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Upcoming Event

Join LB3 for the 14th Annual Telecom Negotiation Conference in San Diego, CA on September 18-19, 2006. For more information, call (866) 620-5938 or log onto <http://www.ccmi.com/conferences/negotiate/index.html>.

Visit www.lb3law.com for new articles, the latest on the telecom megamergers and other breaking news, including LB3's recent victories in the Second and Third Circuits in the FET litigation.

The Impact of the AT&T/BellSouth Merger on Your Telecom Procurement Strategy

Turmoil in the telecom marketplace continues: shortly after the SBC/AT&T and Verizon/MCI mergers closed, AT&T swooped in to snatch BellSouth. As a result, enterprise customers must reassess their telecom procurement strategies in an increasingly concentrated marketplace. Further, customers should not assume that post-2006 deals with AT&T and Verizon will be as customer-friendly as past agreements.

Background: the Problem of Special Access

The central concern raised by the megamergers is that the landline market for enterprise customers is turning into something close to a Verizon/AT&T duopoly. Economists will tell you that a market needs at least three players to be realistically competitive. As those who bought cell phone service in the 1980s can testify, duopolies are breeding grounds for parallel pricing and mediocre performance.

Many industry observers, including enterprise customers, hoped that Bell South might become a competitive alternative to AT&T and Verizon (perhaps by selling its share of Cingular to SBC and using the proceeds to buy Sprint). Under this scenario, BellSouth would have been the third leg on the competitive stool that enterprise customers need to get free-market service quality and pricing. The elimination of BellSouth as even a potential competitor exacerbates an already problematic market situation.

The market problem is dedicated broadband connections, also known as "special access". This is the service *every* enterprise customer must buy because it is the "first mile" for its networks. ISPs need it also, as do long distance companies. And with astonishingly few exceptions, they can only buy special access from the Bells: in SBC's, Verizon's and BellSouth's home regions, they are basically the only game in town. When the FCC stopped regulating special access prices (in the name of competition), the RBOCs raised them significantly, to the point where their returns on special access now range from 30% - 80%. Combine a virtual special access monopoly that stretches across the SBC/BellSouth region with AT&T's long-distance service, and you get the ability to leverage that monopoly and freeze out competing ISPs, long-distance companies, and CLECs to an even greater degree than SBC/AT&T already does now.

Policy makers in Washington, DC chant the mantra that local markets are competitive, even for enterprise customers, thanks to cable providers and broadband over power line (BPL) technology. But there are no cable systems in business districts (or they are not configured for capacities of DS-3 and

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The Impact of the AT&T/BellSouth Merger on Your Telecom Procurement Strategy

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above), and BPL is just a cool concept with unresolved technical issues that remains billions of dollars and several years away from competitive deployment. Finally, although WiMax may be a possible solution, it also remains years away from widespread deployment.

The Ramifications of the Mergers

Reasonable minds can disagree on whether the post-merger market for selling telecom to enterprise customers will be more or less competitive than the pre-merger market. Pessimists worry about the ability of AT&T and Verizon to use grossly inflated special-access prices to squeeze competitors. For example, an AT&T that includes SBC and BellSouth would, under current special-access rates, probably earn profits of more than 70% (fully loaded) from interstate special-access services. For the overwhelming majority of opportunities, out-of-region competitors will have to procure special-access from incumbent local carriers, such as AT&T and Verizon, to connect their nodes to enterprise customers. Inflated special-access rates would increase the competitors' cost of serving such enterprise customers. The incumbent local carriers, however, would not experience the same increase in their costs. For AT&T and Verizon, excessive special-access prices are simply an intra-corporate transfer: the money moves from the right pocket (AT&T/Verizon IXC) to the left pocket (AT&T/Verizon ILEC).

Further, AT&T and Verizon could use the high rents from the sale of interstate special access to subsidize their own bids. The resulting price squeeze would make it too expensive for Qwest and Sprint to compete in AT&T and Verizon territory. Similarly, AT&T and Verizon would be vulnerable to price squeezes from each other in their respective territories, and they might conclude that in most cases it would not be profitable to pursue business opportunities outside of their ILEC regions.

