

## LEXSEE

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**ARTICLE:** De-Regulation as the New Regulation: Telecom's Philosophy Turnabout and the Story Of a Forward-Looking Formula That Brought Back Competition

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**SUMMARY:**

... The Court made holdings concerning the FCC's ratemaking methodology and interpretations regarding the practical implementation of the Telecommunications Act of 1996 ("1996 Act"). ... *AT&T Corp. v. Iowa Utilities Bd.* reversed the Eighth Circuit's determinations that the FCC had no authority to control state commissioners' ratesetting methodology, and that the FCC misconstrued the language of the 1996 Act. ... The first objection that the Court fields from the incumbents is not that the 1996 Act, in theory, precludes any forward-looking methodology, but that "the cost of providing a competitor with a network element in the future must be calculated using the incumbent's past investment in the element and the means of providing it. ... " The incumbents base their rationale on the fact that TELRIC references a "hypothetical, most efficient element at existing wire-centers" and not the literal network element that is given to the competing carrier. ... The Court concludes this holding by rationalizing that the incumbent, rather than the entrant is in the best position to efficiently connect the elements and they are entitled to a reasonable fee for their services; therefore, the connection is really just another way to make money from the entrants. ... " Justice Breyer says that this sharing is counter-competition and will increase the need for regulation rather than curtail it. ...

**TEXT:**

[\*209]

I. Introduction

While the United States takes pride in its exemplary capitalistic success, there are many industries which, because of their nature, high public demand, widespread use, and need for uniformity, develop into natural monopolies. n1 Since the era of the railroad, Congress has vested authority in agencies to manage the specific challenges of monopolistic industries. n2 The history of telephone service is a classic example.

On May 13, 2002, the Supreme Court reaffirmed Congress's delegation of power over local telephone carriers to the Federal Communication Commission (FCC) in *Verizon Communications, Inc. v. F.C.C.* n3 The Court made holdings concerning the FCC's ratemaking methodology and interpretations regarding the practical implementation of the Telecommunications Act of 1996 ("1996 [\*210] Act"). n4 These decisions answered overarching issues in each of the five separate cases which were joined together for the court's consideration. n5 First, reaffirming the FCC's authority to require state utility commissions to the set rates incumbent phone carries charge competing phone carriers for the lease of network elements, the Court found that these rates can be forward-looking, as opposed to being based on the incumbent carriers' past historical rate trends or investments. n6 The Court also found the FCC's method of setting rates for the lease of the network elements to competing carriers to be reasonable and consistent with the 1996 Act. n7 Finally, the Court asserted that under the 1996 Act, the FCC may require the incumbent phone carries to combine network elements for the competing phone carriers if the competing phone carriers request combination, and are unable to combine without

assistance. n8

The Verizon opinion had the practical implication of clearing the air and giving a clean interpretation of the 1996 Act for the many jurisdictions that were struggling with similar issues nationwide, but the decision also struck a curious balance: de-regulating through an industry's regulatory agency. n9 Somehow, the FCC has come out of the Telecommunications Act crucible with more power than ever, provided that the agency accepts their new role as guardian of competition, not competitors. n10

[\*211] This note will begin in Part II, with a summary of the historical development of ratemaking and regulation in the telecommunications industry through the judiciary. Part III is a critique of the Verizon case, which includes: (a) the facts of the case; (b) an analysis of the majority opinion; and (c) a statement of the concurring opinions with an analysis of the dissent. Part IV discusses the impact of the case on the legal landscape and our society at large, and Part V will conclude with an illustration of Verizon's impact.

## II. History

### A. Interstate Commerce Act of 1887

The history of federal ratemaking through congressionally appointed regulatory agencies began most significantly with the Interstate Commerce Act of 1887 (1887 Act). n11 The 1887 Act was born with the rise of industry in America, and while it primarily governed rates of the railroads, it was the basis for all interstate regulations. n12 As certain commodities, e.g., railroad shipping and transportation, electricity, power, airlines, and telecommunications, became available and almost instantaneously vital to our day-to-day lives, "natural monopolies" sprang up. n13 The first providers to market became the only players in town. n14 Rather than sacrifice the usefulness of the industries that were making the day-to-day lives of Americans more convenient and comfortable by shutting the [\*212] monopolies down completely, Congress began to regulate these businesses. n15 This had the practical effect of leaving the monopoly intact, but under the watchdog of an agency that would impose rules that allowed the utility to be used in the best interest of the people. n16

### B. Fair Value Method

Enabling Acts for these agencies would generally mandate that rates for the utilities or commodities were "just and reasonable." However, specific guidelines were needed to truly keep discrimination at bay, and as a result, a rate determination scheme known as the "fair value method" was introduced. n17 In *Smyth v. Ames*, the Court determined that the calculation of the rate base must be the "fair value of the property being used by [the utility] for the convenience of the public." n18 Several factors were to be considered in the determination of "fair value" including: cost, expenditures on improvements, market value, probable earning capacity, and operating expenses. n19

### C. Twentieth Century Struggles

In *Western Union Tel. Co. v. Call Publishing Co.*, the Court required telegraph companies "to serve all customers in a nondiscriminatory manner as a common carrier." n20 Furthermore, between 1894 and 1906, thirty-four states mandated interconnection obligations in an effort to "resolve disputes that had arisen between [\*213] the Bell System, the largest telephone company at the time, and smaller independent telephone companies." n21 The next logical step came in 1910, when the Mann-Elkins Act brought interstate telephone regulation under the Interstate Commerce Commission. n22 Then, in 1913 under the "Kingsbury Commitment" AT&T agreed to interconnect with independent local telephone companies for long distance calls in response to a threatened antitrust case. n23

### D. Prudent-Investment Rule

Rate determination continued to morph when the "prudent-investment rule" was introduced in the early 1920s. Under this rule, "'cost' came to mean 'cost of service,' [specifically,] the cost of prudently invested capital used to provide the service. This was calculated subject to deductions for accrued depreciation and allowances for working capital...." n24

### E. Communications Act of 1934

Finally in 1934, Congress passed the Communications Act of 1934 (1934 Act), "for the purpose of regulating interstate and foreign commerce in communication by wire and radio...." n25 This Act enabled the creation of the Federal Communication Commission (FCC) and its enforcement of "the public interest, convenience, and necessity." n26

In section 214(a) of the 1934 Act, Congress bestowed upon the FCC the power to regulate entry into the interstate telecommunications industry. n27

[\*214] Section 214 (a) prohibits hopeful competitors "from entering the interstate market "unless and until there shall first have been obtained from the Commission a certificate that the present and future public convenience and necessity require or will require [such entry]." n28 The 1934 Act facilitated the regime of regulated natural monopolies, where "retail and input rates and investments were directly regulated by government, and jurisdiction was split between states and the federal government." n29 States regulated telephone services within the state, and the FCC regulated telephone services between the states. This distinction, while perhaps seemingly logical at first, in a nation that gives much deference to each State's power and autonomy, became very costly, and led to inefficiencies in adapting new technologies and pricing structures. n30 The results prohibited competition on one hand, while "providing incentives for arbitrage and opportunistic entry that would not occur in a competitive market on the other." n31 Some states were so adamant about maintaining this rate structure and control that many passed laws prohibiting competing telephone companies altogether. n32

#### F. Actual Legitimate Cost

During this time, rate determination was shaped again. The courts set limits for the deductions allowed under the "prudent-investment rule" through their holdings that "actual legitimate cost" was required. n33 "Actual legitimate cost" was simply a refusal to make allowances for amortization apart from the overall operating cost, because amortization was already figured into costs, therefore, disallowing a "double benefit" to utility owners. n34

[\*215]

#### G. The Bell Breakup

In the 1970s, MCI and other common carrier competitors obtained approval from the FCC to provide private-line services, and the D.C. Circuit in its "'Execunet' ruling held that the FCC, having permitted MCI into one part of the interstate telecommunications business, could not artificially cordon it off from other parts unless the agency was willing explicitly to conclude that an AT&T monopoly in long-distance telecommunications was required by the public interest." n35

From the late 1970s into the early 1980s, MCI and other competitors proved that the Bell System was not a necessary monopoly. n36 The Department of Justice brought suit against the Bell System in *United States v. American Tel. & Tel. Co.*, and the Court ordered the breakup of the Bell System into AT&T, a long distance service and equipment company, and the seven Regional Bell Operating Companies which provided local telephone services. n37 This ruling, however, did not increase competition in the [\*216] "persistently monopolistic local markets, which were thought to be the root of natural monopoly in the telecommunications industry." n38

#### H. Price Caps

"The final stage in a century of developing ratesetting methodology" at the federal level, was the advent of price caps. n39 Price caps came along because the prudent-investment rule was losing its teeth due to the telephone carriers' manipulation of the amounts invested, depreciation and allowances, all factors that determined the rate base. n40 The price cap scheme works as follows:

The price-cap scheme starts with a rate generated by the conventional cost-of-service formula, which it takes as a benchmark to be decreased at an average of some 2-3 percent a year to reflect productivity growth, subject to an upward adjustment if necessary to reflect inflation or certain unavoidable "exogenous costs" on which the company is authorized to recover a return. n41

Even though the telephone carriers can still try to massage the numbers regarding productivity offset and which costs are allowable, companies have an incentive to maximize their productivity, because they will be allowed to keep all profits above the productivity offset. n42

