REGULATORY DEVELOPMENTS

So You Thought the Supreme Court Had Decided Things…

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The recent ruling won't be the last word on the Telecom Act. In fact, matters may be as uncertain as ever.

On January 25, the Supreme Court ruled mostly in favor of the FCC in the Eighth Circuit appeal regarding the FCC's authority to establish binding pricing regimes for unbundled network elements (UNEs) and local service resale. So this settles things once and for all, and Telecom Act implementation can proceed. Right?

Well, not quite. The Supreme Court decision appears to leave three major issues unresolved:

1. We don't know which UNEs will exist when the dust settles. In August 1997, the FCC defined seven distinct UNEs. These classifications had seemed relatively secure, with future changes limited to adding or splitting UNEs (e.g., adding DSLAMs and separate feeder loop UNE definitions, in order to facilitate DSL deployment).

To many people's surprise, however, the Court found that the FCC had done a proper job of defining UNEs but had not demonstrated that these UNEs met the Telecom Act's "necessary" and "impaired" tests (i.e., that the UNEs are necessary for fostering new entry competition, and that new entrants will be impaired if they don't get access to these UNEs). Accordingly, the Court vacated FCC Rule 319 requiring that seven UNEs be available to new entrants, and remanded the issue to the FCC.

The result will be uncertainty for some time to come. We will probably see a Notice of Proposed Rulemaking this month, with a revised Order by the summer. Assuming that the FCC largely reconfirms its original seven UNE requirement, ILECs will litigate the decision (probably in the Eighth Circuit). Perhaps in the first six months of 2000, we will hear its decision, and inevitably the losing side will appeal. However, the Supreme Court may well opt not to hear the appeal, since it would not involve major constitutional questions. If the Court did take the case, we would have final resolution by 2001.

2. We don't know the price of UNEs: The August 1997 FCC Local Competition Order mandated UNE proxy rates on the basis of TELRIC (Total Element Long Run Incremental Cost). These rates arguably are substantially below historical GAAP (generally accepted accounting principles) levels, by around 50 percent. Accordingly, they were challenged by GTE et. al. in the Eighth Circuit on the grounds that they constituted an unconstitutional "taking of property" (see "The Taking of Property Issue," p. 36).

The Eighth Circuit never ruled on the TELRIC "taking of property" issue, declaring it moot (it instead decided on the basis of federal/state rights). As a result, the Supreme Court never addressed this issue, and it remains an open question.

14 Point Checklist

- ■ (red) *UNE-Related Elements*
- ■ (blue) *Non-UNE-Related Elements*

- ■ (blue) Interconnection.
- ■ (red) Nondiscriminatory Access to Network Elements.
- ■ (blue) Nondiscriminatory Access to the Poles, Ducts, Conduits and Rights-of-Way.
- ■ (red) Unbundled Local Loop Transmission.
- ■ (red) Unbundled Local Transport.
- ■ (red) Unbundled Local Switching.
- ■ (blue) Nondiscriminatory Access to 911 and E911; Directory Assistance; Operator Call Completion Services.
- ■ (blue) White Pages Directory Listings.
- ■ (blue) Nondiscriminatory Access to Telephone Numbers.
- ■ (blue) Nondiscriminatory Access to Databases and Associated Signaling.
- ■ (blue) Number Portability.
- ■ (blue) Local Dialing Parity.
- ■ (blue) Reciprocal Compensation Arrangements.
- ■ (red) Telecom Services Available for Resale.

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The Taking of Property Issue

Perhaps the biggest unresolved legal issue destined for Supreme Court review is whether TELRIC is an unconstitutional "taking of property."

The taking of property issue derives from the Fifth Amendment to the U.S. Constitution. After stating the right to non-self-incrimination so beloved in TV courtroom dramas, the Amendment states that no one shall "be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation." In this context, the RBOCs have argued that a government regulatory restriction on their free market pricing is a "taking" of private property. Note that the Fifth Amendment doesn't ban taking of property outright; it simply requires that any such taking be done by "due process of law" and with "just compensation."

Looking at these requirements, the FCC clearly is taking private property for public use, and the FCC's legal process arguably constitutes "due process of law." So the real issue is whether TELRIC represents "just compensation."

Fortunately, the issue of "just compensation" for actions taken by utility regulators has been reviewed more than once by the Supreme Court, so we have some idea regarding the relevant issues. The two most important precedents—*FPC v. Hope Natural Gas,* 1944 and *Duquesne Light Co. v. Barasch,* 1989—lead us to the following observations:

There is nothing inherently wrong with TELRIC as a methodology. There are no grounds for objection on the part of those who—simply on principle—prefer good old-fashioned historical GAAP (generally accepted accounting principles) to forward-looking long-run incremental costs. In *Hope Gas,* it was clearly stated that "the validity of an order…fixing rates…is to be determined on judicial review by whether the impact or total effect of the order is just and reasonable, rather than by the method of computing the rate base." The decision goes on to state that, "It is not theory but the impact of the rate order which counts." *Duquesne* reaffirmed this element of *Hope Gas.* So it seems clear that the current Supreme Court shouldn't have an inherent problem with TELRIC.

