GRANTED

Supreme Court, U.S.
FILED
JUL 23 2001
OFFICE OF THE CLERK

No. 00-555

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

---

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

THOMAS F. O'NEIL III
WILLIAM SINGLE, IV
WORLDCOM, INC.
1133 19th Street, N.W.
Washington, D.C. 20036
(202) 736-6096

DONALD B. VERRILLI, JR.*
JODIE L. KELLEY
IAN HEATH GERSHENGORN
JENNER & BLOCK, LLC
601 13th Street, N.W.
Washington, D.C. 20005
(202) 639-6000

Counsel for Petitioner WorldCom, Inc.

July 23, 2001

* Counsel of Record

[*Additional Counsel Listed on Inside Cover*]

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20001

JONATHAN M. ASKIN
THE ASSOCIATION FOR
LOCAL TELECOMMUNICATIONS
SERVICES
888 17th Street, N.W.
Suite 900
Washington, D.C. 20006
(202) 969-2597

Counsel for Petitioner the Association for Local Telecommunications Services

CAROL ANN BISCHOFF
ROBERT M. MCDOWELL
COMPETITIVE
TELECOMMUNICATIONS
ASSOCIATION
1900 M Street, N.W.
Suite 800
Washington, D.C. 20036
(202) 296-6650

ROBERT J. AAMOTH
KELLEY DRYE &
WARREN LLP
1200 19th Street, N.W.
Suite 500
Washington, D.C. 20036
(202) 955-9600

Counsel for Petitioner Competitive Telecommunications Association

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page

CASES

TABLE OF AUTHORITIES - continued

Page

TABLE OF AUTHORITIES - continued

Page

STATUTES

ADMINISTRATIVE RULINGS

MISCELLANEOUS

TABLE OF AUTHORITIES - continued

Page

The response briefs of the incumbent carriers are audacious in their disregard for both the governing law and the facts. The incumbents have made almost no effort to show that the TELRIC pricing and network element combinations rules of the Federal Communications Commission ("FCC") violate any rule of law. The brief of BellSouth *et al.,* No. 00-555 ("ILEC Br.") does not even cite *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), or acknowledge the rule that courts should defer to reasonable agency judgments on matters of economic policy – especially those involving predictive judgments about dynamic and evolving markets. Instead, advancing arguments appropriate to a theoretical seminar in regulatory economics, the incumbents invite this Court to brush aside the FCC's policy judgments, and to decide for itself how to bring competition to local telephone markets.

To make matters worse, the incumbents' policy arguments depend on empirical claims that find no support in the administrative record, and for which the incumbents cannot even muster plausible extra-record support – claims, for example, that under TELRIC "[n]etwork-element rates have been set at only *one-half* or even *one-third* of historical cost," (ILEC Br. at 6), that the incumbents face ruinous losses and billions in unrecoverable investments, and that the FCC's TELRIC methodology was expressly designed to impose such harsh results. All of those claims are false. Indeed, despite the FCC's purported giveaway to new entrants, the incumbents continue to earn excessive returns on their 92% share of local markets, and are exploiting the 1996 Act to enter in-region long distance markets across the country. Meanwhile, under the current regime, competitive local carriers are struggling to stave off bankruptcy, and Congress' goal of competitive local markets remains a distant prospect. The incumbents thus come to this Court not to reform local competition, but to bury it.

The FCC, however, has violated no "clear limit[]" in the 1996 Act, *see AT&T Corp. v. Iowa Utilities Board*, 525 U.S. 366, 397 (1999), has exercised its delegated authority "in a way that is reasonable in light of the legislature's revealed design," *Lopez v. Davis*, 531 U.S. 230, 242 (2001) (quotation and citation omitted), and has adopted a policy that has not been shown (and could not be shown) to pose any risk of denying just compensation under the Fifth Amendment. This Court should therefore affirm the FCC in all respects.

I. TELRIC IS CONSISTENT WITH § 252(d)(1).

There is no basis for the incumbents' argument that Congress "spoke[] to the precise question at issue" in § 252(d)(1) and unambiguously foreclosed TELRIC. *See Chevron*, 467 U.S. at 842. The incumbents do not deny that § 252(d)(1) confers broad methodological leeway. Specifically, the incumbents do not contend that the term "cost" in § 252(d)(1) forecloses forward-looking cost measures such as TELRIC. Qwest even concedes that the FCC "could have chosen a variety of pricing methodologies that were consistent with the Act" – including forward-looking methodologies. Qwest Br. No. 00-511 at 38-39 ("Qwest Br."). Nor do the incumbents purport to defend the Eighth Circuit's decision on its own terms. Although the appeals court invalidated the portion of the FCC's rules requiring that rates be based on efficient replacement cost, it upheld the FCC's rule forbidding consideration of the incumbents' historical costs. Thus, if the Eighth Circuit were upheld, rates would have to be based either on the cost of replicating the existing network today (with all its inefficiencies) or on the short-term incremental cost of providing network elements.