#### I. Telecommunications Act of 1996

[\*217] When the 1996 Act was passed, it turned the traditional telecom philosophy on its head. n43 A self-proclaimed "Act to promote competition and reduce regulation in order to secure lower prices and higher quality services for American telecommunications customers and encourage the rapid deployment of new telecommunications technologies," it demanded that the past protection of natural monopolies be abandoned. n44

### 1. FCC's First Report and Order

With any sweeping change comes a long winter of interpretation and challenge, and the 1996 Act has not changed. The FCC's first reaction to the 1996 Act was to issue its First Report and Order, Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, [hereinafter First Report and Order] on August 8, 1996. n45 The First Report and Order contained comments and rules regarding the local competition provisions of the 1996 Act. n46

### 2. Stay of the First Report and Order

Immediately after its release, the First Report and Order was criticized on two counts: (1) pricing provisions in Part 51(F); and (2) the incumbent responsibilities to the new competitors in Part 51 (I) section 252(i) (referred to by incumbents as the "pick and choose" rule). n47 Challenges were made by four states and certain incumbent telephone Local Exchange Carriers (LECs) in Iowa Utilities Board v. F.C.C., when they sought and obtained a stay of the interconnection order, pending judicial review of the Commission report and order promulgating rules. n48

#### [\*218]

#### a) Criticism of the Total Element Long-Run Incremental Cost (TELRIC)

The first pricing complaints chiefly surrounded 51.505(b), which mandates that state commissions must use the:

TELRIC method to calculate the costs that an incumbent LEC incurs in making its facilities available to competitors... After applying the TELRIC method and arriving at a cost figure, the state commission, acting as arbitrators, must then determine the price that an incumbent LEC may charge its competitors, based on TELRIC driven cost figure. n49

LECs had two main complaints about the TELRIC method: Section 51.505(d)(1) did not allow the incumbents to consider past ("historical" or "embedded") costs they may have incurred, and section 51.505(b)(1) required LECs to measure their cost "as if the incumbent were using the most efficient telecommunications technology currently available, regardless of the technology presently employed by the incumbent and to be used by the competitor." n50 The LECs feared that their costs would be underestimated and that prices would be too low, "effectively requiring them to subsidize their competitors and thereby threaten the viability of [their] own businesses." n51

#### b) Criticism of "Pick and Choose" Rule

LECs complaints regarding Part 51(I), are primarily based on the fact that the FCC added the language "rates" to 252(i) of the 1996 Act. n52 Under 252(i), LECs are merely required to offer the same "terms and conditions" (not rates) to competing carriers that the LECs (themselves) have for interconnection services or network [\*219] elements. n53 The LECs object that by including "rates" among the competing carriers list of things to "shop for," the FCC has effectively allowed entering competitors the ability to "'pick and choose' the lowest-priced individual elements and services they need from among all of the prior approved agreements between that LEC and other carriers." n54 At its worst, the result would be non-binding contracts and instability. n55

### 3. Eighth Circuit Cases that Led to the First Supreme Court Evaluation

In 1997, the following cases became the basis for the Supreme Court's first writ of certiorari, and review.

#### a) Iowa Utilities Bd. v. F.C.C.

In Iowa Utilities Bd. v. F.C.C., the Eighth Circuit's Judge Hansen made four rulings: (1) The FCC was outside of its authority when it issued rules regarding rates; (2) the FCC's "pick and choose" rule was unreasonable; (3) incumbent

telephone service carriers didn't have to provide higher quality service than what they gave themselves; and (4) the incumbent carriers were not responsible for recombining elements that were requested as separate. n56

b) *People of the State of Cal. v. F.C.C.*

In *People of the State of Cal. v. F.C.C.*, petitioners challenged FCC rules for intra state telecom communications. Judge Hansen, held in this case, to the extent that FCC's dialing parity rules pertained to intralocal access and transport areas, that such rules exceeded the scope of the FCC's jurisdiction. n57

[\*220]

4. First Supreme Court Evaluation in: *AT&T Corp. v. Iowa Utilities Bd.*

*AT&T Corp. v. Iowa Utilities Bd.* reversed the Eighth Circuit's determinations that the FCC had no authority to control state commissioners' ratesetting methodology, and that the FCC misconstrued the language of the 1996 Act. n58 The Supreme Court upheld the FCC's jurisdiction to impose a new ratesetting methodology, and the Court reinstated the "principal combination rule," 315(b), which forbids existing telephone carriers from separating currently combined network elements before leasing them to competitors. n59 However, the Court found that FCC Rule 319 was not consistent with the 1996 Act because 319 did not require access to the network elements to be necessary, nor did it require the entering carrier to show it would be "impaired;" both are required under 251(d)(2) of the 1996 Act. n60 The Court then remanded the cases "for proceedings consistent with [their] opinion." n61

5. Remand from the Supreme Court to the Eighth Circuit in: *Iowa Utilities Bd. v. F.C.C.*

On remand, the Court of Appeals invalidated not only the TELRIC method, but several of the FCC rules regarding interconnection and unbundled network elements. n62 The Eighth Circuit held that 252(d)(1) of the 1996 Act barred the use of TELRIC methodology because the Act required rates to be based on actual, not hypothetical costs of providing network elements. n63 The [\*221] court also interpreted the "combining requests" that came in from new competitors to the incumbent telephone carriers to mean that the competing carriers had to do the combining as opposed to the incumbents. n64 These two issues then became part of the larger framework for the Supreme Court's analysis and determination in their second review of the 1996 Act, *Verizon Communications, Inc. v. F.C.C.* n65

6. Final Supreme Court Evaluation in: *Verizon Communications, Inc. v. F.C.C.*

Now that a cursory foundation of the timeline and events that brought the Verizon case to the Supreme Court has been given, the critique is discussed below.

III. Critique

A. Facts of the Case

After the Supreme Court's initial ruling in *AT&T Corp.* and the Eighth Circuit Court of Appeals' remand, the petitioners once again sought and were granted review, along with four other cases the Court decided to join together in its review of the FCC's rules prompted by the 1996 Act. n66 The Court's holdings and analysis are discussed in the sections below.

B. Analysis of the Majority Holding

The majority held that "The FCC is authorized: (1) to require state utility commissions to set the rates charged by the incumbents for leased elements on a forward-looking basis, untied to incumbents' investment; and (2) to require incumbents to combine such elements at the entrants' request when they lease them to the entrants." n67

[\*222]

1. FCC's Forward-Looking Rate-Setting Requirement is Upheld by the Supreme Court

There were four reasons that the Court upheld the forward-looking rate formula that the FCC mandated for state commissions (in the instance that incumbents and new entrants cannot work out a "just and reasonable" contract for lease of services). n68 The first three reasons support the Court's broad objectives in adhering to Congress's intent through the 1996 Act. n69 The fourth and last reason, addresses the Court's approval of the FCC's methodology behind the formula

and delves heavily into the various rationales for dismissing incumbent complaints. n70

a) The Court Upholds the FCC's Forward-Looking Formula Because Congress Gave the FCC the Power to Prescribe Methods for Ratesetting

To begin, Congress specifically directed the FCC to prescribe methods for state commissions to use in setting rates in the 1996 Act. n71 Congress's intent was to "reorganize markets by rendering regulated utilities' monopolies vulnerable to interlopers ... the approach was deliberate ... setting a basic, default methodology for use in setting rates when carriers fail to agree, but leaving it to state utility commissions to set the actual rates." n72

It is a striking fact that none of the numerous lawsuits which resulted in this case attacked the Constitutionality of the 1996 Act itself. The incumbents seem to know that their stance is inherently pitted against the anti-trust sentiments of the Constitution and the nation's vote against skyrocketing prices and market manipulation which allowed the passage of the 1996 Act. The incumbents seem to be searching for a second-best theory to support the rationale behind their historical hold on power in the local telecom market. Their [\*223] claims come disguised in the sheep's cloth of State's rights while the impact of their resistance exposes their national stronghold over telecom power.

b) The Court Upholds the FCC's Forward-Looking Formula to Offset Monopoly Power

Accordingly, the second reason the Court upheld the rate formula was to offset incumbent monopoly power. n73 Because local exchanges are networks that connect all telephones, faxes and modems within a geographical area to one another through what amounts to a "'central office,'" (trunks) the Court balked at the "almost insurmountable competitive advantage" that incumbents have in controlling the routing as well as the market, stating that "[a] newcomer could not compete [in this market] ... without coming close to replicating the incumbents' entire existing network [including] ... laying down the 'last mile' of feeder wire ... to the thousands (or millions) of terminal points in individual houses and businesses." n74 A market so described, certainly falls outside of the perimeters of the 1996 Act's call to equal opportunity in the market and non-discriminatory competition. n75

But in the vivid details of the Court's rationale, it is difficult not to consider the many hours, days, months, and years that people spent in the rain, snow and sun (even underwater) to build the existing systems. Those people were paid by companies that took great economic risk during Telecom's first bloom, and expanded the network to keep up with the rapidly increasing pace of the average American's life. Indeed, there is something paradoxical about the Court raising the "good old-fashioned competition" argument when all of the heavy-lifting has been done.

