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IN THE

# Supreme Court of the United States

WORLDCOM, INC., *et al.*,
*Petitioners*,
v.
VERIZON COMMUNICATIONS, INC., *et al.*,
*Respondents*.

**On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit**

## BRIEF FOR PETITIONERS WORLDCOM, INC., THE ASSOCIATION FOR LOCAL TELECOMMUNICATIONS SERVICES, AND COMPETITIVE TELECOMMUNICATIONS ASSOCIATION


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## QUESTIONS PRESENTED

1. Whether the court of appeals erred in holding that 47 U.S.C. § 252(d)(1) (Telecommunications Act of 1996) forecloses the cost methodology adopted by the FCC, which is based on the efficient replacement cost of existing technology, for determining the interconnection rates that new entrants into local telecommunications markets must pay incumbent local telephone companies.

2. Whether 47 U.S.C. § 251(c)(3) prohibits regulators from requiring that incumbent local telephone companies combine certain previously uncombined network elements when a new entrant requests the combination and agrees to compensate the incumbent for performing that task.

## LIST OF PARTIES AND CORPORATE DISCLOSURE STATEMENT

The parties to the proceedings before the Eighth Circuit are listed in the Appendix at Pet. App. 1a, 35a-38a.

Pursuant to Supreme Court Rule 29.6, petitioners state as follows:

*WorldCom, Inc.*

WorldCom, Inc., through its wholly-owned subsidiaries, provides local and long-distance telecommunications services domestically and internationally. WorldCom, Inc is a publicly traded company on the Nasdaq National Market under the symbol "WCOM." No publicly held company owns 10 percent or more of WorldCom, Inc. stock.

*The Association for Local Telecommunications Services*

The Association for Local Telecommunications Services ("ALTS") is the national trade association representing facilities based providers of competitive local telecommunications services. ALTS has no parent companies, subsidiaries, or affiliates that have issued shares or debt securities to the public.

*Competitive Telecommunications Association*

The Competitive Telecommunications Association ("CompTel") is a national industry trade association representing competitive telecommunications carriers and their suppliers. Its over 300 members include large nationwide suppliers as well as scores of smaller regional carriers. CompTel has not issued shares or debt securities to the public. CompTel does not have any parent companies, subsidiaries, or affiliates that have issued shares or debt securities to the public.



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## OPINION BELOW

The opinion of the United States Court of Appeals for the Eighth Circuit is reported at 219 F.3d 744, and is reprinted at Pet. App. 1a-34a. That decision reviewed the First Report and Order, *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98 (Aug. 8, 1996) ("*Local Competition Order*"), issued by the Federal Communications Commission ("FCC" or the "Commission"), and the accompanying regulations. The *Local Competition Order* is published at 11 F.C.C.R. 15499 (1996); the FCC's regulations are codified at 47 C.F.R. §§ 51.1-51.809. Relevant portions of the *Local Competition Order* are reprinted at JA 264-452; relevant regulations are reprinted at Pet. App. 152a-158a.

## JURISDICTIONAL STATEMENT

The Court of Appeals had jurisdiction pursuant to 28 U.S.C. § 2342(1) and 47 U.S.C. § 402(a). The Eighth Circuit entered its decision on July 18, 2000. The petition for certiorari was filed on October 10, 2000. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

## STATUTORY PROVISIONS INVOLVED

This case involves the Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56, codified at 47 U.S.C. §§ 151-276 ("the 1996 Act" or "the Act"). The relevant provisions of the 1996 Act were reprinted at Pet. App. 134a-151a.

## STATEMENT OF THE CASE

### A. Introduction

Petitioners WorldCom, Inc. ("WorldCom"), the Association for Local Telecommunications Services ("ALTS") and Competitive Telecommunications Association seek reversal of the Eighth Circuit decision invalidating regulations promulgated by the FCC to implement the Telecommunications Act of 1996, a statute designed to make local telephone markets competitive "as quickly as possible." H.R. Rep. No. 104-204, at 89 (1995) ("H. Rep.").

As this Court has recognized, the 1996 Act is "an unusually important legislative enactment," *Reno v. ACLU*, 521 U.S. 844, 857 (1997), that seeks to bring about fundamental structural change in "a crucial segment of the economy worth tens of billions of dollars." *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 397 (1999). For the second time in five years, the Eighth Circuit, in the guise of interpreting the text of that landmark statute, has imposed its own views of telecommunications policy upon the Nation, and rejected those of Congress, the FCC, and the States. Specifically, the Eighth Circuit properly concluded that Congress granted the FCC broad discretion to choose the pricing methodology best suited to further the Act's mandates (including a forward-looking measure of cost). It nonetheless went on to hold that the 1996 Act forbids the FCC from using a particular, widely accepted forward-looking cost methodology to establish the rates incumbent local telephone companies charge new entrants who lease parts of the local network to provide service. The Eighth Circuit also held that the Act's text forecloses FCC rules requiring incumbents to combine elements at the request of new entrants, notwithstanding this Court's unequivocal prior ruling that Congress had authorized such rules.



The regulations invalidated by the Eighth Circuit are critical to the success of the 1996 Act. Unless reversed by this Court, the Eighth Circuit's rulings will continue to hobble the prospects for competition in local markets, where incumbents still control more than a 94% share. *Local Telephone Competition at the New Millennium*, Table 6 (FCC Aug. 2000).

### B. The 1996 Act

The central goal of the 1996 Act was to open historically monopolized local telephone markets and offer consumers the benefits of competition in those markets "as quickly as possible." H. Rep. at 89. To that end, Congress preempted all state laws restricting local competition, including the exclusive franchises States had granted incumbent local exchange carriers to provide local service. Congress did not anticipate, however, that preempting legal barriers to entry would suffice to bring about local competition. As Congress recognized, incumbents controlled ubiquitous networks, the construction of which had been funded over decades by captive customers. Competitors could not possibly enter markets rapidly if they were forced to build duplicative stand-alone networks "because the investment necessary is so significant." H.R. Conf. Rep. No. 104-458, at 148 (1996) ("Conf. Rep."); *accord* P. Huber, M. Kellogg & J. Thorne, *The Telecommunications Act of 1996*, § 1.1.2, at 8 (1996) ("Having assembled tightly integrated, end-to-end monopolies, incumbent phone companies begin with powerful advantages over newcomers – the ability to offer end-to-end one-stop shopping to all comers, immediately. Competitors have to build up, piece by piece, a process that can take years.").

Congress therefore imposed a comprehensive set of affirmative requirements "intended to facilitate market entry." *AT&T*, 525 U.S. at 371. One such requirement was a rule authorizing new entrants to resell incumbents' retail offerings; incumbents were therefore required to offer their services at wholesale rates to new entrants. 47 U.S.C. § 251(c)(4). Congress also required incumbents to "interconnect" with new entrants that have constructed their own networks – so new entrants' customers can communicate with the incumbents' customers – and to establish mechanisms for reciprocal compensation for the exchange of such calls. *Id.* §§ 251(c)(2), 251(b)(5). Without such "interconnection," competing networks would be of limited value to consumers.

Congress also embraced a regulatory initiative that had been previously adopted in a number of States – making the constituent elements of the local network, as well as the "features, functions, and capabilities" of these elements, available for lease by new entrants on an "unbundled" basis. *Id.* § 251(c)(3) (mandating "unbundled" access to "network elements"); *id.* § 251(d)(2) (requiring FCC to identify elements to be unbundled); *id.* § 153(29) (defining "network elements"). At the most basic level, the local network consists of *local loops* that connect homes and businesses to the incumbent local carriers' facilities, *switches* that route calls, and *transport facilities* that connect local loops and switches to other switches and to other networks (of long distance providers or competitors). The 1996 Act instructed the FCC to decide which network elements should be made available on an "unbundled," or separately priced, basis for use by new entrants. *Id.* § 251(d)(2) (requiring unbundling if new entrants would be "impaired" without access to the element). New entrants can use leased elements of the existing network in combination with their own facilities – *i.e.*, by building a



network of switches and transport facilities, and leasing local loops to connect to individual customers' premises. Or they can rely on leased elements to extend their competitive reach as they build out their own networks. They can also lease network elements to provide competitive service in areas where it is not economically efficient to build duplicate competing networks.

Congress recognized that its market-opening effort would not succeed, however, if the rates incumbents charged for use of the existing network were not set appropriately. Congress thus required that rates for interconnection and for the leasing of network elements be "just, reasonable, and nondiscriminatory" and "based on the cost . . . of providing" interconnection or the network element. 47 U.S.C. §§ 251(c)(3), 252(d)(1). Congress also required that these rates be "determined without reference to a rate-of-return or other rate-based proceeding" of the kind that had traditionally been used to set the incumbents' local retail rates. *Id.* § 252(d)(1)(A)(i). The FCC was charged with promptly implementing these and other requirements of the 1996 Act. *Id.* § 251(d)(1) (requiring regulations within six months of the Act's passage).

Consistent with its command that rates be "based on . . . cost," Congress legislated an end to the prior system of implicit cross-subsidies that was a central feature of the prior ratemaking regime for local telephone service. Under the prior regime, some services (principally those in rural and other high cost areas) were purportedly provided below cost, while others (including service in urban areas, business services, and advanced features such as call-forwarding) were provided significantly above cost in order to subsidize the below-cost services.[1] Such subsidies could not coexist with local competition, because in the Act Congress mandated a fundamentally different approach for ensuring affordable service. Section 254 of the 1996 Act, 47 U.S.C. § 254, mandates the removal of implicit subsidies, and the adoption instead of explicit and competitively neutral subsidy systems at the state and federal levels.

The 1996 Act's insistence on cost-based rates and its prohibition on rate-of-return proceedings also reflected a growing recognition among federal and state regulators that the traditional method of rate setting was unsatisfactory. Cost-of-service ratemaking requires that rates be set at levels sufficient to allow a regulated firm to recover its operating expenses, an allowance for depreciation on equipment that comprises its rate base, and a reasonable rate of return on the value of its rate base. For reasons of perceived ease of administration, regulators had traditionally used a regulated entity's "historical costs" – that is, the past investments carried on its books – to determine its rate base. In theory, historical cost ratemaking would "roughly duplicat[e] the benefits of competition," *National Rural Telecom Ass'n v. FCC*, 988 F.2d 174, 178 (D.C. Cir. 1993), because regulators would allow recovery only of costs that were prudently incurred – thereby replicating some of the discipline that a competitive market would otherwise impose. *NEPCO Mun. Rate Comm. v. FERC*, 668 F.2d 1327, 1333 (D.C. Cir. 1981).