Optimists counter that, although AT&T and Verizon will probably not compete aggressively for residential and small business traffic in each other's regions, they will continue to compete vigorously for enterprise customer business. People in this camp reason that most enterprise customers are geographically dispersed and that SBC and Verizon would not have purchased AT&T and MCI for billions of dollars if they did not intend to compete for enterprise customer business nationwide. To optimists, the enterprise customer market is too valuable and

dispersed to be cartelized.

Post-Merger Procurement Strategies

Only time will tell who is right. What *is* certain is that AT&T's acquisition of BellSouth eliminates the possibility of BellSouth's buying or merging with Sprint or Qwest, a step that might have created a strong third competitor. If only AT&T and Verizon survive as "first tier" entities, there is a very real chance that enterprise customers will have the unhappy experience of dealing with a duopoly, which can be as bad as a monopoly. We are not forgetting Sprint, but it is a selective player, and because it has no local access of its own, it will be particularly victimized by the special-access price squeeze described above.

Even if the bleakest predictions prove accurate, there should be a window of opportunity for enterprise customers to negotiate agreements with favorable terms, conditions and pricing because it will take several months for AT&T and Verizon to organize themselves after the mergers and impose "discipline" on their enterprise customer contracting functions. We estimate that enterprise customers have three months to a year to negotiate favorable deals before the situation begins to deteriorate.

The prudent course for enterprise customers is to recognize that core telecom rates (particularly special-access) *could* stabilize or even rise. This scenario was unthinkable a year ago, but is now a real possibility. To protect themselves, enterprise customers should be more flexible in contracting than they may have been in the past. They also should avoid committing too much of their traffic. In other words, they should maintain a significant cushion between their financial commitments and the value of traffic they anticipate delivering to a carrier. They should also consider longer terms or (better yet) try to get a two- or three-year term with multiple one-year renewal options. If rates go up because of reduced competition, a longer term or renewal options will provide some ability to hedge against the impact of rising rates.

If, on the other hand, rates continue to drop because competitive choices survive or thrive (*e.g.* because of the advent of WiMax), customers can use the threat of moving uncommitted business to incent incumbent providers to lower their rates. If incumbent providers resist the low commitments necessary to act on this strategy, enterprise customers should move traffic whenever possible, even if doing so is inconvenient and even if it means using smaller carriers such as Sprint or Qwest. Of course some services, such as MPLS, are hard to split among carriers. Those problems are not insoluble, but the solutions are

beyond the scope of this article.

Finally, consider making your business more attractive by bundling your procurements for services — such as web-hosting, wireless and network management — into single deals, a phenomenon that the carriers are already encouraging. This can create stickier demand, but might produce lower costs, provided that proper rate adjustment provisions are used.

For more information on the regulatory impact of the megamergers, contact Jim Blaszak at (202) 857-2541 or jblaszak@lb3law.com or Colleen Boothby at (202) 857-2543 or cboothby@lb3law.com. For more information on procurement strategies, please contact the attorney with whom you work at LB3 or Hank Levine at (202) 857-2550 or hlevine@lb3law.com.

Move Over Frame and ATM: MPLS is the Emerging Standard for Enterprise Voice and Data

For many years, enterprise customers have viewed voice and telecommunications transport as separate, commoditized products. The main goal in procurements for these mature products was simple: cut costs.

This time-tested formula may no longer be viable as large customers — with considerable prodding from the service providers — transition from connection-oriented frame and ATM networks to new IP-enabled, any-to-any connectionless services using the MPLS standard for IP networks.

Compared to legacy services, MPLS offers many potential advantages. Because it is connectionless, MPLS can simplify a customer's network architecture. It also offers significant opportunities for cost savings through streamlined network administration and faster provisioning. Finally, it enables enterprise customers to move voice and data services to a converged network.

Enterprise customers considering MPLS need to understand that an MPLS procurement is substantially different from a negotiation for legacy frame or ATM services. Here are a few issues to keep in mind:

- **Service Description** – Many MPLS offerings are still relatively new. Accordingly, it is important to include a comprehensive description of the MPLS service along with the features you expect to receive, such as any-to-any connectivity and support for VoIP and video conferencing. The service description should also include a discussion of the applicable technical or industry standards (*e.g.* jitter, dropped packets and R-Factor for VoIP). Finally, establish a clear dividing line between the provider's and your responsibilities, taking care to broadly define the vendor's responsibilities while limiting your own.