On the other hand, it is easy to understand the FCC and the entrants' argument of "unfair advantage." Many of today's entrants were yesterday's frustrated competitors who might have been able to build equally successful markets and lay just as much "line," if the regulations of the past had fostered competition instead of keeping [\*224] local monopolies in place. The Court seems to be upholding the equivalent of "affirmative action" for "minority" phone service carriers. While these decisions may have been made under the broad strokes of "competition, good-monopoly, bad," the people have spoken through Congress's 1996 Act, and no one is challenging that.

c) The Court Upholds the FCC's Forward-Looking Formula Because it Met the "Just and Reasonable" Requirement of the FCC's Enabling Act

Third, the Court upheld forward-looking rate setting because it effectively met the "just and reasonable" requirement of the FCC's enabling act, while proposing to answer long-standing concerns. n76 The Court recalls the history of intrastate versus interstate carrier duties noting that, "regulation of retail rates at the state and local level was ... focused more on the demand for 'just and reasonable' rates to the public than on the perils of rate discrimination." n77 Furthermore, amidst the growing pains and various incarnations of rate formulas such as: fair-value, the prudent investment rule, actual legitimate cost, and price caps, the Court was keen to point out what did not change. n78 This was "the idea that calculating a rate base and then allowing a fair rate of return on it was a sensible way to identify a range of rates that would be just and reasonable to investors and ratepayers." n79 The Court then takes the opportunity to state another "equally enduring [concern,] dissatisfaction with the successive rate-based variants." n80

From the constancy of this dissatisfaction, one possible lesson was drawn by Congress in the 1996 Act, which was that

regulation using the traditional rate-based methodologies gave monopolies too great an advantage and that the answer lay in moving away from the assumption common to all the rate-based [\*225] methods, that the monopolistic structure within the discrete markets would endure. n81

Undoubtedly, Congress made a big move with the 1996 Act. They took a gamble with the latitude of the FCC enabling act language "just and reasonable rates" and set out to create a formula that made a clean break from the past. n82 Congress's determination to think outside the box went against the grain of over 100 years of precedent in telecom regulation. n83 Perhaps most surprising, was the FCC's acceptance of their charge from the 1996 Act. The FCC had direct pressure from the very incumbents it had been keeping in power for so long. The incumbents naturally urged the FCC to oppose the 1996 Act in the FCC's interpretation and action. The FCC also had the most to lose in terms of scrutiny and fund depletion when the lawsuits started rolling in from state commissions, incumbent carriers, and the judiciary itself. n84

The FCC also could have taken the 1996 Act to court itself, with potential arguments that the 1996 Act's lack of direction as to the means which the FCC was to fulfill its order, or that the 1996 Act was, in essence, an order against the FCC's enabling act, because de-regulation could be considered a death knell for the FCC's future. But the FCC did neither of those things. They accepted the 1996 Act's call for change and delivered the news to their incumbents with a straight face. n85

#### d) The Court Upholds the FCC's Forward-Looking Formula Because the Court Agreed with the Formula's Methodology

Finally, and most importantly, the Court upheld the methodology behind the forward-looking ratesetting formula. n86 Arguments against this methodology were at the foundation of all five underlying cases contained in Verizon, and gave the Court reason to join them and [\*226] grant certiorari. n87 Incumbents in this case attack both the lack of "past investment" as a factor for determining cost, and the TELRIC formula itself. n88

#### i. Incumbents Object to the Methodology of the Ratesetting Formula Because it Precludes the Use Past Investments When Calculating "Cost"

The first objection that the Court fields from the incumbents is not that the 1996 Act, in theory, precludes any forward-looking methodology, but that "the cost of providing a competitor with a network element in the future must be calculated using the incumbent's past investment in the element and the means of providing it." n89 The Court swiftly swoops down on this argument declaring that the incumbents have "picked an uphill battle" because they are arguing that "cost" in this case, "can only mean, in plain language and this particular technical context, the past cost to an incumbent of furnishing the specific network element actually, physically, to be provided." n90 The Court illustrates the lack of logic in the incumbents' "plain language" definition of cost through the example of a merchant who is asked about his cost. The Court says that this merchant may "reasonably quote ... current wholesale market price, not the cost of the particular items he happens to have on his shelves, which may have been bought at higher or lower prices." n91

But it is not illogical to look towards the past when determining costs of any sort for the present or the future; and the incumbents were used to determinations based on past results. n92 Furthermore, the incumbents in this case are not asking that the past be the only factor in determining future cost, only that it be one factor. At first blush, the Court may have been overly cautious in excluding past investment from any part of the final cost equation.

[\*227] However, the Court weighed the deliberate nature of Congress's decision to pass the 1996 Act quite heavily. n93 Congress's intent, together with the history of monopoly and facts showing a need for radical change in order to affect actual competition, resulted in the Court's conclusion that drastic times call for drastic measures; the Court upheld the FCC formula forbidding the consideration of historical or "embedded" costs. n94

Likewise, in the technical realm, the Court notes the following three inconsistencies with the incumbent's interpretation of "cost" as actual past cost: (1) past rate-making did not assume that cost included all past investments, "but at most for those that were prudent," (2) even when entire investment was considered, ratemakers often rejected these "embedded costs," and (3) "cost" traditionally, "was a term in value-based ratemaking" and has been used "in contemporary state and federal ratemaking untethered to historical evaluation." n95 The Court is on its highest ground in the "technical definition of cost" argument, because the term (which was explored in the History section, supra section II) has never been pigeonholed into one particular definition due to the varied and ever-evolving past of ratemaking. n96

While it is true that the 1996 Act is "radically unlike all previous statutes in providing that rates be set "without reference to a rate-of-return or other rate-based proceeding," the rates are still tied to "just and reasonable and nondiscriminatory standards" and allow for a reasonable profit. n97 When taken in line with the overall changes in rate determination and Congress's intent to affect a sweeping change, the Court's decision on this point is not surprising. n98

Finally, the Court cites *Hope Natural Gas* for its assertion that "regulatory bodies required to set rates expressed in [just and [\*228] reasonable] terms have ample discretion to choose methodology." n99 In *Hope Natural Gas*, "the primary issue in [the] cases [the court reviewed] concerned the validity under the Natural Gas Act of 1938 ... of a rate order issued by the Federal Power Commission reducing the rates chargeable by *Hope Natural Gas Co.*" n100

The Court found that under the Natural Gas Act, the ratemaking function of the Federal Power Commission involves making pragmatic adjustments, and the Commission is not bound to the use of any single formula or combination of formulae in determining rates. n101 Both *Hope Natural Gas*, and *Verizon* involve rate orders from federal regulatory agencies which involve the making of pragmatic judgments, judgments which are allowed under the 1934 and 1996 Acts. n102 The Court is reaffirming the message that when Congress gives an agency power to do something that Congress cannot implement in a practical day-to-day manner, either because Congress lacks the expertise, the time or both, then the agency has discretion to make ratemaking decisions that affect change, as long as they are within the parameters of a just and reasonable and nondiscriminatory decision. n103

As a result, the definition of "cost" by the FCC was found to be satisfactory because in both basic and technical usage, "cost" is a flexible concept and "nothing in 252(d)(1) plainly requires reference to historical investment when pegging rates to forward-looking "cost." n104

#### ii. Incumbents Object to TELRIC, the Ratemaking Methodology Chosen by the FCC

The second objection that the incumbents made regarding the FCC's forward-looking methodology, was to TELRIC, the particular [\*229] methodology chosen. TELRIC is the acronym for "total element long-run incremental cost." n105

In Rule 505, the FCC defined the "forward-looking economic cost of an element [as] the sum of (1) the total element long-run incremental cost of the element [TELRIC]; [and] (2) a reasonable allocation of forward-looking common costs," 51.505(a), common costs being costs incurred in providing a group of elements that "cannot be attributed directly to individual elements," 51.505(c)(1). Most important of all, the FCC decided that the TELRIC "should be measured based on the use of, the most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent[s] wire centers." n106

The incumbents raised two complaints regarding TELRIC, first that it was inconsistent "with the plain language of 252(d)(1)," and second, that it was not "within the zone of reasonable interpretation subject to deference under *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843-45 (1984)." n107 The incumbents base their rationale on the fact that TELRIC references a "hypothetical, most efficient element at existing wire-centers" and not the literal network element that is given to the competing carrier. n108

#### 1. TELRIC is Inconsistent With the "Plain Language" of 252(d)(1)

The Court addresses the "plain language" complaint by referencing the incumbents' former plain language argument. n109 Justice Souter dismisses the claim because it presupposes that "plain [\*230] language" means that cost must be tied to a past historical investment, and the Court believes that "'cost' is simply too protean to support the incumbents' argument." n110

Although the Court treats the incumbents' TELRIC plain language argument in the exact same manner as the "cost" plain language argument, the "hypothetical element" questioned by the incumbents here is actually quite different than the consideration of cost in general (although both ultimately deal with the bottom line). n111 Being required to price their elements leased to competitors at a rate that assumes most efficiency is a perfect world approach. n112 It is understandable that the incumbents would reject this mandate, because they had to pay "old regime" prices for their equipment, and assuming that their elements depreciate over time, it is no longer as efficient as it could be. Incumbents get a double penalty because they are required to maintain and support equipment that is less than the "most efficient," while pricing it

as if it is. n113 TELRIC strays from basic business principles because owners, the incumbents, are not allowed to pass along the required maintenance and repair costs to their customers who, stingingly, are also their competitors. n114

## 2. TELRIC is Not Reasonable Under Chevron Deference

The Court gives ample consideration of the incumbents' three-part "reasonable interpretation" argument where the incumbents contend that: (1) Hypothetical elements may simulate, but do not actually induce competition (In other words, assuming "perfect competition" results in no competition. (i.e., why build your own network when you can lease elements?)); (2) TELRIC specifically does not induce competition because it does not allow for depreciation or risk-adjusted capital costs; (3) TELRIC is needlessly, hence unreasonably, complicated and impractical. n115 The Court [\*231] addresses each contention one by one, ultimately rejecting each point.