[1] Incumbents also received multi-billion dollar subsidies in the form of access charges -- rates incumbents charge long distance carriers to initiate and complete long distance calls on the local network. The FCC and state authorities had set those charges at levels far in excess of their cost in order to subsidize local service.



In practice, however, regulators' reliance on historical costs had become an increasingly unwieldy and inefficient enterprise. *See In re Rates for Dominant Carriers,* Second Report and Order, 5 F.C.C.R. 6786, ¶ 29 (1990), *on reconsideration*, 6 F.C.C.R. 2637 (1991) ("*Price Cap Order*"). Regulators had become increasingly frustrated at their inability to obtain "accurate cost information, as the carrier itself is the source of nearly all information about its costs." *In re Rates for Dominant Carriers,* Notice of Proposed Rulemaking, 4 F.C.C.R. 2873, ¶ 31 (1989). And because a regulated firm's profits increase as its spending increases, *see National Rural Telecom Ass'n,* 988 F.2d at 178, basing rates on historical costs creates incentives for incumbents to overinvest in, or "gold-plate," their networks by building facilities not needed to provide local service. *See* Michael K. Kellogg *et al.*, *Federal Telecommunications Law* 478 (1992); *National Rural Telecom Ass'n*, 988 F.2d at 178. Although state regulators scrutinized incumbents' investments, overinvestment was frequently impossible to pinpoint. *See* Harvey Averch & Leland L. Johnson, *Behavior of the Firm Under Regulatory Constraint*, 5 Am. Econ. Rev. 1052, 1062-63 (1962).[2] Even a regulator theoretically capable of detecting all padded investments cannot "drive LECs to become more efficient and productive" because setting rates on the basis of the incumbents' book costs creates no incentive to innovate. *Price Cap Order* ¶ 30.

[2] A recent FCC audit highlights this problem; based on that audit, the FCC concluded that the ILECs' books are filled with "phantom assets," the existence of which cannot be verified. *See, e.g., FCC Releases Audit Reports on RBOCs' Property Records,* Report No. CC 99-3, 1999 WL 95044 (FCC Feb. 25, 1999) (FCC audit comparing book entries for $47 billion in assets with actual assets revealed that ILEC "book costs may be overstated by approximately $5 billion").

As a result, more than a decade ago the FCC introduced "price cap" ratemaking to move LECs away from historical-cost pricing. *See National Rural Telecom Ass'n*, 988 F.2d at 178. Similarly, by 1990 "only a few states" regulated LECs using "traditional rate of return practices." *Price Cap Order* ¶ 39.[3]

## C. The FCC's Regulations

Consistent with Congress' directives, the FCC moved promptly to implement the pricing and unbundling requirements of the 1996 Act. The Notice of Proposed Rulemaking tentatively concluded that the traditional method of setting rates on the basis of the incumbents' "historical costs" would not be consistent with the Act's goals, and sought comment on alternatives. *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996,* Notice of Proposed Rulemaking, 11 F.C.C.R. 14171, ¶ 123

[3] The 1996 Act also provided the Bell Companies (who provided the overwhelming majority of monopoly local telephone services in the country) with a substantial benefit. Once the FCC concluded that the local market in a particular State met congressionally prescribed standards showing it was open to competition, and that the public interest would be furthered, the Bell Company providing local service in that State would be free of the restriction imposed on it by the 1982 AT&T Modification of Final Judgment, and would be permitted to provide long distance and other services to its customers in that State. 47 U.S.C. § 271. The criteria Congress specified as minimally adequate for Bell entry into long distance demonstrate the extent to which Congress intended that new entrants be permitted to rely on appropriately priced leased network elements. Congress made clear that incumbents could not enter long distance markets until they had made available (at competitive rates) local loops, switching, transport facilities, access to all emergency services and directory assistance, operator services, and all databases and signaling necessary for call routing and completion. *Id.* § 271(c)(2)(B).



(1996). The Commission received thousands of pages of comments from more than 200 parties. On August 8, 1996, the FCC released the *Local Competition Order*.

***Pricing***. The FCC's detailed, 244-paragraph pricing analysis began by noting that "[t]he prices of interconnection and unbundled elements . . . will determine whether the 1996 Act is implemented in a manner that is *pro-competitor* . . . or, as we believe Congress intended, *pro-competition*." *Local Competition Order* ¶ 618 (JA 325-26) (emphasis added). After a careful review of the record, the Commission concluded that prices for interconnection and unbundled elements "should be set at forward-looking long-run economic cost" rather than on the "historical" or "embedded" cost approach that prevailed in the monopoly era. *Id.* ¶ 672 (JA 375-76). Both approaches measure all the costs of providing network elements, but in different ways: the money spent in the past to create the network in existence (a historical-cost approach) or the money needed today to build an efficient local network with the same capabilities (a forward-looking approach). *See id.* ¶ 705 (JA 398-99).

As the FCC explained, prices in a competitive market are based on forward-looking costs. *Id.* ¶ 675 (JA 376-77). New entrants – which build facilities using the lowest cost, most efficient technology available – set prices on that basis. Faced with a competitor setting prices based on forward-looking cost, an existing firm would have to match those prices. *See MCI Communications Corp. v. American Tel. & Tel. Co.*, 708 F.2d 1081, 1117 (7th Cir. 1983). That the existing firm's historical or book costs exceed forward-looking costs is irrelevant. If the existing firm continued to set prices based on those book costs, it would be driven out of business by the new entrant. Setting prices at forward-looking cost replicates this market dynamic.

If new entrants' input costs are set at forward-looking costs, they will set their retail rates accordingly. The retail rates of *all* market participants will have to be adjusted in order to remain competitive. Thus, pricing unbundled network elements at forward-looking cost "drives retail prices to their competitive levels." *Local Competition Order* ¶ 679 (JA 379-80); *see also Duquesne Light Co. v. Barasch*, 488 U.S. 299, 308 (1989) (forward-looking costs "mimic[] the operation of the competitive market").

The particular forward-looking approach adopted by the Commission – called "Total Element Long-Run Incremental Cost" or "TELRIC" – is a variant of the forward-looking cost methods that had gained wide acceptance in the professional literature, had been implemented by state utility commissions prior to passage of the 1996 Act, *see Local Competition Order* ¶ 631 & nn.1508-14 (JA 334-36), and had been used by numerous regulatory agencies in analogous contexts. *See Texas Office of Pub. Util. Counsel v. FCC*, 183 F.3d 393, 411-12 & nn.12 & 13 (5th Cir. 1999), *cert. granted sub nom. GTE Serv. Corp. v. FCC*, 120 S. Ct. 2214 (2000), *withdrawn*, 121 S. Ct. 423 (2000). To determine the TELRIC rate for a network element, the direct forward-looking cost of constructing, maintaining, and operating the element is calculated. 47 C.F.R. § 51.505(b)(1). That calculation includes the risk-adjusted cost of capital, thus allowing firms to recover a "normal" economic profit. *Local Competition Order* ¶¶ 699-700 (JA 393-95). The portion of forward-looking joint and common costs – that is, the overall costs of the firm – attributable to each element is then added. *Id.* ¶¶ 682, 694 (JA 381-82, 388-89). Thus, TELRIC allows incumbents to recover all of the forward-looking costs associated with providing a network element, plus a normal rate of return.



In designing its TELRIC methodology, the Commission sought to achieve several objectives. Most importantly, the Commission sought to ensure that its approach would send the right signals to new competitors and incumbents, and thereby encourage efficient entry. *Local Competition Order* ¶¶ 630, 672, 679 (JA 333-34, 375-76, 379-80). If the rates for network elements were set below long-run forward-looking cost, new entrants might be deterred from building competing networks where it was otherwise efficient to do so. Moreover, some new entrants would be induced to compete by leasing network elements where it would not otherwise be efficient to do so. If the rates for network elements are set too high, however, competitive entry may never occur. That is because the time it takes to build a competing ubiquitous network is sufficiently long that competitors must rely, at least in part, on leased network elements. If the rates at which the elements are priced are too high to allow new entrants to price their retail services at competitive levels, new entrants will be forced out of business before competition ever takes hold. Incumbents would be in a position to implement "price squeezes," by pricing their own retail offerings at their economic or forward-looking cost, while leasing unbundled elements to new entrants at rates based on historical cost. *Id.* ¶ 706 (JA 399-400).

By designing a forward-looking cost methodology that simulated a competitive market, the Commission sought to ensure that the rates eventually produced by that methodology would encourage new entrants to build competing facilities, *id.* ¶ 685 (JA 383-84), without stifling competition from the outset. To account for any hypothetical risk that new entrants might lack adequate incentives to build their own facilities, the FCC made a pragmatic adjustment to its methodology, and measured costs assuming that the incumbents' existing serving wire centers remain in place. "[T]his approach encourages facilities-based competition to the extent that new entrants, by designing more efficient network configurations, are able to provide the service at a lower cost than the incumbent LEC." *Id.*

At the same time, the Commission sought to compensate incumbents for the *total* cost of providing a network element. The FCC thus rejected a short-run incremental, or marginal, cost approach that does not measure fixed costs (such as plant), but instead measures only the *additional* cost an incumbent incurs in providing a given element to a new entrant. Because the FCC's methodology uses a "period long enough that all costs are treated as variable and avoidable," both fixed and variable costs are attributed to the cost of each element. *Id.* ¶ 692 (JA 387-88). By coupling a long-term cost methodology with attribution to each element of a reasonable share of joint and common costs, the FCC ensured that TELRIC rates capture *all* costs associated with providing each element to new entrants. *Id.* ¶¶ 682, 694-698 (JA 381-82, 388-92).