- **Implementation** – Understand how long it will take to implement the new MPLS network and determine whether to include a detailed transition plan as part of the agreement. Consider whether you will need to maintain your frame or ATM network until the entire new MPLS network is up and running. If you do, require the MPLS provider to take responsibility for any unexpected duplicate network costs caused by delayed implementation.

- **Pricing** – Stabilize the pricing and include language that prevents the provider from indirectly increasing your costs. For example, if pricing is based on Class of Service (CoS) or is provided for moves, adds and changes, clearly define these terms and associated activities in the contract.

- **SLAs** – Include SLAs for end-to-end monthly availability, latency, jitter and dropped packets. Beware of carve-outs and SLA exclusions: what service providers give with one hand (*e.g.* an end-to-end availability SLA), they may try to take away with the other (*e.g.* excluding local access failures from SLA calculations).

- **Remedies for Service Problems** – The connectionless nature of MPLS networks and the integrated applications they carry require companies to think differently about defining effective remedies for service problems. With a hub-and-spoke network using frame relay and ATM services, the remedy was the right to terminate services that consistently performed poorly and to replace them with another carrier's services. This approach does not work with an MPLS network, which is not so easily broken apart and put back together again. Consider which remedies work and which don't in the new world of MPLS. Terminating a single site might not work if the VoIP application is performing poorly but the data applications are doing well. But offsetting the monthly cost by the amount you have to pay a third party to complete what would have been on-net VoIP calls may be effective. Terminating a single site might not be worth the effort,

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but terminating the entire contract without liability if a key site is chronically bad may be.

For more information, contact Deb Boehling at (202) 857-2546 or dboehling@lb3law.com.

Do the FCC's VoIP Regulations Apply to Enterprise Customers?

And now for a few words about an old issue — E911 — that has re-surfaced at the FCC in a new context: VoIP. The FCC made quite a splash in the summer of 2005 when it released the *VoIP E911 Order*, which ordered VoIP providers to change their services to ensure that “911” emergency calls would reach the appropriate emergency responder. The open question is whether private networks are subject to the same requirements.

The *VoIP E911 Order* requires VoIP providers like Vonage or AT&T to ensure that emergency calls from their customers will (1) be delivered to the emergency dispatcher, known as the public service answering point (PSAP), assigned to the caller's location; and (2) include information on the caller's location so that the PSAP can dispatch help to the right place. To accomplish that, the FCC imposed certain notice, interconnection, and network configuration requirements on VoIP providers. But the FCC's new requirements are not necessary for most private networks because those networks already deliver emergency calls with location information to the right PSAP. VoIP deployment doesn't change any of that.

VoIP service typically uses an IP PBX to switch voice traffic in VoIP format among points at the same site. For 911 calls, the IP PBX converts the call from VoIP to the traditional transmission protocol for voice networks and then does just what a traditional PBX does: it hands off the call and location information to the local phone company for termination at the PSAP assigned to the PBX's location.

The FCC's *VoIP E911 Order* includes language that appears to exempt IP PBX arrangements from the order's requirements. But the FCC has not formally confirmed that interpretation. In fact, the FCC has informally questioned the use of VoIP by telecommuting workers or “nomadic” employees at off-site locations who use VoIP to reach their employer's network. Some FCC policy makers have even suggested that enterprise customers should

be required to disable remote calling features on their private networks.

The Commission will be issuing orders over the next several months to clarify the *VoIP E911 Order*. If you have deployed VoIP technology, you will need to monitor the FCC's proceeding. You might also consider contacting FCC personnel to help persuade them not to impose special requirements on IP PBXs.

For more information, contact Colleen Boothby at (202) 857-2543 or cboothby@lb3law.com or Andrew Brown at (202) 857-2549 or abrown@lb3law.com.