### a. Hypothetical Elements Do Not Induce Competition

The Court disagrees with the incumbents' first argument on three points: First, TELRIC does not assume perfect competition and, in fact, "includes several features of inefficiency" that do stimulate competition. n116 For example, ratesetters are to calculate the cost from elements available at the "existing" center, not elsewhere. n117 This narrows the range of "most efficient" rates to choose from. n118 Also, it takes time for competitors to shop around and see what the most efficient rates are, so there will not be a mass exodus of customers or forced rate drop every time a new element is introduced. n119

There is something to be said for the Court taking such a realistic approach. It is hard to argue with its assertion that no matter how competitively "perfect" the assumptions of TELRIC are on paper, inefficiencies in implementation are always the great equalizer. Furthermore, the limitation of the "existing center" in determining "most efficient" elements is no small matter. This effectively ties the competitors to the incumbent market they are seeking to enter and allows no unfair advantage in terms of national leverage. n120

In fact, it could be argued that this limitation goes as far as introducing the "historical" cost effect on the competing entrants, because if they are tied to an existing center's most efficient rate, the incumbents are already quite aware of the rate range and have adjusted cost accordingly. This would undoubtedly show up in the range of rates available to the competing entrants.

Secondly, comparisons of TELRIC with the alternatives presented by the incumbents, shows that the FCC had good reasons for rejecting the alternatives and choosing TELRIC. n121 The Court considered three alternative methods offered by the incumbents: [\*232] "embedded-cost methodologies, efficient component pricing rule, and Ramsey pricing." n122 The Court found that each alternative raised the basic complaint that TELRIC encouraged short-term efficiency and discouraged a long-term cycle of building, growing, innovating, and competing.

The Court opposed these alternatives for two reasons. n123 First, if lease rates "compensated" the incumbents for their inefficiencies, the rates would go up and it would keep potential competitors out of the market. n124 Second, innovation works both ways. The incumbents were claiming that TELRIC would keep competitors from building because they would just latch onto the next, lowest rate and not build. n125 But the Court said that incumbents could do the very same thing as soon as an incumbent came out with a new, more efficient technology, essentially it is a wash. n126

While the Court's decision is certainly logical for the purposes of honoring the 1996 Act's intent to increase in competition, the incumbents' argument that long-term stability is being sacrificed for short-term stimulation of competition is valid. There was a reason that the "natural monopoly" of telecom was protected for as long as it was: utilities cannot afford to be unstable because of the vast public reliance on their services.

The danger in the Court's general characterization of these alternatives in favor of competition at all costs, is that the telecom market will get a bunch of "fly-by-night" entrants who collapse leaving their customers with unreliable means of communication. n127 This could wreak havoc on the state of business and our economy as a whole, and put those that last into the unenviable position of having to rebuild the industry for the second time and with stripped resources. Third and finally, the Court found the results of the FCC's First Order and Report spoke for themselves. n128 From the passage of the 1996 Act through 2000, \$55 billion dollars have been invested in [\*233] competing markets. n129 The FCC breaks down the new competitors into the following categories: "33 percent of entrants were using their own facilities; 23 percent were reselling services; and 44 percent were leasing network elements." n130 The Court needed no further persuasion, finding that TELRIC induces competition. n131

It is pretty hard to argue with the facts, especially when 33 percent of the entrants are building from the ground up when it would be much easier for them to lease. These facts indicate that TELRIC is not an open call for a gold rush, but an open door for serious competitors who anticipate staying in the industry once allowed in.

b. Competition is not Induced Because it Does Not Allow for Depreciation or Risk-Adjusted Capital Costs

Addressing the second part of the incumbents' three-part "reasonable interpretation" argument, the Court once again found that the FCC had not erred in their adoption of TELRIC. n132 The incumbents argue that TELRIC does not allow for enough tax incentives to induce "rational competition" because "the incumbents will be stuck ... with sunk costs in less efficient plants and equipment, with their investment unrecoverable through depreciation, and their increased risk [is] unrecognized and uncompensated." n133

The Court argues that the incumbent's argument rests on a "fundamentally false premise," because the FCC has given state commissions the responsibility for these matters in paragraph 702 of the First Report and Order. n134 The Court contends that TELRIC does not fix percentage rates or delineate a particular useful life for purposes of calculating depreciation, because "TELRIC rates are calculated on the basis of individual elements. TELRIC rates leave plenty of room for differences in the appropriate depreciation rates [\*234] and risk-adjusted capital costs depending on the nature and technology of the specific element to be priced." n135

This argument by the incumbents seems almost comical because "increased risk" is never a guarantee of a positive tax outcome. It simply results in loss or gain and is categorized and dealt with accordingly. What the incumbents seem to complain about here is that they somehow want a tax break if they are forced to comply with the FCC's rules regarding the 1996 Act. We all would like a tax break for doing what we are told, but sadly, there are only penalties for non-compliance when you are dealing with the U.S. government.

The incumbents are understandably reluctant to follow the new regime. But while it may be true that TELRIC does not allow for the depreciation to be passed along to the competing entrants, nowhere in the FCC's order does it instruct the final elements of taxation.

c. TELRIC is Needlessly, and Hence Unreasonably, Complicated and Impractical

Finally, the Court speaks to the third and last part of the incumbents' "reasonable interpretation" argument, by simply finding that the alternatives are just as complex. The Court follows this up with a nod to the ease of the TELRIC calculation, and concludes that while "battles of experts" are unavoidable, the FCC was wise to choose the approach that did not preserve the "home-field advantages for the incumbents." n136

The "home-field advantage" is the key to the Court's reasoning. While Justice Souter patiently and dutifully addresses each of the incumbents' arguments, there is an overall sense that the Court might as well tell the incumbents that whatever arguments they might have cannot prevail because the Court is interpreting the purpose of this Act as one that takes away incumbent advantage in order to get new players and put them on an equal playing field. n137

Therefore, the Court's finding that TELRIC is consistent with the plain language of the 1996 Act 252(d)(1) and within the reasonable interpretation subject to deference under *Chevron U.S. A. Inc. v. [\*235] Natural Resources Defense Council, Inc.*, 467 U.S. 837, was due to the fact that the incumbents failed to show unreasonableness. n138 The incumbents failed, in great part because they "mischaracterized the FCC's departures from the assumption of a perfectly competitive market ... as inconsistencies rather than pragmatic features of the TELRIC plan." n139

In a last stab at the FCC's methodology, the incumbents argue that TELRIC is unconstitutional because: (1) the ratemaking methodology is "so divorced from investment actually made," that it constitutes a taking under the Fifth (or Fourteenth) Amendment; and (2) the incumbent's reliance interests are "jeopardized by an intentional switch in ratesetting methodologies." n140

The first argument is unusual because the incumbents are not arguing that a particular rate itself is the problem, which is the normal rule for this type of argument. n141 The Court says that the lack of a specific rate to review is of special note because "this Court has never considered a taking challenge on a ratesetting methodology without first being presented with specific rate orders alleged to be confiscatory." n142 The incumbents argue that their claim should be considered a special case because there are "signs, too strong to ignore" that TELRIC will result in takings. The Court dismisses this assertion because, with no number to review, the Court would be making a constitutional decision on a ratemaking issue

"sight unseen." n143

The second argument by upset incumbent reliance interests is similarly dismissed by the Court because they claim there was no "'switch' of methodologies, since the wholesale market for leasing network elements is something brand new under the 1996 Act" and that it was not made in the interests of being opportunistic, but for the very opposite reason. n144

[\*236] While theoretically, a methodology is separate from its result, and theoretically should be able to be analyzed apart from a real-life rate number, the Court decides not to indulge that type of analysis in this case. n145 It is a decision that is practical and understandably in the interests of efficiency, relevancy, and accuracy. There will be many years to deal with the real-life rate conflicts resulting from the decisions in this case. There is no need to seek out invisible rate-monsters hiding under the bed of this young statute.

The impact of judicial review of the rate methodology issues in this case, as opposed to executive or legislative review, which will be expressed when the public experiences the effects of the 1996 Act in their day-to-day lives, is also significant. Because the judiciary can only rule on what is before it, the Court has no power to take case law precedent and combine it with aspects of the 1996 Act to "smooth out the edges." This must have been a tough limitation to recognize in the wake of so much litigation passed, and no end in sight.

2. The FCC is Authorized to "Require Incumbents to Combine Such Elements at the Entrant's Request When they Lease Them to the Entrants."

