A Tale Of Two Decisions

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So you thought telecom regulation didn't matter? Well, guess again.

May 2002 will go down in telecom regulatory annals as a particularly schizophrenic month:

- On May 13, the Supreme Court affirmed the FCC's right to apply total element long-run incremental cost (TELRIC) pricing rules as the basis for wholesale rates for unbundled network elements (UNEs). TELRIC rules are based on the cost of building a new network today, using current (presumably less expensive) technology.

  In making its ruling, the Court rejected ILEC arguments that: *a.*) Pricing should be based on historical (and presumably higher) costs; *b.*) TELRIC was an unconstitutional "taking of property" without just compensation (in violation of the Fifth Amendment to the U.S. Constitution).

- Then, on May 24, the Washington, DC Court of Appeals found that the FCC misinterpreted the "necessary" and "impair" tests of the Telecom Act regarding UNEs—whether a particular UNE is "necessary" for competition, and that not making it available to CLECs will "impair" competition.

  In particular, the court took the FCC to task for deciding that most UNEs must be made available to CLECs nationally, thereby ignoring potentially important local differences in entry barriers and degree of competition. As a result, the Court remanded the UNE definition issue to the FCC.

  On similar grounds, the Court vacated the right of data CLECs (DLECs) to purchase the low-frequency part of a local loop as an UNE (a practice known as "line sharing"), thereby substantially increasing the cost of provisioning DSL service.

At first glance, all of this is confusing: The Supreme Court gives a big victory to the CLEC industry, and then 10 days later a Court of Appeals gives a potentially bigger victory to the ILECs. The ILECs' victory is potentially bigger because if you don't have to make a particular UNE available for resale, the question of pricing becomes moot. So are the courts diametrically opposed, or is there commonality beneath the surface?

The short answer is that the two courts are not far apart. This becomes clear when we consider the rationales behind the two decisions, rather than focusing on the results. The implications for telecommunications competition are interesting, to say the least.

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Recap: The Supreme Court Decision

In the TELRIC case (*Verizon Communications Inc. v. FCC*), the Supreme Court based its decision on landmark gas regulation precedents. The most important case is *FPC v. Hope Natural Gas* (1944), in which the Court ruled 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 *Hope* decision goes on to state, "It is not theory but the impact of the rate order which counts." Since then, most Supreme Court regulatory pricing decisions have been based on *Hope Gas*.

With this as precedent, it should not have been a surprise that the Court found TELRIC to be a reasonable pricing construct, as long as the practical effect of the order is found to be reasonable.

Indeed, this is what happened in the TELRIC case. The Court noted that "it was the very point of *Hope Natural Gas* that regulatory bodies required to set rates…have ample discretion to choose methodology." The Court then found that the FCC's use of TELRIC was a reasonable approach, and was made after the FCC considered and rejected several alternatives. So to the Supreme Court, there is nothing inherently wrong with TELRIC, so long as the outcome is fair.

To assess TELRIC's fairness, the Court next sought to consider the practical impact of the FCC rate order, focusing on the ILEC argument that TELRIC represents a confiscatory "taking of property" without just compensation. To support their case, the ILECs offered a broad-brush national network cost demonstration, but unfortunately for them, the Court rejected it as being mathematically wrong, and then pointed out that the ILECs failed to demonstrate that any specific set of TELRIC-based prices had resulted in an unfair taking of property. Specifically:

- On the ILECs' broad-brush argument, the Court found that the ILECs incorrectly based their calculation of "historic" cost on the industry's aggregate "total plant" value of $342 billion. By

Net effect: ILECs stay in the catbird seat

contrast, building the same network with current technology would cost "just" $180 billion based on TELRIC, the ILECs maintained. "They argue that the huge and unreasonable difference is proof that TELRIC will necessarily result in confiscatory rates," the Court noted.

There's just one problem: The ILECs didn't include accrued depreciation in their "total plant" figure, as they should have done under the traditional public utility model. As a result, "…the 'balance sheet' number is patently misstated," the Court found. "…The net plant investment after depreciation is not $342 billion but $166 billion, an amount less than the TELRIC figure the incumbents would like us to assume."

■ The Court also faulted the ILECs for not citing any actual TELRIC rates to support their claim that such rates are confiscatory—even though actual rates exist; indeed, some states have instituted rates based on TELRIC: "This…is significant, given that this Court has never considered a taking challenge on a ratesetting methodology without being presented with specific rate orders alleged to be confiscatory."

Recap: The Appeals Court Decision

In the UNE case (*United States Telephone Association v. FCC*), the Court of Appeals began by reviewing a January 1999 ruling, in which the Supreme Court:

a.) Supported the FCC's authority to establish binding pricing regimes for unbundled network elements; but

b.) Found that the FCC had not demonstrated that its list of 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).

As a result, the issue was remanded to the FCC for further rulemaking. It was the FCC's amended set of UNEs that was being challenged in the 2002 Appeals Court proceeding.

The Court began by noting the Supreme Court's 1999 remand, based on a finding that the UNE definition was too broad: "Under such a standard it was hard to imagine when the incumbent's failure to give access to the element would not constitute an 'impairment.'"

Furthermore, the Appeals Court added, the 1999 Supreme Court decision criticized the FCC for failing to recognize that competitors have options other than the incumbents' UNEs, including self-provisioning or leasing from other providers: "If Congress had wanted to give blanket access to incumbents' networks, it would simply have said (as the Commission in effect has) that whatever requested element can be provided must be provided."

Accordingly, in reviewing the FCC's revised UNE rules three years later, the Appeals Court looked to see if the revised rules met the increased specificity test—and it did not like what it saw:

"As to almost every element, the Commission chose to adopt a uniform national rule, mandating the element's unbundling in every geographic market and customer class, without regard to the state of competitive impairment in any particular market," the Appeals Court wrote. "As a result, UNEs will be available to CLECs in many markets where there is no reasonable basis for thinking that competition is suffering from any impairment of a sort that might have been the object of Congress's concern."

The Appeals Court continued: "The Commission never explicitly addresses by what criteria want of unbundling can be said to impair…. And, although it offers an explanation as to why it is desirable as a general matter that CLECs should have 'ubiquitous' unimpaired access to network elements, it never explains why the record supports a finding of material impairment where the element in question—though not literally ubiquitous—is significantly deployed on a competitive basis.

"In the end, then, the entire argument about expanding competition and investment boils down to the Commission's expression of its belief that in this area more unbundling is better," the Appeals Court concluded. "But Congress did not authorize so open-ended a judgment."

Accordingly, the Appeals Court remanded the UNE issue to the FCC for a second time.

Conclusion

As previously noted, there is substantial commonality between these two decisions. Both courts are saying that decisions on network unbundling requirements and pricing of UNEs cannot be made on a broad-brush national basis. They need to be justified on a regionally-specific basis, recognizing that unit costs, entry barriers and degree of competition vary widely by geography.

There are important implications here for the telecom industry. First, telecom regulation is alive and well. Despite the fact that the Telecom Act was supposed to foster deregulation via transition to a market economy, we now have two courts inviting future challenges to pricing and UNE decisions based on geo-specific economic and competitive data. The amount of work coming out of this is likely to be mind-boggling!

A second implication is that this renewed legal fight favors the ILECs, who can afford to play the game indefinitely. In contrast, the CLECs have neither the time nor the money. The IXCs, who have the money, are declining annuities that don't have the time to fight the battle indefinitely. So at the end of the day, the ILECs are the ones who should be the happiest with the overall outcome□