There also is nothing inherently wrong with TELRIC even if it results in unjust taking of property in a narrow slice of ILEC business. In *Duquesne,* the public utility argued that the particular action taken by the regulator had the effect of reducing return on rate base to below cost of capital on the affected rate base elements (thus representing "unjust compensation"). The Supreme Court rejected this parsing approach, observing that, "The Constitution does not require that…ratemaking methodology be examined piecemeal." Instead, the overall return is what counts.

In this context, the FCC is likely to argue that:

(*a.*) ILEC statutory rate of return is 11.25 percent.

(*b.*) Given today's low current interest rates, cost of capital should be even lower than this.

(*c.*) Current RBOC interstate rate of return is approximately 16 percent, or well above the cost of capital.

(*d.*) The financial impact of UNEs priced at TELRIC is likely to be limited, even considering prospective CLEC penetration levels.

(*e.*) Allowing RBOCs to enter long distance will offset reduced returns in their core business, so that…

(*f.*) The net impact is likely to be a rate on historical rate base that is above the statutory cost of capital.

On the other hand, if the overall effect of TELRIC reduces the rate on historical rate base to below the cost of capital, the Court is likely to find this an unconstitutional taking of property. While the FCC clearly has become enamored of its forward-looking costing methodology, it will get into trouble if it ignores return on historical rate base entirely. In *Hope Gas,* the Court found that, while it didn't mind different theoretical regulatory constructs, "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks." The Court in *Duquesne* emphasized this point by using this quote in its ruling.

In this context, ILECs are likely to argue that:

(*a.*) TELRIC methodology as applied by the FCC results in rates that are roughly half those that ILECs would obtain using historical GAAP accounting.

(*b.*) At these rates, ILECs would not generate an adequate return on investment on their historical rate bases.

(*c.*) Given the "fire sale" nature of the prices (as they perceive TELRIC), it is likely that a substantial share of the ILECs' rate base will be used to support these below-market rates.

(*d.*) Given the increasing riskiness of the telephony business due to deregulation, ILEC cost of capital is likely to increase, so that…

(*e.*) The net effect will be that ILEC overall profitability will drop below the statutory cost of capital.

Who is right here? The Supreme Court will tell us in a couple of years□

Answering the question will take some time. A probable timeline:

- In the next two months, one or more ILECs files litigation against the FCC on the taking of property issue in the Eighth Circuit.
- The Eighth Circuit decides sometime in the first half of 2000.
- The loser appeals to the Supreme Court in mid-2000.
- The Supreme Court hears the case because it involves a major constitutional question.
- The case is heard in the fall of 2000 and is decided in the first half of 2001.

3. We don't know the extent of the Commission's authority to supersede existing state UNE/resale agreements: The Supreme Court found that this issue was not yet "ripe" for judicial review (because rules first need to be established before they can be used to challenge state PUC resale arbitration agreements). So we can look forward to a series of court challenges on this issue.

What Might Happen

Arguably, these uncertainties have several potentially important implications for telecom evolution:

1. In Some Cases, UNEs Could Be Abruptly Withdrawn (causing problems for CLECs): Over the past three years, lots of UNE agreements were reached. Given the obvious litigation uncertainty, many of the agreements likely include "change of law" clauses allowing either party to terminate the agreement if there is a material change in underlying laws/regulations.

If so, we may see some ILECs (particularly non-RBOCs such as GTE, who have little to lose on the long distance entry side) terminate their UNE agreements, on the basis of the UNE remand cited in #1 above. If they do, CLECs who relied on these agreements will be left high and dry. For now, Chairman Kennard appears to have negotiated a "stand-still" agreement with the RBOCs and GTE. Longer term, if TELRIC is overturned, count on a wave of abrupt terminations.

2. We Could See the Imposition of Density-Zone-Defined UNEs: In the Local Competition Order, the FCC established a minimum of three pricing zones (reflecting the fact that TELRIC costs will be higher in low-density areas). However, the same set of seven UNEs applied to all zones.

Given the Supreme Court's focus on the "necessary" and "impaired" tests for UNEs, we may see UNEs defined differently according to density zones. The FCC may find that certain UNEs pass the "necessary" and "impaired" tests in lower-density geographies, but not in the top 500 to 1,000 central offices. As a concrete example, in lower Manhattan, lots of people arguably can justify installing their own switches, so ILEC sale of this UNE might not be "necessary" in this zone.

3. Look for Changes in the FCC's 706 Rules: In last year's 706 Order, the FCC ruled that DSLAMs installed within an ILEC's regulated telco entity represent an additional UNE element. Arguably, since companies such as Covad and NorthPoint do this successfully outside the RBOC plant, this won't pass the "necessary" and "impaired" test. Therefore look to a total revamping of the FCC's 706 approach.