The second main argument is brought by the Government and the competing carriers. They would like the Court to "overturn the Eighth Circuit's invalidation of the additional combination rules" found in the 1996 Act's sections 51.315(c)-(f). n146 The incumbents counter by saying that the "challenge is barred by waiver," because the initial petition for review to the Eighth Circuit in 1999 only considered 315(b) and not (c)-(f). However, briefing was invited on (c)-(f). n147

Despite this, the incumbents say that the Eighth Circuit exceeded their scope and as a result the Supreme Court should "decline to reach the validity of Rules 315(c)-(f)" because it encourages [\*237] "piecemeal litigation." n148 The government strikes the incumbent's argument down on two grounds: first, the Court did not believe that addressing this issue was wasteful, but would direct the Court's attention to "the invalidation of FCC rules meant to have general and continuing applicability." n149 This was not a case where no appeal had been made because of "litigation tactics." n150 Secondly, the Court cites *United States v. Williams* as standing for the fact that "any issue 'pressed or passed upon below' by a federal court ... is subject to this Court's broad discretion." n151

It seems an odd tactic of advocacy for the incumbents, who have taken such blows already, to raise an objection that intimates any limitation on the Court's power. The incumbent's argument seems to dare the Court to go where, clearly, the Eighth Circuit was not afraid to go when it opened the topic of these additional rules. The history of these rules in the earlier cases is non-dramatic, as the Court points out, so the incumbents' whole approach comes across as "stirring-up trouble."

The Court proceeds to attack the Eighth Circuit's finding that the "four additional combination rules" were at odds with the 1996 Act. n152 The Court begins with its rationale for why the rules were put into place and why they are necessary, stating that before their implementation, incumbents "were refusing to give competitor's technicians access" to the incumbent's physical plants to make the connections between the competitor's new line and the incumbent's main hub. n153

The Court considers the first two substantive rules, 315(c), and (d). 315(e), and (f) are procedural and had no independent significance to the Court. n154

[\*238]

Rule 315(c) requires an incumbent to "perform the functions necessary to combine unbundled network elements in any manner, even if those elements are not ordinary combined' in the incumbent's own network, so long as the combination is 'technically feasible' and "would not impair the ability of other carriers to obtain access to unbundled network elements or to interconnect' with incumbent's network. The companion Rule 315(d) likewise requires the incumbent to do the combining between the network elements it leases and a requesting carrier's own elements, so long as technically feasible. n155

The incumbents argue that the rules are not valid because they are inconsistent with plain language, and are unreasonable interpretations of the 1996 Act 251(c). n156 The language in question is 251(c)(3), "an incumbent local exchange carrier shall provide such unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service." n157

While the Eighth Circuit held this language to mean that incumbents were excused from any duty of combining for entrants, the Court on review, interprets it differently stating, "if Congress had treated incumbent and entrants as equals" the Eighth Circuit's interpretation would have made sense. n158 But since the 1996 Act "proceeds on the understanding that incumbent monopolists and contending competitors are unequal ... it takes a stretch to get from permissive statutory silence to a statutory right on the part of the incumbents to refuse to combine." n159

Weighing this rationale along side of the practical interpretations of the surrounding statutes, as well as the Chevron rule, (which gives deference to the federal agency unless its interpretation is found to be [\*239] unreasonable) resulted in the Court's finding that "an obligation on the part of an incumbent ... only arises when the entrant is unable to do the job itself. When an incumbent does have an obligation, the rules specify a duty to "perform the functions necessary to combine,' not necessarily to complete the actual combination." n160

The Court concludes this holding by rationalizing that the incumbent, rather than the entrant is in the best position to efficiently connect the elements and they are entitled to a reasonable fee for their services; therefore, the connection is really just another way to make money from the entrants. n161

Certainly this aspect of the case is the greatest issue where reasonable minds may differ. Both sides concede that there is a gray area in the language of the 1996 Act, but find different ways of "wordsmithing" their way into its meaning. n162 The Court, as with other issues in the case, weighed the overall intent of pro-competition heavily, landing firmly on the side of the entrants. n163

While the incumbents are in the most advantageous position to combine elements with the least amount of effort (they own the system, built the system and still control who comes in and out through contracting) it is only logical that they connect the elements if their new "lessee" cannot. However, seems to coddle the entrants almost too much. If the entrants are supposedly competing on an equal playing field, and there is to be nondiscriminatory treatment, they need to be ready to handle the responsibilities of playing in the telecom sandbox. They should be able to bring their own shovels.

[\*240]

#### 7. Concurring Opinion and Analysis of the Dissent

Justice Breyer agrees that the 1996 Act does not require costs and rates to be determined by historical investment, and that the FCC rules do not constitute a taking under the Fifth and Fourteenth Amendments. n164 Justice Breyer disagrees, however, with "the Court's conclusion that the specific pricing and unbundling rules at issue here are authorized by the [1996] Act." n165

Justice Breyer first attacks the hypothetical nature of the determination of rates under the FCC rules. n166 Through an example in which a five-block stretch of downtown Chicago is named the "network element," Justice Breyer contrasts the costs of what an actual incumbent would have to pay to give it service versus the TELRIC hypothetical in which a new supplier with the most efficient technology builds the network from scratch. n167 Justice Breyer states that this system exceeds even the wide discretion that agencies have in ratemaking due to their expertise. n168 Justice Breyer fails to see the required "rational connection" between the statutory purpose of the 1996 Act to promote competition, and the egregious difference between a hypothetical and perfectly efficient formula and the actual cost to the incumbent facilitating the connection. n169

Justice Breyer makes a good point, especially in light of the fact that the Court has held that results of a ratemaking strategy are what count, and not the strategy itself. n170 How are we to resolve the bias towards the entrants? The Majority said we are not to resolve it. The Majority asserts that it is Congress's intent to turn things upside down. n171

Yet, there is something that seems unfair about holding the incumbent's advantage against them. We, as Americans, have been [\*241] raised with the ideals of "first in time, first in right" and that we should be rewarded for our hard-won place in society and the economy - not penalized for it. Taking the big hand of Congress and sweeping it across the table of the telecom industry in an effort to "do over" frustrates 100 years of hard-earned history.

In Part II of his opinion, Justice Breyer admonishes that "The Telecommunications Act is not a ratemaking statute seeking better regulation. It is a deregulatory statute seeking competition." n172 To this end, Justice Breyer believes that the 1996 Act does not allow FCC regulations that would hinder the transition of the telecom industry from a regulated industry to a non-regulated industry, which he believes the TELRIC rates will do. n173

Justice Breyer aptly supports his view with five elements including the 1996 Act's express goal to "promote competition and reduce regulation," concluding that the 1996 Act "seeks new local market competition insofar as local markets can support that competition without serious waste." n174 "And we must read the relevant rate setting provision - including the critical word 'cost' - with that goal in mind." n175

This portion of Breyer's opinion may be too severe. The incumbents do not argue that the FCC order is an attempt to thwart competition. n176 What Justice Breyer seems to be saying is that the FCC is getting in the way of its own goal through its choice of TELRIC as the preferred method of ratemaking. n177

While TELRIC may be controversial, this criticism goes too far because it assumes that the FCC's intent is to gain tighter control under the guise of promoting competition. However, the FCC did not draft a whole Special Edition tome of the FCC Record for the fun of it; Congress mandated that the FCC play an integral part in the implementation and enforcement of the 1996 Act. n178

[\*242] In Part III of his opinion, Justice Breyer asserts that TELRIC will promote wasteful behavior by incumbents and entrants because there will be uneconomical sharing of the incumbent's facilities because the entrants will lease instead of "building or buying elsewhere." n179 Justice Breyer says that this sharing is counter-competition and will increase the need for regulation rather than curtail it. n180 In addition, Justice Breyer finds the TELRIC method speculative to a degree which necessitates a "battle of the experts," and can find no offsetting advantages for these faults. n181

In theory, Justice Breyer's concern is quite valid. What competitor would actually want to build a new network when the incumbents' networks are ready to lease? But the reality of entrant activity (discussed infra Section IV, in the Impact section) answers this question with the solid figure of 33 percent. n182 The reasons to build can be just as convincing: the use of the newest technology, control of your own lines and a bottom to top network that doesn't change hands along the way. Time, ultimately will tell if Justice Breyer's concerns come back to haunt the telecom industry.