The incumbents instead raise a different statutory challenge to TELRIC, which rests on the phrase "of providing" in § 252(d)(1). They contend that the cost "of providing" a network element must be the actual cost incurred by the entity that provides it – *i.e.*, the incumbent – and not the "hypothetical" cost of providing that element efficiently. But

that begs the question. If "cost" can mean "forward-looking cost" (a point Qwest concedes and no other incumbent contests) and if "forward-looking cost" can mean "efficient replacement cost" (a point no party disputes) then the statutory reference to "the cost . . . of providing" a network element can certainly mean the efficient replacement cost of the element the incumbent provides. An asset's replacement cost is "the present cost of obtaining the identical service that the old asset provides." *See* Stephen Breyer, *Regulation and Its Reform* 38 (1982). The forward-looking "cost . . . of providing" a network element is, therefore, what it would cost under current conditions to obtain the function the element provides. That is what TELRIC measures, and it will be no different for the incumbent than for an efficient new entrant. Thus, § 252(d)(1) cannot be read as foreclosing TELRIC.

The incumbents' extended contrary argument seeks to establish that TELRIC necessarily fails to capture the "cost . . . of providing" network elements because neither incumbents nor new entrants starting from scratch will ever be able to achieve the kinds of efficiencies TELRIC assumes. That, however, is not a statutory construction argument. Rather, it is an argument that TELRIC is an unreasonable means of implementing the statutory command. As such, it should be tested (and upheld) under the deferential standards applicable to agency policy judgments.

II. TELRIC REASONABLY IMPLEMENTS THE 1996 ACT.

The FCC's TELRIC methodology is reasonable in every respect.

1. At the outset, it is necessary to respond to the incumbents' general effort to discredit TELRIC by alternatively disparaging it as a "throw-back to times long past" (ILEC Br. at 3) or a radical "new methodology." *Id.* at 2. TELRIC is

neither. To the contrary, it is widely used today by regulators in a variety of contexts. In particular, TELRIC is indistinguishable from the methodologies prescribed in numerous state statutes and regulations mandating the use of forward-looking costs. *See* Appendix A (listing state statutes and rules). The incumbents seek to distinguish these state provisions as merely seeking to create price floors for retail rates, in order to prevent predatory pricing by incumbents in competitive markets. But that is false. Many of the provisions specifically apply to carrier-to-carrier rates for interconnection and network elements. The incumbents thus retreat to the argument that States adopted TELRIC pricing involuntarily, with the *Local Competition Order*[1/] (though stayed by the Eighth Circuit) dangling over them like a sword of Damocles. That too is false. States had adopted TELRIC before the FCC acted, and many advocated similar methods during the FCC rulemaking proceeding. *Local Competition Order* ¶¶ 671 & n.1675, 681 & n.1687 (JA 374-75, 381). Indeed, the FCC explicitly modeled TELRIC on those progressive state provisions. *Id.* ¶ 681 (JA 381). That is doubtless why the National Association of Regulatory Utility Commissioners has filed a brief supporting TELRIC.

The FCC's decision to rely on these state efforts to open local markets was entirely reasonable. The FCC understood that while there were competing ways to calculate a carrier's "costs" – as the statute commanded – those differences implicated different policy judgments about the proper way to implement the Act. The FCC noted that the weight of expert economic testimony in the record supported forward-looking methods such as TELRIC, *id.* ¶ 705 (JA 398-99), as did the 1996 Act's goal of transforming local telephone monopolies

---

1/ *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, 11 F.C.C.R. 15499 (1996) ("*Local Competition Order*").

into competitive markets. TELRIC sends the correct price signals to potential market entrants, allowing them to build when it is more efficient to do so, and to lease when building competing facilities would be inefficient. *Id.* ¶ 679 (JA 379-80). TELRIC also prevents incumbent carriers from engaging in "price squeezes" with respect to network elements having natural monopoly or "bottleneck" characteristics. *Id.* ¶¶ 11, 635, 679 (JA 270-71, 340-42, 379-80). Indeed, TELRIC pricing was necessary to allow new entrants to build competing facilities because they would need to incorporate incumbents' bottleneck facilities into their own networks, especially in the near term. *Id.* ¶ 679 (JA 379-80).