4. CLECs May Need to Rethink Their Make/Buy Decisions: In the initial aftermath of the FCC's Local Competition Order, companies such as AT&T believed that they could use UNEs as a vehicle to avoid substantial facilities-based investment. This did not survive the Eighth Circuit decision; instead, AT&T purchased TCI and committed itself to a facilities-based strategy.

Now, however, the make/buy decision may shift back in favor of renting UNEs. This factor could destabilize the business models of facilities-based CLECs.

5. The Ruling Could Delay RBOC Long Distance Entry Approvals: Unfortunately for the incumbent ILECs, there are five different items on

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Justice Scalia on the '96 Telecom Act: "A model of ambiguity and…self-contradiction"

the infamous 14-point checklist that require RBOC compliance on UNEs (see "14 Point Checklist," p. 35). So if the RBOCs are not in compliance with the Commission's UNE rules, they can't legally get Section 271 long distance entry approval. In turn, if we don't know what UNEs are required and at what prices, how can the ILECs be in compliance?

One scenario is that an aggressive RBOC such as SBC terminates its UNE agreements based on the Rule 319 remand. In this case, the RBOC arguably won't be in compliance on five of the 14 checklist points, so will have its applications rejected. Perhaps to avoid this, and also to avoid retaliation on merger approvals, the RBOCs and GTE appear to be forgoing this approach, at least for now.

A second scenario is that until new FCC UNE rules get established, RBOCs continue to fulfill their existing UNE agreements (reserving the right to terminate once litigation is completed and/or after long distance entry is approved). In this case, the FCC could still reject applications if those UNE agreements don't square with the Supreme Court ruling. As an illustration, many people in the industry expect the first successful long distance application to occur in New York. However, looking at the UNE "deal" that Bell Atlantic entered into with the New York PSC, a number of conditions arguably violate terms of the Local Competition Order:

- There are only two density zones, not the minimum three zones required by the FCC.
- There are differential rates for business and residential UNEs.
- No UNE platforms will be available in New York City in central offices with two or more CLEC colocations involving unbundled loop.
- There is a time limitation (four to six years) for providing UNE platforms on a bundled basis.
- There is a recurring long-term charge for providing UNE platforms, despite the fact that the costs arguably are nonrecurring.

These sorts of disjoints between state and federal regulations will probably be the rule rather than the exception. If so, look for the FCC to reject applications on this basis. And if they don't, look for the IXCs to sue, claiming the FCC is ignoring its own rules.

6. This Ruling Could Hurt RBOC Merger Approvals: The FCC's logic in approving the Bell Atlantic/Nynex merger is interesting and perhaps indicative of what will happen to Bell Atlantic/GTE and SBC/Ameritech. In Bell Atlantic/Nynex, the FCC found the merger would reduce the prospect that each RBOC would enter the other's territory, thus reducing competition. However, the Commission explicitly stated that it was willing to approve the deal, on condition that the merged company agree to provide UNEs on a TELRIC basis. At the time (August 1997), this was of great importance to the FCC; it had just had its UNE pricing proxy rules overturned by the Eighth Circuit and needed to show some progress despite its lack of authority. So it cut the deal, but with misgivings.

However, now the Supreme Court has given the FCC authority to control UNE pricing without the compromise that was forced in the Bell Atlantic/Nynex case. As a result, there is substantially less likelihood that Bell Atlantic/GTE or SBC/Ameritech will get approved: the RBOCs simply no longer have the leverage they had before the Supreme Court ruled.

7. The FCC Could Use the Supreme Court Ruling to Extend Its Authority in Universal Service and Other Areas: The legal basis for the Supreme Court decision was a determination that the Telecom Act of 1996 is legally a part of the Communications Act of 1934, which gives the FCC general power to "prescribe such rules and regulations as may be necessary in the public interest to carry out the provisions of this Act."

This determination was used to justify the FCC's having the right to create binding UNE/resale pricing methodologies. However, the same reasoning can be used to extend FCC authority in other areas.

One particular area to watch is universal service. In May 1997, in the aftermath of the Eighth Circuit's temporary restraining order holding up implementation of the FCC's TELRIC rules, the FCC took pains to avoid trampling on states' rights. As a result, it created a subsidy mechanism for high-cost rural areas that is only 25 percent funded by the federal side, leaving 75 percent funded by each state. This does not work mathematically—in heavily rural states, there simply aren't enough urban lines to pay for the 75 percent subsidy without excessive state rate surcharges. In this context, therefore, one possible FCC stance would be to use its general rule-prescribing power to establish a single federally administered fund charged to both intrastate as well as interstate revenues.

Of course, this will be challenged by every state public utilities commission in the country. But it will be consistent with the Supreme Court decision. And it will be economically straightforward and rational.

Conclusion

Net-net, we come away agreeing with Justice Scalia, who wrote for the majority that:

"It would be gross understatement to say that the Telecommunications Act of 1996 is not a model of clarity. It is in many important respects a model of ambiguity or indeed even self-contradiction. That is most unfortunate for a piece of legislation that profoundly affects a crucial segment of the economy worth tens of billions of dollars."

Unfortunately, the result of all this ambiguity will be uncertainty for some time to come. Stay tuned□