Three Lessons From a Recent MPLS Procurement

LB3 recently assisted a large insurance company in an MPLS procurement with a major carrier. Here are three lessons from that procurement to keep in mind when you do your next deal:

Carriers try to wiggle out of the promises they make in their RFP responses. The RFP required that charges for equipment needed for the transition to MPLS be waived, and the carrier agreed. During contract negotiations, however, the carrier wanted the customer to pay for the equipment up front and receive an offsetting credit several months later. The problem was that the customer had not budgeted for equipment. It took browbeating (including a threat to re-open negotiations with another vendor), before the carrier agreed to waive the charges up front. Lessons learned: draft RFP language that leaves no room for doubt on key financial issues and keep a second vendor in the wings to maintain your leverage during contract negotiations.

Beware of “no-commitment” agreements. Customers hate minimum volume and term commitments. In response, carriers are offering alternatives, including minimum annual percentages, minimum usage guarantees and no-commitment deals with discounts pegged to traffic volumes. But these alternatives may be worse than traditional minimum annual commitments (MACs). In this deal, the carrier proposed an agreement with no minimum term commitment. The catch? Although there was no term for the agreement as a whole, each circuit had a two-year term. Had we not revised the carrier's proposal by reducing the number of circuits subject to the two-year term, the customer would have incurred hefty early termination charges under this more “flexible” scheme because it frequently closes or moves offices. Lessons learned: “no-MAC” deals usually have a catch;

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a traditional MAC can always be managed with a realistic commitment.

Don't save SLAs for last. In the negotiation of complex agreements with multiple attachments, the SLAs are often among the last documents to be reviewed. Because carriers tout the reliability of their MPLS offerings, one might think that MPLS SLAs would be easy to negotiate. In fact, the carrier's first draft of the SLAs was a bare-bones document that fell well short of the customer's requirements. Signing deadlines loomed, and yet the carrier kept stalling; even arguing at one point that the customer could sign the agreement and negotiate SLAs later. Ultimately, the carrier agreed to robust MPLS SLAs, but the process took longer than it should have, and we almost ran out of time. Lesson learned: MPLS SLAs are too important to save for last.

For more information, contact Justin Castillo at (202) 857-2556 or jcastillo@lb3law.com.

Why Service Guides Are Dangerous

We frequently warn our clients about the threat posed by service guides, which are incorporated into contracts through innocuous-looking URL's. But those links incorporate dozens — sometimes hundreds — of pages of additional terms and conditions that will apply to the services you buy unless explicitly overridden by your contract.

The latest example of a dangerous service guide provision comes courtesy of Verizon Business (formerly MCI). It states that even if a contract allows a customer to terminate a service early in exchange for a termination charge, the early termination will still be "deemed to be a material breach by Customer of its contractual obligation to the Company." This is a potentially devastating provision. Not only does it fly in the face of common sense, it would enable Verizon Business, at least in theory, to terminate the contract for breach and demand damages from the customer even though the termination was permitted and Verizon Business compensated for it.

Don't believe us? Read the actual service guide provision: "Early Termination Charges: No provision for payment of a sum upon termination of service prior to the end of a committed term (whether the sum is called a termination charge, termination liability, or is otherwise designated), where termination is (a) by the Customer in the absence of a material breach by the Company of its obligations, or (b) by the Company when permitted

or required, shall be construed as an alternative performance or in any other manner a grant of permission or right to the Customer to terminate service prior to the end of the committed term. Any such early termination will be deemed to be a material breach by the Customer of its contractual obligation to the Company."

For more information, contact Laura McDonald at (202) 857-2545 or lmcdonald@lb3law.com.

Healthcare Companies Look Beyond the "Usual Suspects" for MAN Services

Recently we assisted several clients in the negotiation of Metropolitan Area Network (MAN) agreements. Although MAN services are gaining ground among enterprise users, they are of particular interest to the healthcare sector. Historically, those users had relied on separate transport for voice, video, and data services between data centers and remote locations. But a growing interest in telemedicine applications has prompted healthcare providers to look for ways to connect their local facilities (e.g. imaging and urgent care centers, free-standing surgical centers, hospitals) using high bandwidth services with quality of service guarantees that address particularly latency-sensitive applications. The major telecom vendors all have MAN service offerings, but our experience is that it pays to look beyond the "usual suspects." Other vendors are eager to meet the needs of enterprise customers for MAN services. Not only are they less wedded to their own forms and processes, they are more flexible in meeting the needs of individual customers.