2. The incumbents' principal argument is that TELRIC nevertheless should be invalidated because it systematically underestimates the costs any market participant – incumbent or new entrant – will incur. The incumbents have conceded that long run incremental cost generally is the correct method for setting rates (especially in a competitive market). *See* WorldCom Br. No. 00-555 at 12 & n.4. They nevertheless claim that such methods will underestimate costs in the present context because it is characterized by high levels of sunk investment, rapid cost declines, and "constant and often unforseen" innovation. ILEC Br. at 5. That argument is wrong for three reasons: (i) it is based on entirely contrived premises and multiple misrepresentations about how TELRIC works; (ii) it depends on hotly contested expert arguments that the FCC considered and rejected in favor of other expert analysis; and (iii) it is nothing more than a premature claim that depreciation rates and cost of capital will not be set appropriately by the States in subsequent proceedings.

a. The incumbents have grossly exaggerated the extent to which declining costs put their sunk investments at risk. Although the computer-based elements of the network (such as the switches) may be characterized by declining costs, other elements (such as the loop plant) are not declining; for many elements costs are rising. Indeed, in the FCC's price cap proceedings (where an assumption of declining costs would have reduced LEC revenues), respondent USTA made an argument directly contrary to the one it makes here, asserting that its capital costs are not declining at all, and "that the prices LECs pay for the resources they use in producing telecommunications services change at about the general rate of inflation." *In re Price Cap Performance Review for Local Exchange Carriers*, Fourth Report and Order, 12 F.C.C.R. 16642, ¶ 95 (1997).

The incumbents have likewise caricatured TELRIC in their effort to show that it underestimates costs. They assert, for example, that TELRIC requires that network element rates be recalculated downward every time any innovator comes up with a new approach "in a lab." Qwest Br. at 30. That is false. TELRIC rates are calculated on the basis of the most efficient technology that is *generally available* and actually in use – that is, available to any potential new entrant – and not on the basis of prototypes or proprietary innovations the rights to which a single competitor controls. 47 C.F.R. § 51.505(b)(1). Moreover, TELRIC rates are not constantly updated as new technology hits the market. Rates are calculated during a lengthy arbitration process, and are then incorporated into agreements that typically extend for three or four years. They are a snapshot, not a moving picture, and do not incorporate technological advances during the period in which they remain in place. Thus, it is simply not the case that the relevant costs of local carriers are hurtling downward, or that TELRIC rates reflect the leading edge of that mythical nosedive.

b. Even apart from these pervasive mischaracterizations, the incumbents have advanced no good reason for invalidating the FCC's choice of TELRIC. In this Court, the incumbents rely heavily on Professors Kahn and Hausman and other retained experts to support their argument that TELRIC fails to compensate them for "massive risk not present under historical-

cost methodologies – namely the risk that capital investment cannot be recovered where its value decreases due not to inefficient investment choices but to industry-wide cost trends." ILEC Br. at 4. But the incumbents proceed as though their experts were expounding an immutable law of nature, or speaking *ex cathedra*, when they claimed that TELRIC fails to account for the fact that no real-world competitor operates with only the most up-to-date equipment, and without charging above cost premiums to compensate for risk. Other experts, however, provided testimony that contradicted the views of the incumbents' experts, and provided specific, detailed criticisms of their analysis. Professor Baumol specifically explained that the incumbents' pessimism about TELRIC was unwarranted, and that TELRIC provides a revenue stream "sufficient to recoup the necessary investment over the lifetime of the pertinent assets." Reply Affidavit of Baumol, Ordover & Willig ¶ 3 (JA 141).[2/] Other experts explained that the risks could be fully compensated by selecting appropriate depreciation rates, and risk-adjusted costs of capital. MCI July 24, 1996 Ex Parte (JA 240-63).

On the basis of this record, the FCC expressly concluded that it disagreed with the incumbents that TELRIC

2/ *E.g.*, Affidavit of Baumol, Ordover & Willig (JA 58-82); Reply Affidavit of Baumol, Ordover & Willig (JA 140-48); AT&T July 19, 1996 Ex Parte (responding to Hausman) (JA 215-39); MCI July 24, 1996 Ex Parte (responding to Hausman) (JA 240-63). Of course, TELRIC is not meant to replicate the actual physical network that the incumbents will have in place at any point. It is designed to calculate what the incumbents could *charge* for network elements in a competitive market in which firms entered the market using efficient technology. In such a market, if the cost of new equipment declines, the rates the incumbent could charge for those elements in its network that perform the same function would be driven down, *even if the incumbent did not install a single piece of new equipment in its own network*. That does not mean that the incumbent cannot recover its costs – rather, appropriate depreciation rates will ensure adequate compensation.

"cannot account for risks that an incumbent LEC incurs because it has sunk investments in [its] facilities," *Local Competition Order* ¶ 686 (JA 384-85), and that "when there are mostly sunk costs, forward-looking economic costs should not be the basis for pricing interconnection elements," *id.* ¶ 703 (JA 396). It is not this Court's role to second-guess that judgment, which is supported by substantial evidence and is fully explained. "When specialists express conflicting views, an agency must have discretion to rely on the reasonable opinions of its own qualified experts even if, as an original matter, a court might find contrary views more persuasive." *Marsh v. Oregon Natural Resources Council*, 490 U.S. 360, 378 (1989); *FCC v. National Citizens Comm. for Broad.*, 436 U.S. 775, 811 (1978).