Part IV contains six responses that the FCC gave in response to Justice Breyer's concerns in Part III supra. n183 Justice Breyer ultimately finds that they are not satisfactory in showing the required rational relationship between the 1996 Act and the FCC regulations. n184 Justice Breyer addresses each of the six in order, asserting that:

[\*243]

1. The FCC claims to allow for a depreciation charge for a reasonable investment in equipment, while "requiring state commissions to use current depreciation rates" (not historic). Additionally, there are no incentives to invest. n185
  
2. Permissible profit rates are not flexible enough (despite the FCC's assurances that the state commission can adjust them). Justice Breyer believes that the "tentative guidance" the rules offer are clearly a product of the time crunch the FCC was in to complete the order, and they optimistically assume "that current market conditions mean that current profit rates somehow magically offset the adverse effects of the Commission's other regulations." n186
  
3. The FCC claims that TELRIC has been used by several States and European nations but there is no evidence that this is the case. The TELRIC formula "reflects Congress's desire to obtain not perfect prices but speedy results." n187
  
4. Hypothetically, the most efficient element promotes sharing instead of independent building. Also, the "hypothetical" methodology is consistent with ratemaking for regulation and not deregulation. n188

5. The FCC says TELRIC leaves freedom of interpretation for the States, yet they have national standards and guidelines. n189

6. The Majority's assertion that "lag time" keep the hypothetical most efficient element in check and [\*244] based in reality, doesn't fix the underlying problem of its disparate effects. n190

Taken together, these claims call out the imperfections and controversies of the FCC Rules. The choice of the methodology does not have history on its side, nor is it firmly based in reality. n191 TELRIC is a formula, like many others used in the past as a means to an end. When the effects of its parameters (or lack thereof) come to light, Congress will be called on to answer for them. The Majority has decided to trust Congress. It is easy to see why this would be unsettling to Justice Breyer. Where is the precedent? Where is the reasonableness in venturing into the great unknown? Justice Breyer appears to cry out as the last guard at the post as his colleagues all jump off the cliff. But TELRIC, in the end, is probably a small curb of a drop rather than the cliff the incumbents would make it out to be. The FCC has too much accountability to telecom businesses to hang its old nearest and dearest completely out to dry.

In Part V, Justice Breyer continues his claim that the FCC Rules will result in more regulation in their operation, and the Statute's aims were de-regulation. n192 Justice Breyer claims that the Majority has been overcome by the deference to the technical expertise of the FCC. n193 He intonates that they may not have "dug-in" substantively enough, although he doesn't insinuate that the Majority neglected thorough review. n194

It is an easy criticism to say that a regulatory agency would want more regulation, but the FCC did not take it upon themselves to issue the First Report and Order. n195 Nor did the FCC come up with the rules out of thin air. n196 According to Reed Hunt, Chairman of the FCC, the First Report and Order rules were based on four elements of pro-competition approach, which included the 1996 Act and its harmony with them:

[\*245]

1. Do not favor any particular mode of competitive entry (such as facilities construction, leasing unbundled elements or resale), but allow entrants to select the methods of entry that best fit their business plans;
2. Entrants must not be charged more than economic cost, and incumbents must be allowed to charge economic cost, for leasing parts of the incumbent network or for terminating calls on the network for leasing those elements and termination.
3. Wholesale prices for resold local service must be priced at retail less avoided costs that can or should be avoided; and
4. The job of creating and sustaining subsidies must be separated from the prices for leasing parts of the incumbent monopolist's network, or for terminating calls on the incumbent's local network. n197

While the FCC does have the upper hand in technical expertise, the Majority "dug-in" enough to know that the Rules were submitted in good-faith with. Their opinion cites and evaluates several competing theories, ultimately coming to the conclusion that TELRIC passes the test. n198

Finally, in Part VI, Justice Breyer is joined by Justice Scalia. n199 Both contend that the Majority's holding – that incumbents are required to combine network elements for the entrants when they are unable to do so – is in opposition to the language of the 1996 Act. n200 They join the incumbents in questioning, "How ... can a statute that speaks of the requesting carriers combining elements, grant the FCC [\*246] authority to insist that they, the incumbents, combine the elements?" n201

Perhaps the real question is how many times each party can stand on their own side of a statutory gray area and declare violation of their interpretation of that statute! Discussion of the Majority's decision to require incumbents to combine

elements was discussed earlier, but Justice Breyer scores a practical point in his expectation that entrants come prepared to play in the big leagues now that they are able. n202

#### IV. Impact

The Verizon decision, while significant, simply solidified FCC rules and facilitated the tide toward competition that began with the 1996 Act. n203 Therefore, analyzing the impact of Verizon a mere eight months post-verdict is, at this stage of the game, one piece of an overall evaluation of the increase in telecom competition as a whole. As time goes by, the finer details of the Court's decision will make themselves apparent, but the following highlights of telecom's six year journey towards competition illustrates where the issue stands to date.

##### A. First Look: January, 1998

The first formal review of the "State of Local Competition" was held before the FCC January 29, 1998. n204 The panel included: the [\*247] U.S. Telephone Association, ALTS (local service carrier trade association), the National Association of Regulatory Utility Commissioners, and a sampling of new carriers. n205 Each representative had a unique perspective of the status of competition in the local telecom carrier market, but the general findings were that: there were over 100 competing carriers which were making yearly revenues of 2.7 billion dollars, which was six times the amount they had made pre-1996 Act in half the time. n206 However, the incumbent carriers had yearly revenues of 101 billion dollars, despite the fact that they are spending an average of 2 billion dollars each to open up the markets to competitors. n207 These numbers show that competing carriers still had a long way to go to reach "effective competition," which the 1996 Act defines as serving fifteen percent of potential subscribers. n208

##### B. Three Year Review: 1996 - 1999

Climbing to nearly five percent of all local exchange carriers, the competitors increased their marketshare by the end of 1999. n209 As the competitors continued to attract capital, their "5-year returns beat the S&P 500." n210 Rising strength in the competitive market was also indicated by the competitor's increased political contributions. n211

##### C. Three Year Review: 2000 - 2002

On December 9, 2002, the FCC issued a local telephone competition report, which compared marketshares of incumbent and competing carriers from December 1999 through June 2002. n212 The [\*248] data was compiled from the mandatory FCC Form 477, which all carriers must fill out and return to the FCC. n213

The findings showed that of the approximately 191 million switched access lines nationwide, competitive local carriers (CLECs) have consistently taken more of the total market share:

December 1999: CLEC Lines = 8 million CLEC Share = 4.3% June 2000: CLEC Lines = 11.5 million CLEC Share = 6.0% December 2000: CLEC Lines = 14.9 million CLEC Share = 7.7% June 2001: CLEC Lines = 17.3 million CLEC Share = 9.0% December 2001: CLEC Lines = 19.6 million CLEC Share = 10.3% June 2002: CLEC Lines = 21.6 million CLEC Share = 11.4% n214 [\*249]

#### V. Conclusion

The numbers paint a picture of regulatory success. While it is true that the percentage of actual growth has slowed from 1.7 percent in December 1999 and June 2000, to 1.3 percent for June and December 2001, to 1.1 percent in June 2002, there can be no denying that the growth itself is continuing despite the stock market "bubble burst" in 2000, the post-September 11, 2001 jitters, the corporate greed of WorldCom and other non-telecom companies, and the challenges of competing companies entering into a market held down for over 100 years by large incumbents. n215

So far the FCC has carved a new niche for itself as the "enforcer" of deregulation: guarding the seeds of promising new competitors. n216 [\*250] But to ensure the future of this competition, it is important that the FCC hold a firm ground and resist catering to the incumbents in an effort to ease their workload. n217 There is always the temptation to think the battle has been won, but until the competitors are operating at levels of marketshare that free the public from outrageous phone bills, there is still work to be done.

#### FOOTNOTES:

n1. Reed Hundt, Antitrust and Interconnection: Old Wine in New Bottles (Telecommunications Act of 1996), Remarks at the Antitrust Conference for Corporate General Counsels (Oct. 22, 1996) at 1, available at 1996 WL 646783.

n2. *Id.*

n3. *Verizon Communications, Inc. v. F.C.C.*, 535 U.S. 467, 496-527 (2002).

n4. *Id.* at 498-524.

n5. *Id.* at 473.

n6. *Id.* at 496-526.

n7. *Id.* at 496-524.

n8. *Id.*

n9. Thomas W. Hazlett, The Telecommunications Act of 1996: Past and Future Economic and Political Consequences of the 1996 Telecommunications Act, 50 *Hastings L.J.* 1359, 1394 (1999) (citing Alfred Kahn, Letting Go: Deregulating the Process of Deregulation or Kleptocrats and the Political Economy of Regulatory Disingenuousness (1998)).

n10. FCC Commissioner Gloria Tristani, The Enforcement Model: Breaking Through Barriers On The Road to Competition, PLI Annual Institute on Telecommunications, Dec. 14, 2000, available at <http://www.fcc.gov/Speeches/Tristani/2000/spgt013.html>.

