects the FCC to trump these state decisions by clarifying that Internet traffic is indeed interstate, effectively reasserting its federal jurisdiction over data or Internet transport.** *(Reciprocal compensation is a regulatory arrangement where local telecom providers pay each other for "the cost" of terminating the calls they originate. In most cases, reciprocal compensation traffic is two-way and thus largely offsetting. However, since Internet/data traffic is one-way, there is little "reciprocal" about this arrangement. It is just a regulatory compensation windfall for CLECs/ISPs.)*

A Big Deal for Investors: **This reciprocal compensation arbitrage is a significant part of the existing "data growth engine" of many CLEC and ISP business models.** Consequently, investors need to be aware that in some instances, short-term projected results may be **artificially "juiced up," potentially providing an illusion of faster-than-real long-term growth.** The flip side of this problem is that reciprocal compensation is **a significant and growing liability, primarily for the Baby Bells.** It is growing at such a rapid rate that it could be a significant threat to earnings roughly in 1999, if not fixed by the FCC by then.

Why the FCC Will Fix It: First, reciprocal compensation for one-way Internet traffic is arguably **the single greatest arbitrage opportunity and hence market distortion in the telecom sector today.** TPG flagged this important issue in our April 6 *"Internet Regulation Preview"* bulletin as akin to a broken bank ATM machine that only allows withdrawals and takes no deposits. No other place in the sector can companies reap as much as a 4,000 percent arbitrage for minimal, value-added service. No competitive market, legal or illicit, can generate such gargantuan arbitrage. Only regulatory distortions can generate this size arbitrage over an extended period of time.

Second, this arbitrage opportunity is **greatly contributing to an artificial misalignment of the market structure** of this newly emerging competitive voice/data niche. Reciprocal compensation is driving many alliances, mergers and acquisitions for purely regulatory and not economic or competitive reasons. Thus, in some instances, an ISP is currently an asset to a CLEC, but could become a serious liability without the arbitrage of reciprocal compensation. *Third,* **it discourages economically sound facilities-based local investment and inhibits the development of an efficient competitive market.** It has the perverse effect of turning customers from assets into liabilities. Why would any competitor want to win a customer if that customer would cost them more in reciprocal compensation terminating minutes than they could earn in revenue from that customer?

What to Expect From the FCC: Investors need to appreciate **that it is not that hard for the FCC to fix this in the coming months.** ALTS, the association representing the CLECs, has an active petition (dated June 20, 1997) requesting that the FCC issue a clarification that the traffic in question is local and not interstate. ALTS argues in its petition that "this clarification is clearly in the Commission's (FCC) exclusive jurisdiction." For FCC legal authority, ALTS cites a 1980 Computer II FCC decision which was subsequently upheld in the DC Court of Appeals in 1982 and again in 1984. Now that the states have ruled the CLECs' way, the association likely regrets having requested this clarification from the FCC.

Why would the FCC believe such Internet calls are not local, but interstate? The FCC has exempted this traffic from interstate access charges for over a decade. Why would an exemption from interstate access charges be needed if the FCC thought it was a local call? Moreover, in the FCC's April 10 report to Congress, (paragraph 106) the FCC said that ISPs "are not entitled to reciprocal compensation for terminating local telecommunications traffic." However, the FCC explicitly did not comment on whether CLECs that serve ISPs are entitled to reciprocal compensation for terminating Internet traffic. They said that issue was now before the FCC. * * * * *