c. As the FCC correctly found, all the risks identified by the incumbents can be accounted for by setting proper depreciation rates and costs of capital. *Local Competition Order* ¶¶ 686, 703 (JA 384-85, 396). The FCC made clear that TELRIC depreciation rates should not be based merely on the useful life of network elements, but should account for economic depreciation, that is, the risk that technological change will make equipment obsolete. Thus, TELRIC can account for rapid technological change by depreciating assets over fewer years or relying on accelerated depreciation (*i.e.*, depreciating more of an asset's cost in the first years of its use). *Id.* ¶ 686 (expressing confidence "that parties to an arbitration with TELRIC studies can propose specific depreciation rate adjustments that reflect expected asset values over time") (JA 384-85); *id.* ¶ 29 ("States will determine, among other things, the appropriate risk-adjusted cost of capital and depreciation rates.") (JA 273-74). The FCC followed exactly the same approach respecting the cost of capital. Indeed, the FCC made crystal clear that "States may adjust the cost of capital if a party demonstrates to a state commission that either a higher or lower level of cost of capital is warranted" with respect to all

elements, or with respect to particular elements. *See also id.* ¶ 29 (JA 273-74). Such judgments can, of course, increase TELRIC rates and provide the incumbents with additional compensation.

TELRIC cannot be faulted for failing to account for these risks because the FCC's order does not purport to set depreciation rates or the cost of capital. It leaves those judgments to the States on the basis of records compiled in state proceedings. 47 C.F.R. §§ 51.505(b)(2), (b)(3). If, as the incumbents claim (but did not show in the FCC proceedings), they face serious risks of nonrecovery of capital investment, TELRIC rates can be adjusted to account for those risks. The incumbents nonetheless assert that in suggesting that current depreciation rates and costs of capital should serve as a starting place for analysis at the state level, the FCC denied them just compensation. That is not so. The FCC merely allocated to the incumbents the burden of justifying their claims about the pace of technological change. And with respect to cost of capital, the FCC merely required the incumbents to show that the risks of a competitive market would justify a cost of capital above the current 11.25% rate – a rate that the FCC explained appeared to be *high* taking into account market conditions that included the advent of competition. *Local Competition Order* ¶ 702 (JA 395-96).

Thus, the incumbents' argument that TELRIC is undercompensatory is not really a dispute with TELRIC itself, but an assertion that the States might apply it incorrectly. But States have been setting TELRIC rates for more than four years, and the incumbents have filed dozens of federal actions seeking review of those decisions under § 252(e)(6). In those concrete contexts, the incumbents have consistently failed to show any undercompensation. Indeed, in most cases they have not even bothered to try. In the unlikely event a State misapplies TELRIC to produce undercompensatory rates, the incumbents have a full remedy.

3. There is no merit to the incumbents' alternative argument that TELRIC defeats the 1996 Act's goal of promoting facilities-based competition. To begin with, the 1996 Act expresses no preference for facilities-based entry over other forms of competition. Its core provisions, §§ 251-252, mandate extensive sharing of the local network, and this Court has already held that neither the Act's text nor its purpose was violated by an FCC rule authorizing new entrants to compete exclusively through the leasing of unbundled elements. *AT&T*, 525 U.S. at 392-93. Indeed, § 271 of the Act expressly mandates unbundling of virtually the entire network as a minimum precondition to Bell Company entry into in-region long distance markets – a provision flatly at odds with what the incumbents contend was the congressional model.

Moreover, the FCC reasonably concluded that TELRIC would not deter new entrants from building competing facilities. New entrants have ample incentives to build their own facilities even if it would, theoretically, cost no more to lease the existing network. Most importantly, a new entrant that relies extensively on leasing from the incumbent subjects itself to serious risk of myriad forms of nonprice discrimination – the incumbent can delay processing orders, provide inferior or inadequate service, or otherwise degrade the quality of the product a new entrant can offer to its customers. Leasing also imposes substantial transaction costs that are avoided if a new entrant relies on its own facilities. And reliance on the incumbent sharply curtails the ability of new entrants to innovate or otherwise provide superior service to consumers.

In any event, the FCC made a pragmatic adjustment to TELRIC specifically to "mitigate[] incumbent LECs' concerns" in this regard. *Local Competition Order* ¶ 685 (JA 383-84). By basing rates on "the most efficient technology deployed in the incumbent LEC's current wire center locations," the FCC created added incentives for new entrants to build competing

facilities "by designing more efficient network configurations" than those of the incumbents. *Id.*

Experience has confirmed the FCC's predictive judgment. Although the incumbents make extravagant claims that, as a result of TELRIC, many entrants "rapidly changed their plans away from deploying competing facilities" (ILEC Br. at 8), the truth is that new entrants have invested more than *$56 billion* in their own facilities. *See* ALTS, *The State of Local Competition 2001* at 20 (Feb. 2001). WorldCom serves thousands of its customers entirely over its own network. New entrants generally use their own facilities and unbundled elements in roughly equal proportions. *Id.* Perhaps most tellingly, the incumbents themselves have managed to abstain from this "irresistible opportunity for regulatory arbitrage" (ILEC Br. at 3), having made no real effort to compete on each other's home turf by leasing network elements.