The FCC carefully evaluated alternatives to TELRIC, as well as more general objections to the use of forward-looking pricing. In particular, the Commission rejected historical-cost pricing, in accordance with "[t]he substantial weight of economic commentary in the record," *id.* ¶ 705 (JA 398-99),[4]

[4] Even the economists hired by the incumbent LECs acknowledged that long-run incremental cost is the appropriate measure of cost, although some urged that incumbents also be allowed to recover what they deemed stranded historical costs. *See, e.g.*, Declaration of Robert W. Crandall ¶ 10 (attached to Comments of Bell Atlantic, CC Docket No. 96-98 (FCC filed May 16, 1996)) ("From an economic standpoint, the pricing of any network function . . . should be based on long-run incremental costs. . . .") (JA 84); Affidavit of Robert G. Harris and Dennis Yao at 5 (attached to Comments of U.S. West, CC Docket No. 96-98 (FCC filed May 16, 1996)) ("LEC prices should reflect the total service long run incremental cost (TSLRIC), shared



because it would force competitors to pay for the existing inefficiency of the incumbents' networks and would not "ensure the efficient investment decisions and competitive entry contemplated by the 1996 Act." *Id.* Additionally, the Commission specifically considered the practicality of forward-looking cost models and concluded (on the basis of the States' increasing use of such models) that such models were practical. *Id.* ¶ 681 (JA 381). The Commission also considered and rejected other methodologies such as "efficient component pricing" and "Ramsey pricing." *Id.* ¶¶ 708-711 (JA 401-03); ¶¶ 645, 696 & n.1700 (JA 352-53, 390-91). The FCC also declined to establish a formula that would estimate the "forward-looking" cost of the incumbent's *existing* network. *Id.* ¶ 684 (JA 383). Because this approach would allow incumbents to recover costs "that reflect inefficient or obsolete network design and technology," the FCC found it would be "essentially an embedded cost methodology." *Id.* Finally, the Commission rejected the incumbents' suggestions that TELRIC would produce significant levels of "stranded" or unrecoverable historical costs, noting that the record did not support such a conclusion. *Local Competition Order* ¶ 707 (JA 400-01). The Commission indicated its willingness to revisit the issue,

and common costs, a reasonable profit" and historical costs for an interim period) (JA 137). This is consistent with arguments incumbents have made in related contexts. *See* David Gabel & David I. Rosenbaum, *Who's Taking Whom?*, 52 Fed. Comm. L.J. 239, 255 (2000) (citing a number of instances in which incumbents have argued that forward-looking incremental costs are the best way to ensure economically efficient pricing policies). Indeed, the primary critique aimed at the use of a pure forward-looking methodology was its purported failure to allow for the recovery of joint and common costs. *See, e.g.*, Affidavit of Edward C. Beauvais at 7 (attached to Comments of GTE Service Corp., CC Docket No. 96-98 (FCC filed May 16, 1996)) ("TSLRIC is a very reasonable starting point for the development of [network elements] prices" although it must "recover joint and common costs") (JA 110). As noted, the FCC addressed that concern.

however, if incumbents were able to "provide specific information to show that the [TELRIC] pricing methodology, as applied to them, will result in confiscatory rates." *Id.*

***Combining Network Elements.*** The *Local Competition Order* also implemented the Act's unbundling requirements. Specifically, the FCC promulgated Rules 315(b)-(f), which are designed to ensure that new entrants can use the network elements they lease to provide any telecommunications service. The Commission concluded that new entrants do not, as a practical matter, have the necessary information about the incumbents' networks to combine elements without the assistance of the incumbent. *Local Competition Order* ¶ 293 (JA 295-96). Accordingly, its rules prohibit the incumbents from separating elements already combined in their network (Rule 315(b)), and, to the extent technically feasible, require incumbents to combine requested elements that are not already combined in the existing network (Rule 315(c)) and to perform the functions necessary to combine elements of the incumbent's network with elements possessed by new entrants (Rule 315(d)). *See* 47 C.F.R. § 51.315(b)-(f).[5] Absent such requirements, the Commission found, new entrants' ability to use network elements to provide local service would be seriously and discriminatorily undermined. *Local Competition Order* ¶ 293 (JA 295-96).

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[5] To the extent that the combination of network elements imposes additional cost on the incumbent, the new entrant is required to pay that cost. *Cf. Local Competition Order* ¶¶ 314, 382, 384 ("[T]he 1996 Act requires a requesting carrier to pay the costs of unbundling. . . .") (JA 304-05, 312-13).



### D. Judicial Review

The incumbents' initial challenges to the FCC's rules were consolidated in the Eighth Circuit, which stayed and then vacated the FCC's pricing rules on the ground that the FCC lacked authority to promulgate them. *Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997) ("*IUB*"), *aff'd in part and rev'd in part sub nom. AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999). The Eighth Circuit also struck down the FCC's "combinations" rules, 47 C.F.R. § 51.315(b)-(f), reasoning that "the plain meaning of the Act indicates that the requesting carriers will combine the unbundled elements themselves." *IUB*, 120 F.3d at 813.

On January 25, 1999, this Court entered an opinion reversing the Eighth Circuit in both these respects. *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999). With respect to pricing, the Court concluded that the general grant of rulemaking authority to the FCC in § 201(b) of the Communications Act, 47 U.S.C. § 201(b), "means what it says: The FCC has rulemaking authority to carry out the 'provisions of this Act,' which include §§ 251 and 252, added by the Telecommunications Act of 1996." 525 U.S. at 378. With respect to Rule 315(b), the Court held that § 251(c)(3) of the 1996 Act "does not say, or even remotely imply that elements *must* be provided in [physically separate] fashion and never in combined form." 525 U.S. at 394. "The reality," the Court concluded, "is that § 251(c)(3) is ambiguous on whether leased network elements may or must be separated, and the rule the Commission has prescribed is entirely rational. . . ." *Id.* at 395. Thus, the Court upheld Rule 315(b) as a reasonable interpretation of the Act's unbundling requirements.

On remand, the Eighth Circuit considered the FCC's TELRIC rule on the merits, and invalidated a portion of it. Pet. App. 1a. The court did not, however, accept the incumbents' argument that the 1996 Act requires a historical-cost methodology. The court acknowledged that the statutory "term 'cost'. . . is ambiguous, and Congress has not spoken directly on the meaning of the word in this context." *Id.* at 9a. Because "[f]orward-looking costs have been recognized as promoting a competitive environment which is one of the stated purposes of the Act," the court reasoned, "the FCC's use of a forward-looking cost methodology was reasonable." *Id.*

The court nevertheless found fault with a single (but critical) component of the FCC's TELRIC methodology – Rule 51.505(b)(1) – which requires rates to be calculated "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 LEC's wire centers." 47 C.F.R. § 51.505(b)(1). The court concluded that this requirement was inconsistent with the Act's plain language, which indicates that rates are to be "based on the cost . . . of providing *the* interconnection or network element." Pet. App. 7a (quoting § 251(c)(3)) (emphasis in opinion). Congress' use of the word "the," the court reasoned, was a clear statutory bar precluding the FCC from setting rates based on efficient replacement cost. The court acknowledged the explanation of both the FCC and its supporting intervenors that "TELRIC does reflect the [incumbents'] costs, but on a predictive forward-looking basis that assumes a reasonable level of efficiency." *Id.* at 6a. The court dismissed these arguments, asserting that "Congress was dealing with reality, not fantasizing about what might be. The reality is that Congress knew it was requiring the existing [incumbents] to share their existing facilities and equipment with new competitors . . . and it expressly said that



the [incumbents'] costs of providing those facilities and that equipment were to be recoverable by just and reasonable rates." *Id.* at 7a. Thus, the court concluded, new entrants must pay the cost associated with *"the specifically requested existing network elements* that the competitor will in fact be obtaining for use. . . ." *Id.* (emphasis added)

It is not entirely clear from the Eighth Circuit's opinion exactly what measure of cost it intended. On the one hand, the court appears to have endorsed a cost measure based on the long-run "forward-looking" cost of the existing network. On the other hand, the court seems to have embraced a cost measure based on a purely incremental (*i.e.*, short-run) forward-looking cost methodology that compensates the incumbent only for the *additional* cost it incurs when it allows a new entrant to use a network element. Indeed, much of the court's language suggests that it was endorsing the latter approach. The court concluded, for example, "that a forward-looking cost calculation methodology that is based on the incremental costs that an ILEC actually incurs or will incur in providing . . . the unbundled access to its specific network elements . . . will produce rates that comply with the statutory requirement of § 252(d)(1). . . ." *Id.* at 10a-11a. But the court did not vacate those portions of the FCC's order that mandate the use of a long-term, rather than short-term, forward-looking methodology, 47 C.F.R. § 51.505(b), and that require the allocation of joint and common costs to each element, *id.* § 51.505(c). Nor did the court appear to understand that its decision could be interpreted to mandate a sweeping *reduction* in network element rates. Thus, the interpretation of the Eighth Circuit's opinion that is most consistent with what it did is to mandate the use of a long-run "forward-looking" cost measure based on the existing network – the very measure the FCC rejected as "essentially an embedded cost methodology." *Local Competition Order* ¶ 684 (JA 383).[6]

The court also reexamined FCC Rules 315(c)-(f) in light of this Court's reinstatement of Rule 315(b). Although this Court had held that § 251(c)(3) does not "even remotely imply that elements *must* be provided in [discrete pieces] and never in combined form," *AT&T*, 525 U.S. at 394, the Eighth Circuit "reiterat[ed] what [it] said in [its] prior opinion" and held once again that Congress had unambiguously foreclosed the FCC from requiring incumbents to combine elements at the behest of new entrants. Pet. App. 22a-23a. Accordingly, the Eighth Circuit again invalidated Rules 315(c)-(f). *Id.*

### E. The State of Local Competition

Because of the Eighth Circuit's initial stay and decision, the FCC's pricing rules did not take effect until after this Court's January 1999 decision. Thus, for over two years, state commissions implementing the Act were not bound by the FCC's TELRIC rule. Nonetheless, these commissions unanimously rejected the incumbents' arguments that the 1996 Act mandates the use of historical costs, and instead stated that they were adopting forward-looking cost methodologies that were, in most instances, the same as, or similar to, the FCC's TELRIC methodology. *See* David Gabel & David I. Rosenbaum, *Who's Taking Whom?*, 52 Fed. Comm. L.J. 239, 245 (2000) (noting that during the period the TELRIC rules were stayed "at least thirty-five states have independently

[6] The Eighth Circuit stayed the issuance of that portion of its mandate invalidating the network element pricing rules, pending review by this Court. *See Iowa Utils. Bd. v. FCC*, No. 96-3321, Order Granting Stay of the Mandate (8th Cir. Sept. 22, 2000).



approved a TELRIC unbundled elements pricing methodology") (citation omitted). Accordingly, since the 1996 Act was adopted, rates for interconnection and access to network elements have been based on forward-looking cost.