Section 271 also provides for some specific enforcement processes. Once an application has been approved, the FCC has explicit authority to take enforcement action if a Bell company ceases to meet a condition of its approval. If this occurs, we can order the carrier to come into compliance with the terms of their 271 approval, we can fine them, we can suspend their ability to provide long distance service and, in egregious cases, we can revoke the long distance authority. *Id.*

n11. *Verizon*, 535 U.S. 478 n.3 (The Interstate Commerce Act of 1887 "was the model for subsequent federal public-utility statutes like ... the Mann-Elkins Act of 1910, 36 Stat. 539 [which] was the earliest federal statute

prescribing rates for interstate and foreign telephone and telegraph carriers, as part of revisions to railroad rates set by the Interstate Commerce Commission." See R. Vietor, *Contrived Competition: Regulation and Deregulation in America* 171 (1994).

n12. *Id.*

n13. Reed Hundt, *supra* note 1.

n14. Gregory Ogden, Federal and State Administrative Law class lecture (Aug. 20, 2002).

n15. *Id.*

n16. *Id.*

n17. *Verizon*, 535 *U.S.* at 478, 481 & n.4 (citing Barnes, *Economics of Public Utility Regulation* 37-41 (1942)). The rationale behind this method was to guard the public from any misfortunes the telephone company may encounter after the public had come to rely on the service.

n18. *Smyth v. Ames*, 169 *U.S.* 466, 470-76, 545, 546 (1898). "If a corporation cannot maintain such a highway and earn dividends for stockholders, it is a misfortune for it and them which the Constitution does not require to be remedied by imposing unjust burdens upon the public." *Id.*

n19. *Verizon*, 535 *U.S.* at 481 (quoting *Smyth*, 169 *U.S.* at 546-47).

n20. Michael Kende, *The Digital Handshake: Connecting Internet Backbones*, G0-00CM Practicing Law Inst. 630, 654 (2000) (citing *Western Union Tel. Co. v. Call Publ'g Co.*, 181 *U.S.* 92, 99-104 (1901)).

n21. *Id.*

n22. Mann-Elkins Act of 1910, Pub. L. No. 61-218, 36 Stat. 539 (codified as amended in scattered sections of 47 U.S.C.).

n23. Michael Kende, *supra* note 20, at 655 (citing Vogelsang and Mitchell, *Telecommunications Competition*, at 64).

n24. *Verizon*, 535 U.S. at 485 (citing P. Garfield & W. Lovejoy, *Public Utility Economics* 56 (1964)). See also *Missouri ex rel. Southwestern Bell Tel. Co. v. Pub. Serv. Comm'n of Mo.*, 262 U.S. 276, 304-06 (1923).

n25. 47 U.S.C. 151 (2000).

n26. 47 U.S.C. 153(h) (2000).

n27. Joseph D. Kearney, Note, Will the FCC Go the Way of the ICC?, 71 *U. Colo. L. Rev.* 1153, 1170 (2000).

n28. *Id.* (quoting 47 U.S.C. 214(a)).

n29. Reed Hundt, *supra* note 1.

n30. *Id.*

n31. *Id.*

n32. *Id.*

n33. *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 596-98 (1944); *Federal Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575, 592-93 (1942); *Lindheimer v. Illinois Bell Tel. Co.*, 292 U.S. 151, 167-169 (1934).

n34. *Natural Gas*, 315 U.S. 575, 593 (1942).

The Constitution does not require that the owner who embarks in a wasting-asset business of limited life shall receive at the end more than he has put into it. We need not now consider whether, as the Government urges, there can in no circumstances be a constitutional [sic] requirement that the amortization base be the reproduction value rather than the actual cost of the property devoted to a regulated business. Cf. *United Railways v. West*, 280 U.S. 234 (1930).

"We refuse to make an allowance of amortization in excess of costs. To do so would not be the computation of a proper expense, but instead the allowance of additional profit over and above a fair return. Manifestly such an additional return would unjustly penalize consumers."

Id.

n35. Joseph D. Kearney, *supra* note 27, at 1171 (citing *MCI Telecomms. Corp. v. FCC*, 561 F.2d 365, 380 (D.C. Cir. 1977)). See, e.g., Peter Huber et al., *Federal Telecommunications Law* 9.3.5-9.4.2, at 748-56 (1999); Glen O. Robinson, *The Titanic Remembered: AT&T and the Changing World of Telecommunications*, 5 *Yale J. on Reg.* 517, 524 (1988).

n36. Michael Kende, *supra* note 20, at 654.

n37. Id. (citing *United States v. American Tel. & Tel. Co.*, 552 F. Supp. 131 (D.D.C. 1982)); *Verizon*, 535 U.S. at 475-76. See also Vogelsang and Mitchell, *Telecommunications Competition*, at 67-69; Brock, *Telecommunications Policy for the Information Age*, Chpt. 9.

n38. *Verizon*, 535 U.S. at 475.

n39. *Id.* at 486-87

n40. *Id.* at 487 (See also, *In re Policy and Rules Concerning Rates for Dominant Carriers*, 5 *FCC Rcd* 6786, 6787, P 1 (1990); *United States Tel. Assn., v. FCC*, 188 F.3d 521, 524 (C.A.D.C. 1999)).

n41. Id. (internal citations omitted) (citing Kahn, *Tariff & Weisman, Telecommunications Act At Three Years: An Economic Evaluation of Its Implementation by the Federal Communications Commission*, 11 *Info. Econ. & Pol'y* 319, 330-32 (1999); 5 *FCC Rcd*, at 6787, P 5).

n42. Id. (citing *United States Tel. Assn.*, 188 F.3d at 524; 5 *FCC Rcd*, at 6787-88, PP 7-9).

n43. Reed Hundt, *supra* note 1.

n44. 47 U.S.C. Title Page to the Telecommunications Act of 1996 (2000).

n45. 11 *FCC Rcd* 1, 15499 (1996).

n46. Id.

n47. *Iowa Utils. Bd. v. FCC*, 109 F.3d 418, 421 (8th Cir. 1996); 11 FCC Rcd 1, 15499, 16217-23, 16235 (1996).

n48. Id.

n49. Id. at 422 (citing 11 FCC Rcd 1, 51.505(b)).

n50. Id.

n51. Id.

n52. Id. at 423.

n53. Id.

n54. Id.

n55. Id.

n56. *Iowa Utils. Bd. v. F.C.C.*, 120 F.3d 753 (8th Cir. 1997).

n57. *People v. F.C.C.*, 124 F.3d 934, 939-43 (8th Cir. 1997). Judge Hansen primarily based this decision on the fact that no Congressional authority was expressly granted, and the 1934 Act requires such a grant for local rules to come under the FCC's rule. Id.

n58. *AT&T Corp. v. Iowa Utilities Bd.*, 525 U.S. 366, 375-97 (1999).

n59. Id.

n60. Id. at 398-99 (citing 251(d)(2) of the 1996 Act).

n61. Id. at 397.

n62. *Iowa Utils. Bd. v. F.C.C.*, 219 F.3d 744, 748 (8th Cir. 2000). Specifically regarding TELRIC, four challenges were made by the petitioners: 1) that the network standard is hypothetical, 2) employs a forward-looking methodology, 3) incumbent carriers will be unfairly burdened by universal service under the "universal services subsidies" and 4) the pricing constitutes a "taking" under the Fifth Amendment. *Id.* at 749-53.

n63. *Id.* at 750.

n64. *Id.* at 757-59.

n65. *Verizon*, 535 U.S. at 498-540.

n66. *Verizon Communications, Inc. v. F.C.C.*, 219 F.3d 744 (2001); *Verizon* 535 U.S. at 467. The four other petitioners were: WorldCom, Inc., F.C.C., AT&T, and General Communications.

n67. *Verizon*, 535 U.S. at 475.

n68. *Id.* at 487-90.

n69. *Id.* at 477-80, 488-89.

n70. *Id.* at 496-527.

n71. *Id.* at 489.

n72. *Id.*

n73. *Id.* at 490.

n74. *Id.*

n75. *Id.* at 487-89.

n76. *Id.* at 478, 489.

n77. *Id.* at 480.

n78. *Id.* at 487.

n79. *Id.* at 487-88.

n80. *Id.* at 488.

n81. *Id.*

n82. *Id.* at 489.

n83. *Id.*

n84. *Iowa Utils. Bd.*, 109 F.3d at 418.

n85. Reed Hundt, *supra* note 1.

n86. *Verizon*, 535 U.S. at 527-28.

n87. See *supra*, note 62.

n88. *Verizon*, 535 U.S. at 496-97, 500, 523.

n89. *Id.* at 498 (emphasis added).

n90. *Id.*

n91. *Id.*

n92. *Iowa Utilities Bd.*, 120 F.3d at 793 n.8.

n93. *Verizon*, 535 U.S. at 489.

n94. 11 FCC Rcd 1, 51.505(b) (1996).

n95. *Verizon*, 535 U.S. at 499 (citing *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 312 (1989)); *Hope Natural Gas*, 320 U.S. at 597-98; see also, *Mobil Oil Exploration & Producing Southeast, Inc. v. United Distribution Cos.*, 498 U.S. 211, 224-25 (1991)).

n96. *Id.* at 477-88.

n97. *Id.* at 489 (quoting 47 U.S.C. 252(d)(1)(A)(i)).

n98. *Id.* (citing 47 U.S.C. 252(d)(1)(A)(i)).

n99. *Id.* at 469 (citing *Hope Natural Gas*, 320 U.S. at 602).

n100. *Hope Natural Gas*, 320 U.S. at 593.

n101. *Id.* at 602-03 (citing Natural Gas Act of 1938, 4(a), 5(a), 6; 15 U.S.C.A. 717c(a), 717d(a), 717(e)).

n102. 47 U.S.C. 261 (2000).

n103. *Id.* at 252(d)(1) (2000).

n104. *Verizon*, 535 U.S. at 501.

n105. *Iowa Utils. Bd.*, 219 F.3d at 749.

n106. *Verizon*, 535 U.S. at 495 (quoting 47 CFR 51.505(a), (b)(1), (c)(1)).