4. There is likewise no merit to the incumbents' argument that the FCC acted arbitrarily when it modified TELRIC to accommodate the incumbents' policy concerns. If it makes more sense to measure costs based on the existing serving wire centers, the incumbents argue, then it must make more sense to base costs on the existing equipment in the network as well. But the FCC did not adopt the "serving wire center" assumption to improve TELRIC's accuracy. Rather, the FCC departed from the pure model to address the possibility that the incumbents' policy argument might have some validity. This was precisely the kind of pragmatic adjustment that this Court has long held agencies must be free to make to reconcile the diverse and competing policy interests at stake in ratemaking. *See Duquesne Light Co. v. Barasch*, 488 U.S. 299, 313-14 (1989); *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 800 (1968).

III. TELRIC RAISES NO TAKINGS ISSUE.

The FCC's TELRIC methodology does not remotely raise a serious constitutional difficulty that would require this Court to construe the 1996 Act as forbidding it. Relying on a misreading of *Brooks-Scanlon Co. v. Railroad Commission*, 251 U.S. 396, 399 (1920), the incumbents contend that TELRIC forces them continually to produce network elements "below the cost necessary to produce them" (ILEC Br. at 36) in violation of the Fifth Amendment's requirement that government "cover the owner's cost of production" and place the firm in "'as good a position pecuniarily as if the use of [its] property had not been taken.'" ILEC Br. at 37 (quoting *Phelps v. United States*, 274 U.S. 341, 344 (1927)). The argument lacks merit on every level.

1. To begin with, this Court need not consider whether the Fifth Amendment should preclude adoption of a ratemaking methodology that systematically underestimates a regulated firm's cost of production because there is no reason to think – and incumbents have not begun to show – that TELRIC does so. Indeed, the argument the incumbents now make suffers from the same flaws as the argument they have previously advanced that TELRIC unconstitutionally "strands" the undepreciated investment on their books. It is simply not true as a matter of logic that TELRIC will inevitably produce rates below an incumbent's "actual" costs, whether measured on the basis of historical costs or on the basis of so-called "actual" forward-looking costs. WorldCom Br. No. 00-511 at 25-31 ("WorldCom Br."). Just as TELRIC rates "may be higher or lower" than the incumbents' historical costs, *Local Competition Order* ¶ 705 (JA 398-99), TELRIC rates could well exceed an incumbent's "actual" forward-looking costs. In any event, there may be no significant difference between the two. *Id.* ¶ 685 (TELRIC "represents the incremental costs that incumbents actually expect to incur in making network elements available to new entrants") (JA 383-84).

Because TELRIC is designed to ensure that the incumbents are fully compensated for all risks of operating in the current market, the question whether TELRIC will systematically result in under-recovery is an *empirical* question that depends on how the methodology is applied in actual settings. As to that, the agency record contains not a shred of evidence supporting the incumbents' claims that TELRIC will produce the confiscatory results they posit. And it has already been demonstrated that the incumbents' extra-record claims about TELRIC's effects are both improper and false. *See* WorldCom Br. at 29-30. The incumbents are thus forced now to point to the new entrants' support of TELRIC as proof that it produces artificially low rates. But it is no surprise that new entrants oppose an "actual cost" standard that leaves entrants at the mercy of both incumbents' wildly inflated assertions of their own costs and their self-serving and untestable methods for allocating those costs to particular elements. TELRIC is transparent, allowing all parties to see and challenge its assumptions. In any event, the new entrants' support of TELRIC is hardly a basis upon which this Court could conclude that it is confiscatory.

2. The incumbents also mischaracterize this Court's jurisprudence. The gist of their argument is that the Takings analysis in cases of utility regulation must depart from the usual rule that the Just Compensation Clause is satisfied if a property owner receives the value of the property taken. *See, e.g.*, *United States v. Toronto, Hamilton & Buffalo Navigation Co.*, 338 U.S. 396, 403 (1949) (stating usual rule and describing actual or original cost as "the 'false standard of the past'") (citation omitted); *Olson v. United States*, 292 U.S. 246, 255 (1934); *see generally* WorldCom Br. at 42-46. In this context, the incumbents insist, the Constitution requires that the incumbents receive the "actual costs" of what is taken. That

argument is rich with irony. Starting with *Smyth v. Ames*, 169 U.S. 466 (1898), and continuing for a half-century, the Court *required* that public utility rates be based on value, and rejected historical cost as a measure, in precisely the circumstances the incumbents describe. And while the Court has subsequently approved utility rates based on historical cost rather than value, it has unequivocally rejected the proposition that the Constitution requires that (or any other) approach. *See Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

Indeed, the incumbents have seriously misstated the precedent on which they rely. They misleadingly suggest, for example, that their position is supported by the statement in *United States v. Causby*, 328 U.S. 256, 261 (1946), that "'it is the owner's loss, not the taker's gain, which is the measure of the value of the property taken.'" ILEC Br. at 37. But the very next sentence in *Causby* holds that "[m]arket value fairly determined is the normal measure of the recovery." 328 U.S. at 261.