Nevertheless, competition has been slow to materialize. Due in part to the uncertainty caused by the incumbents' repeated challenges both to the FCC's regulations and to state commission rulings implementing the Act and the FCC's rules, competitors' market share remains small – less than 6%. *Local Telephone Competition at the New Millennium*, Table 6 (FCC Aug. 2000). The progress that has been made to date, however, has proceeded much as the FCC envisioned. Although the incumbent LECs predicted that rates set at forward-looking cost would discourage facilities-based entry and lead to a rush of competitors competing only through the use of "underpriced" network elements, in fact new competitors have entered using resale and network elements, while building out their own networks. Thus, as of the second quarter of 2000, competitive local exchange carriers used an almost equal proportion of each of the three entry methods to serve their customers. Thirty six percent were served through the use of the competitors' own facilities; 33% were served by leased elements; and 31% through resold services. ALTS, *The State of Local Competition 2001*, at 12 (Feb. 2001) ("ALTS Report").

## SUMMARY OF ARGUMENT

The Eighth Circuit has inappropriately usurped the FCC's authority and substituted its own ill-considered and impractical views about how the landmark local competition provisions of the 1996 Act should be implemented. With respect to the two most critical parts of the Act's market-opening initiative – the rates at which new entrants will be able to lease elements of the existing network and the terms on which they will have access to those elements – the Eighth Circuit rejected the FCC's reasonable policy judgments on the basis of implausible readings of the statutory text. It is imperative that the FCC's pricing and combinations rules be restored if the 1996 Act is to have any prospect of bringing about the competitive local telephone markets Congress envisioned.

1. There is no basis in the text, structure, or purpose of the 1996 Act for the Eighth Circuit's holding that Congress intended to foreclose the FCC from basing rates for interconnection and unbundled elements on an efficient replacement cost methodology. The relevant statutory text requires only that rates be "just and reasonable" and "based on the cost of providing . . . the interconnection or network element." 47 U.S.C. §§ 251(c)(2), (c)(3), 252(d)(1). Far from imposing the kinds of clear limits needed to invalidate an agency rule at the first step of the analysis mandated by *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843 (1984), those provisions delegate to the FCC broad authority to decide the basis upon which to set rates. Both the terms "just and reasonable" and the term "cost" have repeatedly been held to authorize agencies to decide whether to base rates on efficient replacement costs or on historical costs. Against that backdrop, Congress could not reasonably be thought to have intended to foreclose an efficient replacement cost methodology by enacting § 252(d)(1), and it certainly did not use statutory language manifesting any such clear intention. Indeed, reading such an intention into the 1996 Act would have the perverse consequence of invalidating as a matter of federal law the very pricing methodologies progressive States had adopted as part of their pre-1996 efforts to open local markets to competition – efforts which served as the model for



Congress' nationwide market-opening initiative in the 1996 Act.

The Eighth Circuit's belief that Congress foreclosed an efficient replacement cost methodology and commanded that new entrants must pay the cost associated with "*the specifically requested existing network elements* that the competitor will in fact be obtaining for use," Pet. App. 7a (emphasis added), is insupportable. It would be absurd to read § 252(d)(1)'s command that rates be "based on the cost of providing the interconnection or network element" as an unyielding mandate that rates be calculated individually on the basis of the "specifically requested existing network elements" the new entrant will "in fact be obtaining," for that reading would require the impossible – an individual rate calculation for each of the many millions of elements leased under the 1996 Act. Nor can this statutory text be read as yoking the FCC to a methodology that calculates rates based on what it would cost today to replicate the precise network presently in place – even if no one would replicate that network because more efficient alternatives exist. This Court has repeatedly held that such an approach is nonsensical. *Market Street Ry. Co. v. Railroad Comm'n*, 324 U.S. 548, 567 (1945); *see also Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n of Mo.*, 262 U.S. 276, 312 (1923) (Brandeis, J., concurring). The simple fact is that the "forward-looking cost" of providing a network element *is* its efficient replacement cost. Once it is acknowledged (as the Eighth Circuit did) that § 252(d)(1) authorizes rates based on forward-looking cost, there can be no argument that Congress foreclosed TELRIC's reliance on efficient replacement costs.

Nor is the FCC's TELRIC methodology vulnerable to challenge on the alternative *Chevron* step-two ground that it is unreasonable. TELRIC is merely an industry-specific application of a well accepted rate-setting method that has been endorsed by the States in the present context, the FCC in other related contexts, and the incumbents themselves. By basing rates on efficient replacement cost, the FCC sought to send appropriate signals to new entrants and incumbents alike, to prevent incumbents from engaging in price squeezes that will hobble new entrants, and to move retail local phone rates toward competitive levels. For these reasons, TELRIC directly furthers Congress's objectives in the 1996 Act. The *Local Competition Order* fully considered and rejected alternatives to TELRIC, reasonably responded to the argument that TELRIC would not be administrable in practice, and explained in detail why the FCC found unpersuasive the criticisms leveled against the TELRIC approach by the incumbents. The *Local Competition Order* thus easily satisfies all requirements of reasoned decisionmaking.

2. The Eighth Circuit's invalidation of FCC Rules 315(c)-(f) – which require incumbents to provide elements to new entrants in combinations the new entrants request – is likewise based on an implausible construction of the 1996 Act. This Court has previously held that § 251(c)(3) of the 1996 Act "does not say, or even remotely imply, that elements must be provided only [separately] and never in combined form." *AT&T*, 525 U.S. at 394. "The reality," as the Court held, "is that § 251(c)(3) is ambiguous." *Id.* Yet in reconsidering its prior invalidation of Rules 315(c)-(f) in light of that holding, the Eighth Circuit once again held that in § 251(c)(3) "Congress has directly spoken on the issue of who shall combine previously uncombined elements" and dictated that "[i]t is the requesting carrier who shall" do so. Pet. App. 22a. That ruling must be reversed, for it flouts this Court's prior holding.



Because § 251(c)(3) does not unambiguously foreclose Rules 315(c)-(f), they must be upheld if they reasonably implement the Act's unbundling requirements. They assuredly do so. The FCC required incumbents to combine network elements requested by new entrants because new entrants have neither the physical access to the existing local networks nor the knowledge of those networks needed to do the combining themselves. A requirement that new entrants combine elements themselves is, for all practical purposes, a denial of access to combined elements, and thus antithetical to the goals of the Act's unbundling requirements. In contrast, Rules 315(c)-(f) impose no undue burdens on incumbent carriers, and the cost of combining elements that were not previously combined in an incumbent's network is fully reflected in the rates the incumbent receives. That is why both the FCC and state utility commissions acting on their own initiative have found the combinations requirement invalidated by the Eighth Circuit to be both appropriate and necessary. *See, e.g.*, *U S West Communications v. MFS Intelenet, Inc.*, 193 F.3d 1112, 1121 (9th Cir. 1999) (upholding a state commission decision requiring an incumbent to provide new combinations), *cert. denied*, 120 S. Ct. 2741 (2000).

## ARGUMENT

### I. THE FCC'S TELRIC METHODOLOGY IS LAWFUL.

The principal question in this case is whether the FCC's TELRIC methodology is a lawful implementation of the 1996 Act's pricing provisions. Resolution of that question is governed by the familiar *Chevron* standard. A reviewing court may invalidate an agency's implementing regulation at the first step of *Chevron* analysis only if "Congress has . . . addressed the precise question at issue" and *unambiguously foreclosed* the agency's choice. *Chevron*, 467 U.S. at 843; *AT&T*, 525 U.S. at 397 (pursuant to *Chevron*, courts are only to "enforce the clear limits that the 1996 Act contains"). At the second step of *Chevron*, "where Congress has enacted a law that does not answer 'the precise question at issue,'" the reviewing court must uphold an agency's implementing regulation so long as the agency "has filled the statutory gap 'in a way that is reasonable in light of the legislature's revealed design.'" *Lopez v. Davis*, 121 S. Ct. 714, 722-23 (2001) (quoting *NationsBank of N.C., N.A. v. Variable Annuity Life Ins. Co.*, 513 U.S. 251, 257 (1995)). A straightforward application of those principles mandates affirmance of the FCC's TELRIC methodology.

### A. The 1996 Act Does Not Foreclose the FCC from Adopting TELRIC.

The Eighth Circuit held that the plain meaning of the 1996 Act unambiguously forecloses the FCC from using an "efficient replacement cost" standard for setting the rates for interconnection and unbundled elements. Pet. App. 5a-8a. But there is no basis for that conclusion in the statutory text or structure, or in its purposes.

#### 1. The Statutory Text Authorizes the FCC to Adopt TELRIC.

In reviewing the FCC's decision to adopt TELRIC, this Court "begin[s] with the language of the statute and ask[s] whether Congress has spoken on the subject. . . ." *Norfolk & W. Ry. Co. v. American Train Dispatchers' Ass'n*, 499 U.S. 117, 128 (1991). With respect to pricing, the language of the statute provides that rates must be "just and reasonable," 47 U.S.C. §§ 251(c)(2), (c)(3), and that the "just and reasonable



rate for the interconnection of facilities and equipment . . . and . . . for network elements . . . (A) shall be . . . (i) based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element . . . and (ii) nondiscriminatory, and (B) may include a reasonable profit." *Id.* § 252(d)(1).

Far from imposing "clear limits" on the FCC's authority, these terms confer "'broad methodological leeway,'" and "say little about the 'method employed' to determine a particular rate." *AT&T*, 525 U.S. at 405 (Breyer, J., dissenting in part) (internal citation omitted). To begin with, it has long been understood that when Congress imposes a statutory requirement of "just and reasonable" rates, it has granted to the agency broad discretion to choose between a forward-looking and a historical-cost approach. *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944). Thus, courts of appeals have noted that the words "just" and "reasonable" are precisely the type of "ambiguous statutory terms" that require "substantial deference to the interpretation the Commission accords them." *Capital Network Sys., Inc. v. FCC,* 28 F.3d 201, 204 (D.C. Cir. 1994).