For more information, contact Ellen Block at (202) 857-2542 or eblock@lb3law.com.

The USF Surcharge Heads Back Up

The FCC announced that the universal service contribution factor for the second quarter of 2006 increased from 10.2% to 10.9%. The USF contribution factor had held steady at 10.2% for the three prior quarters.

For more information about USF and other regulatory issues that impact enterprise customers, contact Jim Blaszak at (202) 857-2541 or jblaszak@lb3law.com or Colleen Boothby at (202) 857-2543 or cboothby@lb3law.com.

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Levine, Blaszak, Block & Boothby, LLP (LB3) is dedicated to meeting the needs of enterprise customers in the procurement and use of telecom and IT services. LB3 has extensive experience in negotiating custom network service agreements, network outsourcings, and related transactions on behalf of large users and information technology companies; assisting enterprise customers when their agreements with carriers “go south” and representing the interests of enterprise customers before the Federal Communications Commission. For more information, see our newly-redesigned website at www.lb3law.com.

Inside Wire is a quarterly newsletter that helps enterprise customers stay current with the latest telecom and IT developments. If you have any questions about any of the articles in this edition of *Inside Wire*, please e-mail us at insidewire@lb3law.com, or contact us at:

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Carrier Updates

Verizon business boosts property tax surcharges yet again. For the second time in two years, Verizon Business is raising its property tax surcharge. In late 2004, the surcharge shot up from 1.4% to 2.3%. Effective May 1, 2006, the surcharge increased to 2.5%. The property tax surcharge applies to a customer’s total interstate and international charges (including usage and nonrecurring charges) after the addition of applicable discounts and credits. It is not a pass-through of any kind, just an effort pioneered by MCI to saddle customers with a carrier’s ordinary costs of doing business. Any month now we’re expecting to see a “health insurance” surcharge.

Remember — when comparing various carriers’ bids, looking at rates alone is not enough. You must also consider the impact of surcharges and taxes, which can vary from carrier to carrier.

In case you thought there might actually be something good for enterprise customers in the MCI/Verizon merger. One of the principal public rationales behind the Verizon/MCI merger was to create synergies and extend benefits such as Type 1 treatment and pricing across the board to customers buying services from the “old” and “new” (MCI) Verizon companies.

Over the past few months Verizon has been working to create an integrated company. Indeed, customers of the former MCI have noticed everything from product names to account teams changing as Verizon assimilates MCI.

But there is at least one troubling wrinkle: Verizon is seeking to *perpetuate* distinctions between the services provided by Verizon and MCI in a way that could create substantial problems for unwary customers.

The change seems innocuous enough at first glance: in

tariffs and elsewhere, Verizon recently introduced the term “MCI Legacy Company.” The phrase is defined as “[o]ne or more of MCI Communications Services, Inc. d/b/a Verizon Business Services; MCImetro Access Transmission Services LLC d/b/a Verizon Access Transmission Services; MCImetro Access Transmission Services of Virginia, Inc. d/b/a Verizon Access Transmission Services of Virginia; and MCImetro Access Transmission Services of Massachusetts, Inc. d/b/a Verizon Access Transmission Services of Massachusetts.”

The problem with the term is that Verizon is extending or excluding promotions, discounts, credit to commitments and other benefits depending on whether or not they are provided by MCI Legacy Companies. For example, certain promotions apply only to services provided by MCI Legacy Companies. A customer that orders a service from the “wrong” Verizon entity may thus find itself paying higher prices for service. The wall that Verizon is creating (supposedly in the name of legal requirements, this goes well beyond the law) reduces customer flexibility and increases customer risk by creating a situation in which expenditures for certain Verizon services do not count toward MCI commitments.

Verizon’s approach thus gives customers the opposite of what they want from the merger. It is also inconsistent with what MCI and Verizon were promising to provide before the merger.

As you order services or negotiate new or amended agreements with Verizon Business, watch out for references to “MCI Legacy Companies.” Understand and manage the risks it presents to your company *before* you order service or sign an agreement.

For more information, contact Justin Castillo at (202) 857-2556 or jcastillo@lb3law.com.

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