Similarly, the Court has repeatedly explained that putting a party "in as good a position pecuniarily as if [its] property had not been taken" means giving that party the value of the property, not its original cost. The case that explains this best is *United States v. General Motors*, 323 U.S. 373, 379 (1945) – a case on which incumbents rely. That case makes clear that "the compensation to be paid is the value of the interest taken" and that "[o]nly in the sense that [the property owner] is to receive such value is it true that the owner must be put in as good position pecuniarily as if his property had not been taken." *Id.*

The Court thus did not hold that General Motors should be reimbursed for its actual *cost* rather than the market value of the property taken. To the contrary, the Court held simply that the market value should reflect the short-term lease actually taken, rather than the long-term lease under which General

Motors was operating. Indeed, the Court was careful to note that the actual costs attendant upon the government's temporary use of the property were not compensable as such. Those costs were to be considered solely "to aid in the determination of what would be the . . . market . . . price." *Id.* at 383.

3. Even if the incumbents were correct that the Fifth Amendment entitles them to recovery of their historical costs (rather than the value of the property taken) and even if their speculation about TELRIC's effects were valid, that would at most establish that they have been required to operate one small part of their business at rates that are not fully compensatory. That raises no constitutional difficulty so long as incumbents receive an adequate return on their overall business. *Brooks-Scanlon* involved the effort to discontinue the *entire* regulated business rather than just an allegedly unprofitable portion. That distinction is dispositive.

Legions of cases make this clear. In *Fort Smith Light and Traction Co. v. Bourland*, 267 U.S. 330 (1925), Justice Brandeis' opinion for the Court explained that "[a] railway may be compelled to continue the service of a branch or part of a line, although the operation involves a loss." 267 U.S. at 332. *Brooks-Scanlon*, the Court explained, holds only that a railroad could not be compelled to "continue to operate *its system* at a loss." *Id.* at 333 (emphasis added). *Accord Alabama Pub. Serv. Comm'n v. Southern Ry. Co.*, 341 U.S. 341, 347 (1951) ("[R]eview of an order requiring performance of a particular utility service, even at a pecuniary loss, is subject to considerations quite different from those involved when the return on the entire intrastate operations of a utility is drawn into question."); 341 U.S. at 352 (Frankfurter, J., concurring).[3/]

3/ *See also Western & Atlantic R.R. v. Georgia Pub. Serv. Comm'n*, 267 U.S. 493, 497 (1925); *Chesapeake & Ohio Ry. Co. v. Public Serv. Comm'n of W. Va.*, 242 U.S. 603, 606-07 (1917); *Atlantic Coast Line R.R. Co. v. North Carolina Corp. Comm'n*, 206 U.S. 1 (1907); *St. Louis & San*

The present case is no different. Incumbents could not plausibly contend that any alleged loss on unbundled elements – which account for less than 3% of local lines – has resulted in an unconstitutional return on their overall business. *See generally* WorldCom Br. at 32-34. That is so even if only revenues from other federally regulated interstate services are considered (*i.e.*, revenues within the FCC's control), such as the $29 billion in "access charge" revenue the incumbents receive – compensation at rates set by the FCC for services that are provided over the exact same lines that incumbents are required to unbundle for local service. Nor is there any reason to ignore the vast intrastate revenues the incumbents continue to receive for retail services, at rates set by the States. Thus, the incumbents' assertions can be rejected without any consideration of the massive profits they make from unregulated services – and without considering how to account in the constitutional analysis for the substantial benefits the 1996 Act provides to the incumbents. *See generally* WorldCom Br. at 6-8, 33-34.

4. Finally, the incumbents suggest that the absence of a functioning market for the assets of a regulated utility somehow counsels a different Takings analysis, requiring the use of an "objective benchmark" or "objective indicators of value" (*i.e.*, actual cost) (ILEC Br. at 38, 41), rather than the "subjective valuation" that TELRIC supposedly reflects, *id.* at 40-41. Contrary to the incumbents' suggestions, the absence of a functioning market neither relieves the government from trying to estimate market value nor limits the methods the government may use to do so. As this Court made clear in *Toronto, Hamilton*, when "peculiar circumstances . . . make it impossible to determine a 'market value,'" then "other means of measuring value may have relevance – but only, of course,

---

Francisco Ry. Co. v. Gill, 156 U.S. 649, 665-66 (1895); *Baltimore & Ohio R.R. Co. v. United States*, 345 U.S. 146, 148 (1953).

as bearing on what a prospective purchaser would have paid." 338 U.S. at 402.