The 1996 Act's use of the term "cost" in § 252(d)(1) likewise confers broad methodological leeway. Courts of appeals have routinely recognized that a statutory requirement of cost-based rates does not prescribe any specific measure of costs. "[T]he word 'cost' is a chameleon." *Strickland v. Commissioner, Maine Dep't of Human Services*, 48 F.3d 12, 19 (1st Cir. 1995); *see also Strickland v. Commissioner, Maine Dep't of Human Services,* 96 F.3d 542, 546 (1st Cir. 1996) (there is "ambiguity inherent in the word 'cost,'" and absent explicit congressional guidance, courts cannot conclude that Congress has "spoken directly"); *Appalachian Power Co. v. EPA,* 135 F.3d 791, 809 (D.C. Cir. 1998) (noting "essential ambiguity of the word" cost). And in public utility regulation in particular, "cost" is an "inexact standard" susceptible of being interpreted as meaning either forward-looking or historical costs. *See, e.g., Alabama Elec. Coop., Inc. v. FERC*, 684 F.2d 20, 27 (D.C. Cir. 1982). Thus, the requirements that rates be "just and reasonable" and based on "cost" are not "unambiguous with regard to the point at issue here," and certainly cannot be said to express a Congressional intent to deny the FCC the authority to adopt the specific TELRIC measure of forward-looking cost the Eighth Circuit invalidated. *See Smiley v. Citibank (South Dakota), N.A.*, 517 U.S. 735, 739 (1996); *see also Atlantic Mut. Ins. Co. v. Commissioner*, 523 U.S. 382, 387 (1998); *Babbitt v. Sweet Home Chapter of Communities for a Great Oregon*, 515 U.S. 687, 703 (1995).[7]

At bottom, it is simply not plausible that Congress intended to dictate the precise methodological assumptions that should be used to implement the market-opening requirements of the 1996 Act, rather than to leave that decision to the expert agency. *Cf. FDA v. Brown & Williamson Tobacco Corp.*, 120 S. Ct. 1291, 1301 (2000); Stephen Breyer, *Judicial Review of Questions of Law and Policy*, 38 Admin. L. Rev. 363, 370 (1986). Congress routinely delegates such questions to administrative bodies because they involve technical expertise that the agency possesses and Congress does not. Indeed, it is particularly unlikely that Congress sought to foreclose TELRIC

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[7] Indeed, to the extent the Act points in the direction of a particular methodology, it suggests that Congress intended to foreclose the use of historical costs in favor of the models States were employing. The only clear limit in § 252(d)(1) is its prohibition on calculating cost based on "rate-of-return or other rate-based proceeding[s]." 47 U.S.C. § 252(d)(1)(A)(i). It is such proceedings that States had used in the past when setting rates based on historical costs. *See Illinois Bell Tel. Co. v. FCC*, 988 F.2d 1254, 1258-59 (D.C. Cir. 1993). *See* pages 6-8 *supra*.



when it passed the 1996 Act, because that would mean Congress sought to foreclose the very sorts of methodologies States had implemented before 1996 as part of their efforts to open local markets to competitive entry – efforts that served as the model for Congress in 1996. *See Local Competition Order* ¶ 631 & n.1508 (JA 334-36); S. Rep. No. 104-23, at 5 (1995). Against this backdrop, had Congress intended to dictate the precise method by which rates for interconnection or leasing unbundled elements were to be set, or had it intended to place particular methodologies off limits to the FCC, it would have legislated with far more precision than it did in the 1996 Act.

### 2. The Eighth Circuit's Contrary Conclusion Cannot Withstand Scrutiny.

Although it recognized that the FCC's choice of a forward-looking methodology was both consistent with the statutory text and a reasonable policy choice, Pet. App. 8a-9a, the Eighth Circuit nevertheless held that § 252(d)(1) specifically forbids calculating the cost of a network element on the basis of what it would cost to replace the element efficiently. "It is clear from the language of the statute," the court held, "that Congress intended the rates to be 'based on the cost . . . of providing *the* interconnection or network element' . . . not on the cost some imaginary carrier would incur by providing the newest, most efficient, and least cost substitute for the actual item or element which will be furnished." *Id.* at 7a (emphasis in opinion). In the Eighth Circuit's view, Congress mandated that it is "the cost to the ILEC of providing . . . the *specifically requested existing network elements that the competitor will in fact be obtaining* that must be the basis for the charges." *Id.* (emphasis added).

That reading of § 252(d)(1) is implausible. To begin with, the single article "the" in § 252(d)(1) cannot have the meaning the Eighth Circuit ascribed to it because Congress cannot possibly have intended that a separate charge be calculated for each "specifically requested existing network element[]." Pet. App. 7a. That would be an impossible task. Each individual element leased has a different cost, and hence would have a separate rate from every other "specifically requested" element. The cost of a local loop, for example, will vary depending on how long the loop is – its length will determine the cost of the raw materials (fiber or copper) and the labor needed to construct and maintain it. Yet under the Eighth Circuit's reading, the cost of each "specifically requested" individual loop must be calculated in order to set its rate. To implement the unbundling requirements of § 251(c)(3), millions of such individual calculations would have to be made. It is simply untenable to read § 252(d)(1) as mandating individual rates based on the cost of the specifically requested network element the new entrant will in fact be obtaining. Instead, read in context, it is clear that the word "the" in 47 U.S.C. § 252(d)(1) merely identifies the things to which the cost-based requirement applies.

Nor is it plausible to read § 252(d)(1) more generally as foreclosing the FCC from using the cost of the "most efficient, and least cost substitute for the actual item or element" to set rates on an average basis. Pet. App. 7a. By denying the FCC the power to calculate rates on the basis of what it would cost to replace a network element efficiently, the Eighth Circuit would appear to be requiring that rates be set on the basis of what it would cost to replicate the identical equipment that presently exists in the incumbents' networks at "today's" costs,



even if the technology presently deployed is obsolete.[8] That cannot have been Congress' intent. This Court has repeatedly acknowledged the absurdity of "fix[ing] rates on the present reproduction value of something no one would presently want to reproduce." *Market Street Ry. Co.*, 324 U.S. at 567; *see also Missouri ex rel. Southwestern Bell Tel. Co.*, 262 U.S. at 312 (Brandeis, J., concurring) (describing as the *least* appropriate methodology "what it would cost to reproduce the identical property"). Indeed, this "replication cost" approach is not a forward-looking measure of cost in any meaningful sense. Instead, as the FCC recognized, because the "forward-looking" cost of obsolete equipment incorporates the costs of inefficiencies and obsolete technologies that cannot be recouped in a competitive market, it is essentially an embedded cost methodology. *See Local Competition Order* ¶ 684 (JA 383).

The Eighth Circuit appears to have simply misapprehended what a forward-looking methodology measures. TELRIC and related methodologies measure costs over the long run (that is what the "LR" in TELRIC stands for). A "long-run" measure ensures that *all* relevant costs are captured, because the period

[8] What that would mean as a practical matter is far from clear. If a switch in an existing local network is no longer made by any manufacturer, for example, it is practically impossible (as well as absurd to try) to calculate the cost of reproducing that switch. Unsurprisingly, because the Eighth Circuit's decision is so nonsensical in this respect, parties have been unable to agree on what it requires. The court's conclusion that "it is the cost to the ILEC of carrying the extra burden of the competitor's traffic that Congress entitled the ILEC to recover," Pet. App. 7a, suggests that the Act mandates a short-term incremental cost methodology. Although that would obviate the problem identified above, the Eighth Circuit did not appear to understand that it might be mandating a sweeping downward departure from TELRIC by denying incumbents the ability to recover any costs that are, in the short-term, fixed.

measured is long enough that all costs are variable, and all plant and equipment can therefore be replaced. A rational firm replacing all plant and equipment would do so using modern technology deployed in an efficient manner. Thus, the forward-looking cost of providing *the* elements in *the* existing network *is* the cost of the efficient substitutes for those elements. What the Eighth Circuit derided as "the cost some imaginary carrier would incur by providing the newest, most efficient, and least cost substitute for the actual item or element which will be furnished," Pet. App. 7a, is precisely the definition of a forward-looking cost. By correctly concluding that the 1996 Act authorized forward-looking cost methods, the Eighth Circuit should necessarily have concluded that the Act authorized TELRIC.

### B. The FCC's TELRIC Methodology Was Reasonable.

#### 1. TELRIC Implements the 1996 Act in a Way That Is Reasonable in Light of the Statute's Design.

Because Congress has not spoken to the precise question at issue and has not unambiguously foreclosed the FCC's choice of TELRIC, that choice must be upheld if it is "within the bounds of the reasonable." *AT&T*, 525 U.S. at 395. TELRIC easily meets that test.

Forward-looking cost is a well-accepted measure that has frequently been used by agencies in related contexts, and routinely upheld by reviewing courts. *See, e.g., Illinois Bell Tel. Co. v. FCC*, 988 F.2d 1254, 1262-63 (D.C. Cir. 1993); *Natural Gas Pipeline Co. of Am. v. FERC*, 765 F.2d 1155, 1157, 1163-64 (D.C. Cir. 1985); *see also Local Competition*



*Order* ¶ 631 (JA 334-36) (explaining that a number of States including Arizona, California, Missouri, Oklahoma and Wyoming currently use or have plans to use a forward-looking long-run incremental cost methodology to set prices for unbundled network elements). TELRIC is merely a straightforward application of such a methodology to the pricing of network elements. The Bell Companies themselves have repeatedly urged the use of just such a methodology in closely related contexts. *See, e.g.*, U S West, A Framework for Effective Competition, at 15 ("strongly supporting" prices for interconnection "based on forward-looking long run incremental costs" in Europe, where U S West seeks to compete as a new entrant against entrenched incumbents); Submission to Austel on the Economic and Commercial Issues of Interconnection by Ameritech International, Inc. and Bell Atlantic International, Inc. ¶¶ 1.1-1.2 (same in Australia). Indeed, the Bell Companies themselves have asserted that "forward-looking incremental costs [are] the appropriate pricing floor on which to base pricing decisions" and that the use of embedded or historical costs would result in "non-economic and inefficient pricing policies." George W. Costello, *The Use of Incremental Costs in Regulatory Proceedings, Determining the Economic Cost of Actions Requiring Regulatory Review, in Marginal Cost Techniques for Telephone Services: Symposium Proceedings* 666 (William Pollard ed. 1991).