n107. *Id. at 501.*

n108. *Id.*

n109. *Id.*

n110. *Id.*

n111. *Id. at 502-03.*

n112. *Id.*

n113. *Id. at 504.*

n114. *Id.*

n115. *Id. at 504-05.*

n116. *Id. at 504.*

n117. *Id.*

n118. *Id.*

n119. *Id. at 504-05.*

n120. *Id. at 505.*

n121. *Id. at 504.*

n122. *Id. at 508.*

n123. *Id. at 508-513.*

n124. *Id. at 509-10.*

n125. *Id.*

n126. *Id. at 509-13.*

n127. *Id. at 510, n.27.*

n128. *Id. at 516.*

n129. *Id. at 516-17 (emphasis added).*

n130. *Id.*

n131. *Id. at 504-05, 515-18.*

n132. *Id. at 517-18.*

n133. *Id. at 518.*

n134. *Id. at 517-20 (citing FCC, First Report and Order P 702).*

n135. *Id. at 521.*

n136. *Id. at 521.*

n137. *Id. at 521-23.*

n138. Id.

n139. *Id. at 523.*

n140. *Id. at 526.*

n141. Id. See *Duquesne Light Co.*, 488 U.S. at 302, 303-04 (1989).

n142. *Verizon*, 535 U.S. at 471-72.

n143. *Id. at 525-26.*

n144. *Id. at 528.*

n145. Id.

n146. *Id. at 528-29* (citing 47 U.S.C. 51.315(c)-(f)).

n147. Id.

n148. *Id. at 529* (citing *Communist Party of the United States v. Subversive Activities Control Bd.*, 367 U.S. 1, 30-31 (1961)).

n149. Id. at 530.

n150. Id.

n151. Id. (citing *United States v. Williams*, 504 U.S. 36, 41 (1992)).

n152. Id. at 532.

n153. *Id.*

n154. *Id.* at 532–33.

n155. *Id.* (citing *15 FCC Rcd 3696, 3910 P 482 (1999)* and quoting Rule 315(c)).

n156. *Id.*

n157. *47 U.S.C. 251(c)(3) (2000)*.

n158. *Verizon, 535 U.S. at 533* (citing *Iowa Utils. Bd., 219 F.3d at 759*).

n159. *Verizon, 535 U.S. at 533*. Cf. *47 U.S.C. 251(c) (2000)* ("Additional obligations of incumbent local exchange carriers.").

n160. *Id. at 535* (citing First Report and Order P 294; *47 C.F.R. 51.315(c)–(d)*).

n161. *Id. at 536*.

Thus, the incumbents are wrong to claim that the restriction to "technical feasibility" places only minimal limits on the duty to combine, since the First Report and Order makes it clear that what is "technically feasible" does not mean merely what is "economically reasonable," or what is simply practical or possible in an engineering sense.

(See First Report and Order PP 196–199).

n162. *Id.*; *Iowa Utils. Bd., 219 F.3d at 757–58*.

n163. *Verizon, 535 U.S. at 534–35*.

n164. *Id. at 538–39*.

n165. *Id. at 539*.

n166. *Id.* at 540-42.

n167. *Id.*

n168. *Id.* (citing *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 416 (1971); *Hope Natural Gas*, 320 U.S. at 602).

n169. *Id.* at 542-44.

n170. *Id.* at 503-15. Emphasis added.

n171. *Id.* at 490-91.

n172. *Id.* at 543.

n173. *Id.* at 544.

n174. *Id.* at 544-47.

n175. *Id.* at 548.

n176. *Id.* at 467-68.

n177. *Id.* at 544-47.

n178. 47 U.S.C. 151 (2000) ("There is created a commission to be known as the 'Federal Communications Commission,' which shall be constituted as hereinafter provided, and which shall execute and enforce the provisions of this chapter.").

n179. *Verizon*, 535 U.S. at 549.

n180. *Id.* at 548-53.

n181. *Id.* at 554-55.

n182. *Id.* at 516-17 (citing M. Glover & D. Epps, *Is the Telecommunications Act of 1996 Working?*, 52 *Admin. L.Rev.* 1013, 1015 (2000)). (\$ 30 billion invested through 1999). The FCC's statistics indicate substantial resort to pure and partial facilities-based competition among the three entry strategies: as of June 30, 2001, 33 percent of entrants were using their own facilities; 23 percent were reselling services; and 44 percent were leasing network elements (26 percent of entrants leasing loops with switching; 18 percent without switching). See FCC, *Local Telephone Competition: Status as of June 30, 2001*, at 2. T.3-4 (Feb. 27, 2002).

n183. *Id.* at 554-61.

n184. *Id.* at 554.

n185. *Id.* at 554-56.

n186. *Id.* at 556.

n187. *Id.* at 559.

n188. *Id.* at 559-60.

n189. *Id.* at 560.

n190. *Id.* at 560-61.

n191. *Id.* at 500, 553-59.

n192. *Id.* at 562.

n193. *Id.*

n194. *Id.*

n195. See supra note 175.

n196. Reed Hundt, supra note 1.

n197. Id.

n198. Id. at 500–01.

n199. Id. at 563.

n200. Id.

n201. Id.

n202. Id. at 559–63.

n203. FCC Chairman Michael Powell, Statement regarding U.S. Supreme Court decision of *Verizon v. F.C.C.*, 535 U.S. 478 (2002), May 13, 2002, available at <http://www.fcc.gov/headlines2002.html>.

I'm pleased that the Supreme Court has affirmed the Commission's implementation of the 1996 Telecom Act. This decision brings much-needed additional certainty to the legal landscape and should advance the Commission's efforts to carry out the statute's competition goals. I thank the Solicitor General for his vigorous efforts in representing the Commission before the Court.

n204. FCC Hearing, In Re: En Banc on State of Local Competition, Jan. 29, 1998, available at <http://ftp.fcc.gov/enbanc/012998/tr012998.txt>.

n205. Id. Representing each organization in order: Roy Neel, Heather Gold, Lynn Butler and Mike Mahoney for RCN Corporation.

n206. Id. Heather Gold, President of ALTS.

n207. Id. Heather Gold, President of ALTS; Roy Neel, President of the U.S. Telephone Association.

n208. Thomas W. Hazlett, *supra* note 9.

n209. Id. at 1394.

n210. Id.

n211. Id.

n212. FCC News Release, Federal Communications Commission Releases Data On Local Telephone Competition, Dec. 9, 2002, available at <http://ftp.fcc.gov/Bureaus/Common-Carrier/Reports/FCC-State-Link/IAD/Icom0702.pdf>.

n213. Id.

n214. Id. T.1; n.1

Qualifying carriers reported data as of June 30, 2002 in FCC Form 477 filings due on September 1, 2002. Qualification status is determined separately for each state. If a carrier, or its holding company, has a least 10,000 local telephone lines in service in a state, it must file local telephone data for that state. See *Local Competition and Broadband Reporting, CC Docket No. 99-301, Report and Order, 15 FCC Rcd 7717 (2000)* ... . Readers interested in the specific questions and reporting instructions for this data collection can download FCC Form 477, and associated Instructions, from [www.fcc.gov/formpage.html](http://www.fcc.gov/formpage.html). Id.

n215. Id.; FCC News Release, Chairman Powell's Testimony to Senate Commerce Committee: "Six Critical Steps for Telecom Industry Recovery", July 30, 2002, available at <http://www.fcc.gov/headlines2000.html>; FCC Commissioner Gloria Tristani, *The Enforcement Model: Breaking Through Barriers On The Road to Competition*, PLI Annual Institute on Telecommunications, Dec. 14, 2000, available at <http://www.fcc.gov/headlines2000.html>.

The Washington Post reported last week that the Stock of twenty-seven of the thirty-five publicly traded CLECs is priced below \$10.00 a share. Covad recently announced that it is limiting its provision of residential DSL service to line sharing. Last month ICG Communications filed for bankruptcy. Some analysts are predicting 50 percent or more of the CLECs won't survive.

FCC News Release, FCC Assures WorldCom Customers Concerning Continuation of Phone Service, July 26, 2002, available at <http://www.fcc.gov/headlines2002.html>.

n216. Id. The first of our enforcement tools, found in section 208 of the Act, gives the FCC broad authority to conduct investigations into potential violations of the Act and our rules. Just over a year ago, we created a new Enforcement Bureau that consolidated most enforcement matters in one operation. This action reflected a recognition that we needed a stronger enforcement arm to ensure all parties play by the rules.

FCC News Release, FCC Chairman Powell Recommends Increased FCC Enforcement Powers for Local Telephone Competition, May 7, 2001, available at <http://www.fcc.gov/headlines2001.html>.

FCC Chairman Michael Powell has recommended that Congress increase the forfeiture level imposed on common carriers violating local competition provisions of the Telecommunications Act of 1996 from the current statutory limit of \$1.2 million per violation to at least \$10 million per violation. Powell said, "In my discussions with competitive local exchange carriers, they cite enforcement as the key area for increased regulatory effort."

n217. James K. Glassman, Telecom Waffling at the FCC Helm, *The Washington Times*, Nov 26, 2002, PP 1,3, available at <http://www.clec.com>.

Fair or not, the buzz around Washington on Michael Powell [Colin Powell's 38-year-old son] is that he's indecisive – overwhelmed by the complexity of his job as chairman of the Federal Communications Commission. Perhaps stung by that widespread criticism, he's on the verge of rushing into a disastrous decision that could cost consumers billions of dollars, turn back the clock on telecom innovation and damage the political prospects of the Bush Administration ... Having failed to convince elected officials to gut the law that seeks to deregulate their business – the Telecommunications Act of 1996 – the Bells have turned to Mr. Powell, who may be figuring that he can repair his reputation by giving them what they want.