Indeed, the absence of a functioning market gives regulators *more* flexibility to meet the constitutional command. When estimates of market value are difficult to make, "those whose primary duty it is to make these estimates ought not to be cramped by rules that are too rigid and too artificial." *Id.* at 407 (Frankfurter, J., concurring). Instead, "the training and experience of the fact-finders become important," and this Court should give flexibility and deference to those determinations. *Id.*; *see also id.* at 408.

In any event, TELRIC provides benchmarks every bit as objective as those preferred by the incumbents. TELRIC as implemented by the FCC (in the universal service context) or by the state commissions (with respect to unbundled elements) is based on the real-world costs of building real-world networks – transparent inputs from generally available sources. Inputs include matters such as the cost per foot of cable; the cost of building telephone poles; and the actual cost of a generally available switch. *See generally In re Federal-State Joint Board on Universal Service*, Tenth Report and Order, 14 F.C.C.R. 20156 (1999) ("*Tenth Report and Order*"). In contrast, the incumbents offer a methodology that starts from aggregate "actual costs" on incumbents' books that no one (including the incumbents themselves) believes are accurate and then applies what one court aptly described as a "black box" to allocate those costs to individual elements in particular locations. *See GTE South, Inc. v. Morrison*, 6 F. Supp. 2d 517, 527 (E.D. Va. 1998), *aff'd*, 199 F.3d 733 (4th Cir. 1999). It is the incumbents that fail to offer an objective benchmark.

Finally, TELRIC produces results that comport with incumbents' own estimates of their costs. The value of the incumbents' network calculated using TELRIC in the universal service context is $180 billion, while the depreciated book value of incumbents' network is $166 billion. In the universal service context, some of the state-wide costs generated by the TELRIC model exceeded incumbents' claimed historical costs. *See* WorldCom Br. at 28-29; *Tenth Report and Order* ¶ 25 (describing the FCC's "preliminary, objective check on the model's accuracy"). And in state proceedings, TELRIC rates for particular elements can exceed historical costs. *See* WorldCom Br. at 29 & n.17.

5. At bottom, the incumbents' plea for constitutional avoidance amounts to precisely what *Duquesne*, *Hope*, and the rest of this Court's ratemaking cases forbid: an attack on the "theory," rather than the "impact," of the FCC's order. *Duquesne*, 488 U.S. at 310. It should be rejected for all the sound reasons set forth in *Duquesne*.

IV. RULES 315(c)-(f) ARE LAWFUL.

The incumbents have offered no persuasive argument in defense of the Eighth Circuit's ruling invalidating FCC Rules 315(c)-(f), which require incumbents to combine network elements requested by a new entrant. Although the incumbents persist in arguing that the plain meaning of § 251(c)(3) requires the requesting carrier to do the combining, this Court has already held that the statute is "ambiguous" on that very point. 525 U.S. at 394. Thus, Rules 315(c)-(f) must be upheld so long as they reasonably implement the 1996 Act.

Rules 315(c)-(f) reasonably implement § 251(c)(3)'s nondiscrimination requirements. The FCC made express findings that, as a result of the incumbents' control over existing networks, a rule requiring new entrants to combine elements would "impose technical obligations . . . that they might not be able to readily meet." *Local Competition Order* ¶ 293 (JA 295-96). Thus, the FCC concluded, if the incumbents were not required to combine elements, new entrants would be "seriously and unfairly inhibited" in their ability to use leased elements. *Id.* The incumbents' objection

to that reasoning is utterly without substance, particularly given that they do not purport to challenge the findings and predictive judgments on which the FCC's conclusion rests.[4/]

Nor is there merit to the argument that the FCC relied on the same "technical feasibility standard" this Court rejected in *AT&T*. In adopting the combinations rules, the FCC "decline[d] to adopt the view proffered by some parties that incumbents must combine network elements in any technically feasible manner requested." *Local Competition Order* ¶ 296 (JA 297-98). Instead, the FCC required incumbents to combine network elements not ordinarily combined in the incumbent's network only where the combination was technically feasible, did not adversely affect the reliability or security of the incumbent's network, and did not impede the ability of other new entrants to access elements or obtain interconnection. *Id.* That policy judgment is entitled to deference.

Lacking a persuasive argument on the merits, the incumbents reiterate procedural objections raised in their Brief in Opposition, claiming that a challenge to the Eighth Circuit's invalidation of Rules 315(c)-(f) cannot be raised now because it was not raised when the matter was previously before this Court. But procedural objections raised in a brief in opposition are "*necessarily* considered and rejected" when the Court grants certiorari. *United States v. Williams*, 504 U.S. 36, 40 (1992) (emphasis added); *Stevens v. Department of the Treasury*, 500 U.S. 1, 8 (1991); *see generally City of Oklahoma City v. Tuttle*, 471 U.S. 808, 816 (1985). In any event, because

4/ The incumbents suggest that the FCC did not rely upon the nondiscrimination requirement of the Act because the agency did not explicitly cite to § 251(c)(3)'s nondiscrimination ban in the section of the *Local Competition Order* discussing the combinations rules. But the same argument could have been made respecting Rule 315(b), which is discussed in the same paragraph of the *Local Competition Order*. This Court nevertheless had no difficulty in discerning the antidiscrimination justification for that rule, and the same reasoning applies here.

the Eighth Circuit decided to revisit the issue on the merits, there can be no basis for denying review by this Court.