As the FCC explained, it chose to adopt TELRIC in this context because it unleashes the same dynamic that already exists in a competitive market. *Local Competition Order* ¶ 679 (JA 379-80). Typically, new firms can enter a market and set prices based on the costs of building the necessary facilities to compete. Incumbents must then match those retail prices, or they will be driven out of business. Thus, in a competitive market, the rates of all market participants are driven to forward-looking cost. Forward-looking pricing of network elements achieves a similar result where, as here, new competitors cannot immediately compete on equal terms because the costs of entry – building a competing ubiquitous network – are too great. *See id.*; *Duquesne*, 488 U.S. at 308 (forward-looking costs "mimic[] the operation of the competitive market"); *Potomac Elec. Power Co. v. ICC*, 744 F.2d 185, 189 (D.C. Cir. 1984) (forward-looking prices are a "surrogate" for competition in industry where competition itself has not yet taken root).

The FCC considered and rejected an approach like the one the Eighth Circuit's decision appears to mandate because such a "replication cost" approach would distort the rates consumers pay for telephone service. As the FCC explained, the "forward-looking" cost of replicating obsolete equipment incorporates the costs of inefficiencies that cannot be recouped in a competitive market. *See Local Competition Order* ¶ 684 (JA 383). If incumbent LECs are allowed to impose on new competitors the obsolescence and inefficiencies associated with their existing networks, competitors are prevented from pricing their own retail offerings at the levels that would prevail in a truly competitive market. Thus, a replication cost methodology would prevent consumers from quickly experiencing the benefits of competition.

The use of a replication cost methodology would also frustrate the FCC's policy goal of "giv[ing] appropriate signals to producers and consumers and ensur[ing] efficient entry and utilization of the telecommunications infrastructure." *Id.* ¶ 630 (JA 333-34) (emphasis added). The Commission reasonably concluded that the purpose of the Act was not best served by adopting a rate methodology that would lead to economic



waste, and that it was preferable to adopt a methodology that, by replicating the forces of competition, encouraged entry and investment only when such entry is efficient.

### 2. The FCC's Adoption of the TELRIC Methodology Was Not Arbitrary.

Nor can the FCC's TELRIC methodology be invalidated on the basis of the alternative argument, advanced by the incumbent carriers (and rejected by the Eighth Circuit), that the FCC acted arbitrarily in adopting it. To the contrary, the FCC carefully considered and explained the choices it made. Indeed, the FCC's adoption of TELRIC rests on predictive judgments to which courts owe particular deference. *See, e.g.*, *Baltimore Gas & Elec. Co. v. Natural Res. Defense Council, Inc.*, 462 U.S. 87, 103 (1983) (cautioning that "a reviewing court must generally be at its most deferential" when an agency "is making predictions, within its area of special expertise"); *Turner Broad. Sys., Inc. v. FCC*, 520 U.S. 180, 196 (1997) (noting that reviewing court owes deference to administrative agency's predictive judgments because of the latter's expertise); *FCC v. National Citizens Comm. for Broad.*, 436 U.S. 775, 814 (1978) ("'[A] forecast of the direction in which future public interest lies necessarily involves deductions based on the expert knowledge of the agency.'") (quoting *FPC v. Transcontinental Gas Pipe Line Corp.*, 365 U.S. 1, 19 (1961)).

**The FCC Considered Alternative Approaches.** In its pricing discussion, the FCC identified the numerous and varying views of the more than 200 commenters and "explained in detail its reason for selecting" the TELRIC methodology. Pet. App. 9a. Thus, for example, the FCC rejected a historical cost methodology on the grounds that it would reward past incumbent inefficiency, send the wrong price signals to new entrants, and deny consumers the benefits of competition-based rates. *Local Competition Order* ¶¶ 704-711 (JA 397-403). The FCC rejected the "efficient component pricing" method ("ECPR") on the grounds that it would (by granting incumbents the full measure of profit they would otherwise lose to competition) inappropriately inflate costs borne by new entrants.[9] *Id.* ¶¶ 708-711 (JA 401-03); *see also id.* ¶ 662 (JA 368) (discussing comments of Professors Baumol, Ordover and Willig). And the FCC rejected "Ramsey pricing" on the ground that it was particularly ill-suited to the goals of the 1996 Act, *id.* ¶ 696 & n.1700 (JA 390-91),[10] concluding, as did the Interstate

[9] ECPR begins with forward-looking costs, to which "opportunity costs" are added. *See* Nicholas Economides & Lawrence J. White, *Access and Interconnection Pricing: How Efficient is the "Efficient Component Pricing Rule"?*, 40 Antitrust Bull. 557, 562 (1995). These opportunity costs are particularly inappropriate in a competitive market, because they represent the difference between retail rates and cost. As Professors Baumol, Ordover, and Willig explained, because "[c]ross-subsidies are common in the rate structure, and rates depart systematically from pertinent costs . . . applying ECPR to the existing rate structure would result in component prices that lock in the ILECs' monopoly profits and inefficiencies, would attract inefficient entry when rates are too high, and would preclude efficient entry where rates are too low." Affidavit of Baumol, Ordover, and Willig ¶¶ 22-23 (attached to AT&T Comments, CC Docket No. 96-98 (FCC filed May 16, 1996)) (JA 66-67). This problem is compounded because, in many States, retail rates have been inflated to encourage incumbent LEC infrastructure development. *See Who's Taking Whom* at 260-61. Thus, the use of ECPR not only locks in rates that are already inflated, it would also frequently require new entrants to subsidize the modernization of the incumbents' networks.

[10] The Commission concluded that Ramsey pricing – which allocates more joint and common costs to services with relatively inelastic demand – "could unreasonably limit the extent of entry into local exchange markets by allocating more costs to, and thus raising the prices of, the most critical bottleneck inputs, the demand for which tends to be relatively inelastic." *Id.* ¶ 696 (JA 390-91).



Commerce Commission before it, that the use of Ramsey pricing is also "too difficult and burdensome for universal application" because it requires "the elasticity of demand to be quantified" for every element that will be priced. *See Coal Rate Guidelines*, 1 I.C.C.2d 520, 527 (1985).

**The FCC Assessed TELRIC's Practicality.** The FCC also rejected the argument raised by the incumbents that a forward-looking cost methodology such as TELRIC was beset by practical difficulties. The Commission concluded that forward-looking cost methodologies are practical, relying in part on the fact that States had already chosen to use them, and advocated their use in comments submitted in the rulemaking proceedings. *Local Competition Order* ¶¶ 631 & n.1508, 635 & n.1529, 681 (JA 334-36, 340-42, 381). Indeed, regulators have increasingly turned to this methodology precisely because of its practical advantages. The methodology relies on data that are objective and verifiable. For example, long-run incremental costs are calculated on the basis of actual equipment that is on the market today. The network architecture is also modeled using objective, verifiable data such as population data taken from U.S. Census Bureau reports, locations of businesses taken from Dun and Bradstreet, and topography data taken from the U.S. Geological Survey. *See* Hatfield Model Release 5.0 Model Description, Section 5, CC Docket 96-45 (FCC filed Dec. 11, 1997). Computer modeling – which allows this data to be transformed into discrete cost figures – has made the use of forward-looking cost methodologies both "practical and implementable."

Indeed, regulators have increasingly come to recognize that it is traditional rate-of-return regulation that is impractical and unreliable, for it necessarily depends on the incumbents' impenetrable financial and engineering records or on other selfserving information not subject to verification. But those records are inherently flawed as a source for setting fair and accurate rates. As the FCC recently observed, the incumbents' books are filled with "phantom assets," the existence of which cannot be verified. *See, e.g.*, *FCC Releases Audit Reports on RBOCs' Property Records*, Report No. CC 99-3, 1999 WL 95044 (FCC Feb. 25, 1999) (finding that ILEC "book costs may be overstated by approximately $5 billion").

Even if the incumbents' books did not contain padded investments, the way in which their cost data is recorded precludes using their books to set rates for individual network elements. "[T]he accounting systems currently used by the ILECs do not contain the data that is required for making pricing decisions regarding the provision of [unbundled elements] and the pricing of interconnection" because the data is "not maintained at a level of granularity that is sufficient for determining the costs of individual components of the network." *Who's Taking Whom* at 255. For example, one accounting category of cost tracked by the incumbents is "outside plant." This account includes all costs associated with the copper and/or fiber that runs to individual homes, as well as the fiber that runs between switches in the incumbent's network. But at least three different network elements are subsumed within that aggregate figure (local loops, "network interface devices" that connect the home to the local loop, and transport facilities). The aggregate "outside plant" figures cannot be disaggregated to determine the historical cost for each of the elements. *See id.*[11] Indeed, the incumbents

[11] For this reason States have urged the FCC to mandate that costs be tracked in more narrowly defined accounts. *See In re 2000 Biennial Regulatory Review*, Notice of Proposed Rulemaking, CC Docket No. 00-199, FCC No. 00-364 ¶ 20 (rel. Oct. 18, 2000).



themselves have been forced to rely on modeling in an effort to disaggregate those costs.

Another problem is that the incumbents' books are maintained on a state-wide basis. The FCC has concluded, however, that costs must be separately assessed for high and low cost areas within a State. *See* 47 C.F.R. § 51.507(f) (requiring costs to be "deaveraged" into at least three zones per State); *Local Competition Order* ¶¶ 764-765 (JA 424-25) (same). If this were not done, costs would be inflated in densely populated areas while costs in rural areas would be artificially low, creating an implicit subsidy of high cost areas in violation of § 254's mandate that subsidies for universal service be explicit. It would also fundamentally undermine the Universal Service program implemented by the FCC, in which carriers serving high cost areas receive subsidies from the FCC's high cost fund that allow them to serve rural customers at retail rates lower than the costs would otherwise allow.

Even if these problems could be overcome, calculating "historical" costs would be a difficult process, requiring numerous predictive, and necessarily hypothetical, judgments. For example, under a historical cost approach, regulators set rates based on a firm's costs, discounted by costs determined by the regulator to have been "imprudent," or no longer "used and useful." *NEPCO Mun. Rate Comm.*, 668 F.2d at 1333. These standards require the agency to make judgments about prospective cost and demand judgments that require considerable speculation and by definition are hypothetical in nature. In short, "*any* system of pricing involves the exercise of judgment. The question is whether that judgment should be employed in order best to apply economically efficient principles or irrational principles." I Alfred E. Kahn, *The Economics of Regulation*, at 198-99 (1989) (emphasis added).

**The FCC's Efficiency Assumptions Are Reasonable.** The FCC also gave careful consideration to, and rejected, the incumbents' assertion that the use of a forward-looking cost methodology is flawed because it assumes that a given carrier's network will constantly be updated with the newest technology available. TELRIC makes no such assumption. A rate set on the basis of forward-looking cost is not designed to mirror any given carrier's physical network on a day-to-day basis. Instead, it reproduces what carriers would be able to charge for elements in their network in a competitive environment. That will reflect changes in technology, because they will be the costs incurred by new entrants, who set market rates. Thus, for example, if the cost of new computers dramatically decreased due to an advance in technology, a new entrant would enter the market, buy the less expensive computers, and compete on the basis of their cost. Although an existing competitor would not immediately rush out and replace its existing stock of computers, it would be forced to set its prices at levels that reflect the reduced cost of new entrants.

Nor does TELRIC calculate network costs that evolve daily. First, the FCC's methodology assumes that serving wire centers (which house incumbents' switches) remain in their existing locations in the incumbents' networks, even if a new entrant would configure the network more efficiently. Thus, TELRIC does not assume a perfect network, but assumes a mix of the old and the new. Moreover, TELRIC provides an economic snapshot of the costs an efficient carrier would incur to provide network elements at the time the methodology is applied. The rates are calculated at the beginning of a lengthy arbitration process, and are then incorporated into agreements that typically extend for three or four years. Finally, to the extent the incumbents believe that the rates generated do not take into account any theoretical lag between the introduction



of a new technology and the adoption of that technology, TELRIC accommodates this concern as well. If incumbents believe that the introduction of new technology reduces the useful life of equipment, they can – as they have acknowledged – urge the state commission setting network element rates to shorten depreciation lives. *See* Declaration of Alfred Kahn and Timothy Tardiff, ¶ 8a (attached to Bell Atlantic Reply Comments, CC Docket No. 96-98 (FCC filed May 30, 1996)) (JA 155). And to the extent incumbents believe the advent of competition increases their market risk, they can – as they have acknowledged – address this by seeking increases in the cost of capital set by the States who ultimately administer the pricing methodology the FCC has established. *Id.*

**The FCC Fully Considered Whether TELRIC Would Create Appropriate Incentives.** Finally, the FCC considered the incumbents' concerns that the use of a "pure" TELRIC methodology would create disincentives to building competing networks, and would instead encourage new entrants to rely exclusively on leased network elements. By taking the existing locations of incumbent wire centers as a given (and thereby incorporating inefficiencies in the design of existing networks), TELRIC foregoes some measure of efficiency in calculating forward-looking rates, thereby assuring that they will meaningfully exceed the true cost of efficient entry. That pragmatic compromise on the FCC's part was designed specifically to respond to the incumbents' concerns that TELRIC would have this deterrent effect. *Local Competition Order* ¶ 685 (JA 383-84) (concluding that "this approach encourages facilities-based competition to the extent that new entrants, by designing more efficient network configurations, are able to provide the service at a lower cost than the incumbent LEC").

Even without this concession, TELRIC would not be open to the criticism that it discourages the construction of competing networks. As the FCC recognized, a number of factors incline new entrants to invest in their own facilities. There is, for example, a long and sorry history of nonprice discrimination by incumbents against new entrants with whom they compete, and avoidance of the risk of such treatment is a powerful reason for new entrants to want to control their own facilities. *See id.* ¶ 307 (JA 299-300). No new entrant wants to be dependent on its dominant competitor for a key input and will avoid such dependence. New entrants also will want to be the first to market with innovations, which facilities-based competition makes possible in a way that reliance on the incumbents' facilities does not. *See IUB*, 120 F.3d at 817. The FCC's predictive judgment that these market forces will provide new entrants with additional incentives to build their own facilities is entitled to particular deference. *See Baltimore Gas & Elec. Co.*, 462 U.S. at 103; *Turner Broad. Sys., Inc.*, 520 U.S. at 196; *National Citizens Comm. for Broad.*, 436 U.S. at 814.

Moreover, the FCC's predictions in this area have proven to be correct. As counsel for Verizon has acknowledged, by 1999 competitors had invested nearly 30 billion dollars in facilities of their own, and in the five years since the passage of the Act, spending on new infrastructure by local competitors has increased by over 400%. *See* Michael Glover & Donna Epps, *Is the Telecommunications Act of 1996 Working?*, 52 Admin. L. Rev. 1013, 1015 (2000). And by the second quarter of 2000, more customers served by new entrants were served through the use of the new entrants' own facilities than were served by any other method. ALTS Report at 12.



In the final analysis, TELRIC reflects the FCC's informed predictive judgment that reliance solely on the construction of competing networks would produce limited competition in select geographic areas, and only after many years – whereas allowing the alternative of leasing unbundled network elements would allow new entrants to establish themselves in local markets more quickly and more flexibly than they could relying solely on constructed facilities. To the extent the events of the past five years have proven anything, they have proven that the FCC was too optimistic in its hopes that the alternatives of leasing elements or reselling incumbent services would swiftly produce significant competition. There is simply no basis for concluding that the FCC's pricing determinations are arbitrary.

## II. FCC RULES 315(C)-(F) ARE LAWFUL.

Section 251(c)(3) imposes on incumbent carriers "[t]he duty to provide, to any requesting telecommunications carrier for the provision of a telecommunications service, nondiscriminatory access to network elements," and provides that incumbent carriers "shall provide such network elements in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service." 47 U.S.C. § 251(c)(3). In the *Local Competition Order*, the FCC interpreted the phrase "that allows requesting carriers to combine such elements" to mean "that incumbents must provide unbundled elements in a way that *enables* requesting carriers to combine them to provide a service." *Local Competition Order* ¶ 294 (JA 296-97). Mindful of the incumbents' traditional control over the entire local network, and recognizing the difficulties new entrants might encounter trying to combine an incumbent's network elements to provide telecommunications services, the FCC adopted rules requiring incumbents to provide combinations of network elements for requesting new entrants. *See id.* ¶¶ 292-297 (JA 295-99). The FCC thus adopted Rule 315(b), which forbids an incumbent from providing previously combined network elements in discrete parts by separating them. 47 C.F.R. § 51.315(b). The FCC also promulgated Rule 315(c), which provides that where technically feasible, incumbents must, on request, "perform the functions necessary to combine unbundled network elements in any manner, even if those elements are not ordinarily combined in the incumbent LEC's network," *id.* § 51.315(c), and Rule 315(d), which requires incumbents to "perform the functions necessary to combine unbundled network elements with elements possessed by the requesting telecommunications carrier in any technically feasible manner," *id.* § 51.315(d).[12]

The validity of FCC Rules 315(c)-(f) is (like the pricing issue discussed in Point I) governed by *Chevron*. Application of step one of *Chevron* to Rules 315(c)-(f) is straightforward, because this Court has already determined that § 251(c)(3) is ambiguous as to whether incumbents can be required to combine network elements. The Eighth Circuit's contrary conclusion must therefore be reversed. Accordingly, the FCC's rules must be upheld under the second step of *Chevron* unless they are so inconsistent with the statute's design as to be unreasonable. Rules 315(c)-(f), like Rule 315(b), represent the FCC's considered judgment that incumbents, as opposed to

[12] Rule 315(c) provides that incumbent carriers must combine network elements "in any manner, even if those elements are not ordinarily combined in the incumbent LEC's network, provided that such combination is: (1) Technically feasible; and (2) Would not impair the ability of other carriers to obtain access to unbundled network elements or to interconnect with the incumbent LEC's network." 47 C.F.R. § 51.315(c). Rules 315(e) and (f) set forth the burdens of proof applicable to the technical feasibility and impairment standards of subsections (1) and (2) of Rule 315(c). *Id.* § 51.315(e), (f).



new entrants, are in the best position to perform the function of combining their network elements with each other and with those of requesting new entrants. That judgment is consistent with the Act's language and purpose and is entitled to this Court's deference.

### A. The Court Has Already Held that the Act Authorizes a Requirement that Incumbents Provide Network Elements in Combined Form.

This Court's prior ruling in *AT&T* forecloses any argument that Congress denied the FCC the authority to implement Rules 315(c)-(f). In *AT&T*, the Court squarely rejected the argument that § 251(c)(3) requires incumbents to provide network elements *only* in physically separate pieces. The incumbents argued there that the statutory language required a new entrant to combine leased elements. *AT&T*, 525 U.S. at 394. Reasoning that the 1996 Act places the obligation of combining network elements solely on the new entrant, the incumbents argued that they were free to separate previously combined network elements into distinct pieces.[13] The Court rejected this interpretation. *Id.* As the Court explained, although the Act "assuredly contemplates that elements may be requested and provided in [separate] form, it does not say, or even remotely imply, that elements must be provided only in this fashion and never in combined form." *Id.* The Court also rejected the incumbents' argument that the Act's requirement that incumbents lease network elements "on an unbundled basis"

[13] *See* Brief of Bell Atlantic Corp., *et al.*, *AT&T Corp. v. Iowa Utils. Bd.*, No. 97-826, at 46-47, 53 (U.S. filed May 18, 1998); Brief for Resp. GTE Entities & Cross-Pet. GTE Midwest Inc., *AT&T Corp. v. Iowa Utils. Bd.*, No. 97-826, at 66-67 (U.S. filed May 18, 1998); Opening Brief of Resp./Cross-Pet. US West, Inc., *AT&T Corp. v. Iowa Utils. Bd.*, No. 97-826, at 47-48 (U.S. filed May 18, 1998).

means "physically separated." *Id.* To the contrary, the Court held, the plain meaning of "unbundled " refers to separate *prices* – not separate pieces – of network elements. *Id.*

The Court's interpretation of the 1996 Act applies with equal force to Rules 315(c)-(f). Because § 251(c)(3) does not mandate that network elements be leased only in separate pieces to be combined by the requesting new entrant, a rule requiring incumbents to combine their network elements in new ways, or with elements possessed by the new entrant, falls well within the permissible scope of § 251(c)(3). As this Court noted in reviewing Rule 315(b), "[t]he reality is that § 251(c)(3) is ambiguous" as to who should do the combining and, pursuant to *Chevron*, the FCC's reasonable regulatory implementation of this language must be upheld. *See AT&T*, 525 U.S. at 395. For this reason, courts of appeals other than the Eighth Circuit have upheld state commission requirements that mirror FCC Rules 315(c)-(f). *See US West Communications, Inc. v. Hamilton*, 224 F.3d 1049, 1056-57 (9th Cir. 2000); *MCI Telecommunications Corp. v. US West Communications*, 204 F.3d 1262, 1268 (9th Cir.), *cert. denied*, 121 S. Ct. 504 (2000); *US West Communications v. MFS Intelenet, Inc.*, 193 F.3d at 1121; *see also Southwestern Bell Tel. Co. v. Waller Creek Communications, Inc.*, 221 F.3d 812, 821 (5th Cir. 2000).