CONCLUSION

The FCC's TELRIC methodology and network combinations rules should be upheld.

Respectfully submitted,

THOMAS F. O'NEIL III
WILLIAM SINGLE, IV
WORLDCOM, INC.
1133 19th Street, N.W.
Washington, D.C. 20036
(202) 736-6096

DONALD B. VERRILLI, JR.
Counsel of Record
JODIE L. KELLEY
IAN HEATH GERSHENGORN
JENNER & BLOCK, LLC
601 13th Street, N.W.
Washington, D.C. 20005
(202) 639-6000

Counsel for Petitioner WorldCom, Inc.

JONATHAN M. ASKIN
THE ASSOCIATION FOR
LOCAL TELECOMMUNICATIONS SERVICES
888 17th Street, N.W., Suite 900
Washington, D.C. 20006
(202) 969-2597

Counsel for Petitioner the Association for Local Telecommunications Services

CAROL ANN BISCHOFF
ROBERT M. MCDOWELL
COMPETITIVE TELECOMMUNICATIONS ASSOCIATION
1900 M Street, N.W.
Washington, D.C. 20036
(202) 296-6650

ROBERT J. AAMOTH
KELLEY DRYE & WARREN LLP
1200 19th Street, N.W.
Suite 500
Washington, D.C. 20036
(202) 955-9600

Counsel for Petitioner Competitive Telecommunications Association

APPENDIX

Appendix A

ARIZONA

Ariz. Admin. Code R14-2-1201

Definitions

* * * *

14. "Total Service Long Run Incremental Cost" is the total additional cost incurred by a telecommunications company to produce the entire quantity of a service, given that the telecommunications company already provides all of its other services. Total Service Long Run Incremental Cost is based on the least cost, most efficient technology that is capable of being implemented at the time the decision to provide the service is made. * * * *

CALIFORNIA

***Rulemaking on the Commission's Own Motion*, R-93-04-003, Consensus Costing Principles /Basic Network Functions, at App. C (Cal. Pub. Serv. Comm'n Dec. 6, 1995)**

* * * *

Principle No. 1: Long run implies a period long enough that all costs are avoidable.

* * * *

Principle No. 6: Technology used in a long run incremental cost study shall be the least-cost, most efficient technology that is currently available for purchase. * * * *

Principle No. 7: Costs shall be forward-looking. * * * *

COLORADO

4 Colo. Code Regs. § 723-30-2.45(b)

The strict definition of total service long run incremental cost incorporates a forward looking concept which should, therefore, include the costs that the firm would incur today if it were to install its network from scratch. On the other hand, an estimate of total service long run incremental cost can be generated by assuming that the geographic locations of routes and possible switching locations are the same as those available to the firm today * * * *

ILLINOIS

83 Ill. Adm. Code Part 791.20

* * * *

(b) Long-run costs are the economic costs over a planning horizon long enough so that there are no sunk inputs or costs;

(c) * * * * Forward-looking costs ignore embedded or historical costs; rather, they are based on the least cost technology currently available whose cost can be reasonably estimated based on available data.

MICHIGAN

Michigan Public Service Commission, 1994 Report to the Governor and Legislature as Required by 1991 Public Act 179

* * * *

page 48 * * * * the Staff recommended the following

considerations related to formulating the definition of long-run incremental cost.

1. Long-run implies a period long enough that all costs are avoidable. * * * *

6. Technology used in a long run incremental cost study should be the least-cost, most efficient technology that is *currently* available for purchase. This assumes existing location of structural facilities, but allows for replacement with the most efficient, least cost technology. * * * *

7. Costs should be forward-looking. * * * *

OREGON

***Telecommunications Building Blocks*, Cost Report, Vol. I, Docket UM 351 (Or. Pub. Util. Comm'n July 1993)**

* * * *

page 12 * * * * Cost Principle #1 Definition of Long Run - Long Run implies a period long enough that all inputs are avoidable * * * *

page 13 Cost Principle #2 Choice of Technology - LRIC estimates should reflect the overall least cost technology for the network * * * *

WYOMING

Wyo. Rules and Regs., Pub. Serv. Comm'n, Util. Accom. Ch. 5, § 559

Forward-Looking Economic Cost Methodology.

* * * *

(c) The TELRIC of an element is the forward-looking cost over the long run of the total quantity of the facilities and functions that are directly attributable to, or reasonably identifiable as incremental to, such element, calculated taking as a given the incumbent LEC's provision of other elements.

(i) The TELRIC of an element shall be measured based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent LEC's wire centers.

* * * *