The Eighth Circuit's conclusion that Rules 315(c)-(f) violate the Act cannot be squared with this Court's decision in *AT&T*. Indeed, the Eighth Circuit repeated precisely the error of its prior opinion, once again holding that "Congress has directly spoken on the issue of who shall combine previously uncombined elements. It is the requesting carrier who shall 'combine such elements.'" Pet. App. 22a. But this Court made clear that the language in § 251(c)(3) is ambiguous as to who should do the combining. And that holding applies equally to



a requirement that incumbents combine elements that were not previously combined within their own networks. Indeed, under the Eighth Circuit's reading of the Act, the plain language of the Act prohibits any FCC rule other than one requiring incumbents to provide access to unbundled network elements *only* in separated fashion. *Id.* Thus, the Eighth Circuit's "*Chevron I*" ruling invalidating FCC Rules 315(c)-(f) must be reversed for the same reason this Court previously reversed the Eighth Circuit's invalidation of FCC Rule 315(b).

### B. The FCC's Requirement that Incumbents Perform the Functions Necessary to Combine Elements Is Reasonable.

Because the statute does not forbid the FCC from requiring incumbents to lease network elements in combined form, the FCC's decision about how to implement § 251(c)(3) must be upheld if it is reasonable. And where, as here, the agency responsible for administering the Act makes a predictive judgment about how best to implement the Act's technical provisions, the FCC's decision is entitled to particular deference. *See Pauley v. BethEnergy Mines, Inc.*, 501 U.S. 680, 697 (1991) (deferring to agency's expertise and judgment in context of "complex and highly technical regulatory program"); *see also National Fed'n of Fed. Employees v. Dep't of Interior*, 526 U.S. 86, 99-100 (1999); *Aluminum Co. of Am. v. Central Lincoln Peoples' Utility District*, 467 U.S. 380, 390 (1984); *Baltimore Gas & Elec. Co.*, 462 U.S. at 103.

Rules 315(c)-(f) are reasonable implementations of § 251(c)(3). The FCC concluded that the statutory language requiring incumbents to provide unbundled network elements "in a manner that allows requesting carriers to combine such elements in order to provide" telecommunications services "does not impose the obligation of physically combining elements exclusively on requesting carriers. Rather, it permits a requesting carrier to combine the elements if the carrier is reasonably able to do so. If the carrier is unable to combine the elements, the incumbent must do so." *Local Competition Order* ¶ 294 (JA 296-97).

Given the incumbents' control over existing networks and the difficulties new entrants would face attempting to combine network elements within the incumbents' networks, the FCC concluded that the 1996 Act's goals would be furthered by a requirement that the incumbents do the combining. The FCC therefore adopted Rules 315(c)-(f) to ensure that new competitors are not "seriously and unfairly inhibited in their ability to use unbundled elements to enter local markets." *Id.* ¶ 293 (JA 295-96). In particular, the FCC noted that "in practice it would be impossible for new entrants that lack facilities and information about the incumbent's network to combine unbundled elements from the incumbents' network without the assistance of the incumbent." *Id.* Absent a requirement that the incumbent do the combining, the FCC concluded, competitors could not use unbundled network elements – the most promising of the Act's mechanisms for developing competition – to provide local service. The FCC's decision to adopt Rules 315(c)-(f) was thus motivated by the same policy concerns that support Rule 315(b): to "ensur[e] against an anticompetitive practice." *AT&T*, 525 U.S. at 395.

The FCC's judgments that incumbents are best situated to combine their network elements, and that new entrants will encounter significant difficulties trying to combine an incumbent's elements, are entitled to special deference. *See Baltimore Gas & Elec.*, 462 U.S. at 103. Indeed, the FCC's predictions have been borne out in practice. Despite the Eighth



Circuit's blithe assertion in *IUB* that "the fact that the incumbent LECs object to [the FCC's combinations] rule[s] indicates . . . that they would rather allow entrants access to their networks than have to rebundle the unbundled elements for them," 120 F.3d at 813, incumbents have repeatedly indicated that they would *not* allow new entrants to access their facilities in order to combine elements. In state arbitrations, for example, Southwestern Bell has asserted that the Texas Commission must deny such access because Southwestern Bell "has grave concerns regarding the implications of such an order on the security, integrity and reliability of its network; the quality of its service, and the privacy of its customers." Brief on Eighth Circuit Alternatives, *In re Petition of MFS,* Docket Nos. 16189 *et al.*, at 11 (Tex. Pub. Util. Comm'n filed Oct. 27, 1997). The former Bell Atlantic has similarly warned against allowing a new entrant's employees "with wire snips and screwdriver in hand, to work on" its equipment. Joint Brief of Interveners in Support of the FCC, *Iowa Utils. Bd. v. FCC*, No. 96-3321, at 59 (8th Cir. filed Aug. 16, 1999) (quoting Statement of Donald Albert ¶ 23). For its part, BellSouth has termed such access "an unwarranted and illegal intrusion." *Id.* (quoting Reply Affidavit of Alphonso Varner at 14). The incumbents' refusal to allow new entrants access to their facilities underscores that the FCC correctly determined that Rules 315 (c)-(f) are necessary to ensure that new competitors are not "seriously and unfairly inhibited in their ability to use unbundled elements to enter local markets." *Local Competition Order* ¶ 293 (JA 295-96).[14]

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[14] *See also In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, Third Report and Order and Fourth Notice Proposed Rulemaking, 15 F.C.C.R. 3696, ¶ 482 (1999) (noting that "[e]xperience over the last year demonstrates that incumbent LECs have refused to provide access to network elements so that competitors could combine them" except in very limited circumstances).

This issue has taken on even greater importance because incumbents are rapidly expanding the scope of what they claim are "new" combinations in order to avoid the obligations imposed by Rule 315(b). Incumbents consistently assert that any instance in which they have to combine elements, whether physically or electronically, is a new combination that they do not have to provide, even if such a combination is a typical fixture in the incumbent's network. When a consumer orders a second line for Internet use, for example, incumbents have asserted that attaching the loop from that house to the incumbent's switch constitutes a new combination that need not be provided to new entrants pursuant to § 251(c)(3). This leads to the anticompetitive result that, if a customer orders a second line, that customer must first obtain service from the incumbent (which does the combining) and then switch providers.

The incumbents' cramped reading of what constitutes a "new" combination is inconsistent with the FCC's own interpretation of its rules (to which particular deference is due) and would seriously undermine the obligation to provide existing combinations that this Court upheld in *AT&T*. In the *Local Competition Order*, the FCC made a technical determination that incumbents should be required to perform the combining, and promulgated the various parts of Rule 315 to ensure that incumbents abided by that obligation to combine in a variety of different circumstances, provided it was technically feasible. That regulatory scheme is fully consistent with the language of the Act, and with the FCC's authority to implement the Act's technical provisions. This Court should reinstate Rules 315(c)-(f) and put a stop to the incumbents' dogged attempt to evade their responsibilities under the FCC's regulatory framework.

Nor is there any merit to the incumbents' suggestion that Rules 315(c)-(f) impermissibly require incumbents to bear the



cost of combining. *See, e.g.*, Brief in Opp. of Bellsouth, SBC, and Verizon at 22-23 (U.S. filed Nov. 17, 2000). As with all leasing of unbundled network elements, new entrants who ask incumbents to combine network elements will pay the cost of leasing such elements, including the cost associated with combining the elements. This arrangement is entirely consistent with the Act's language and purpose. *See, e.g.*, *US West v. MFS Intelenet*, 193 F.3d at 1121 & n.7 (upholding provision that states "USWC agrees to perform and MFS agrees to pay for the functions necessary to combine requested elements in any technically feasible manner either with other elements from [US West's] network, or with elements possessed by MFS"). Especially in light of their recent tactics, it is abundantly clear that the incumbents' complaint about Rules 315(c)-(f) is nothing more than a reiteration of their longstanding resistance to providing network elements to new entrants in a manner that allows the new entrants to provide a finished telecommunications service. *See, e.g.*, Brief of Bell Atlantic Corp., *et al.*, *AT&T Corp. v. Iowa Utils. Bd.*, No. 97-826, at 46-47, 56 (U.S. filed May 18, 1998) (complaining that new entrants should not have access to existing combinations of network elements where the incumbent "invested time and effort to combine the constituent elements"); Opening Brief of Resp./Cross-Pet. U S West, Inc., *AT&T Corp. v. Iowa Utils. Bd.*, No. 97-826, at 47-48 (U.S. filed May 18, 1998) (arguing that Rule 315(b) should be invalidated because it unfairly provides new entrants with access to existing combinations when "it was the incumbent that did the work and spent the money to design a network and combine the individual elements that comprise it"). But this Court flatly rejected that argument in *AT&T*, 525 U.S. at 395, and should do so here as well.

## CONCLUSION

The Eighth Circuit's decision should be reversed.

Respectfully submitted,

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