WILMER, CUTLER & PICKERING

Washington • Baltimore • New York • London • Brussels • Berlin

July 24, 2000

TELECOMMUNICATIONS LAW UPDATE

SUPREME COURT GRANTS REVIEW OF FCC'S FORWARD-LOOKING COST METHODOLOGY FOR LOCAL EXCHANGE CARRIERS

The Supreme Court has now agreed to review one of the key underpinnings of the FCC's regulatory regime governing local telephone companies under the Telecommunications Act of 1996. The outcome of the case may well determine how much new entrants in the local telephone business must pay for use of incumbents' facilities in the new competitive world. If new entrants must pay incumbents substantially more than they now do, entrants will have far greater incentives to install their own facilities instead of reselling those of incumbents. Such incentives might shift the entire paradigm of competition for local telephone service.

In an order adopted by the FCC in 1996, the agency decided that, when a new entrant into a local telephone market purchases a "network element" (such as a local loop) from an existing or "incumbent" local telephone carrier, the new entrant should pay for the element on the basis of its "forward-looking cost." That is, the new entrant should pay the incumbent the cost that would be incurred by a hypothetical carrier using the most efficient technology now available, rather than on the basis of the incumbent's actual, historical cost. The FCC used this "forward-looking cost" methodology again when it set up its scheme for determining how much incumbent carriers should receive in "universal service" support payments when they are forced to provide services at below-cost rates to rural and other high-cost customers.

In the case now before the Supreme Court, GTE challenged the FCC's use of forward-looking costs in its universal service scheme. Before enactment of the 1996 Act, local telephone carriers were compensated for the fixed costs of constructing loops to serve high-cost customers based on actual costs incurred. In its order implementing the 1996 Act, the FCC abandoned that mechanism and decided to determine carriers' compensation for universal service by projecting the prospective costs of a hypothetical, efficient carrier using the most current technology. The FCC's choice of a forward-looking methodology was part and parcel of an effort to minimize universal service support payments. Under this methodology, payments to incumbent local carriers are far lower than under traditional models based on actual, historical costs.

GTE appealed the FCC order to the United States Court of Appeals for the Fifth Circuit, challenging the change in the ratemaking methodology. GTE contended that the change effected an unconstitutional taking by requiring incumbent local carriers to provide universal service without adequate compensation. The Fifth Circuit gave GTE's arguments short shrift and upheld the FCC order, relying primarily on the broad deference that courts give federal agencies in implementing statutes. The court rejected GTE's constitutional arguments, holding that GTE had not made a showing that it would actually be undercompensated by the FCC's forward-looking cost methodology. In particular, the Fifth Circuit found that, unless the FCC's order would result in the company's *overall* earnings falling below a compensatory level, there can be no constitutional violation.

At GTE's request, the Supreme Court agreed to review the Fifth Circuit's decision. In its petition to the Court, GTE has raised two main arguments. First, GTE argued that mere switching of methodologies to one that disadvantages the carrier is constitutionally suspect. Second, GTE challenged the FCC's contention that its new, forward-looking cost methodology could not result in an unconstitutional taking so long as GTE's earnings as a company *as a whole* were compensatory. The FCC referred to this notion as the "total effect" test. GTE argued, on the other hand, that in the new competitive world the rate set by a regulator for each service of or obligation imposed on a carrier must be compensatory, and a regulator cannot constitutionally require the carrier to provide any service at a loss. Thus, GTE argued that the effect on an incumbent carrier of the regulatory change in funding for universal service must be considered apart from the revenues that the incumbent earns from other, unregulated operations. GTE contended that incumbents could not be required to provide universal service at a financial loss on the expectation that they would make up the shortfall from competitive lines of business; incumbents would not be able to inflate prices in other lines of business to cover that loss because competitors would be able to undercut those prices.

If the Supreme Court accepts GTE's arguments, its analysis may also require the FCC to abandon its analogous 1996 rules on how incumbents must price network elements to new entrants. Incumbent carriers challenged those rules when they were issued, arguing that the FCC lacked jurisdiction to impose them and that, even if it had jurisdiction, the rules were unlawful because they failed to compensate carriers for their historical costs. The U.S. Court of Appeals for the Eighth Circuit accepted incumbents' jurisdictional argument, but the Supreme Court vacated it. On remand, the Eighth Circuit considered the merits of incumbents' constitutional claim. In an opinion issued earlier this month, that court held that the constitutional claim was not ripe for review because the consequences of the FCC's choice of methodology "cannot be known until the resulting rates have been determined and applied." The court noted, "with no small amount of interest," the Supreme Court's decision to grant certiorari in the Fifth Circuit case.

If the network element pricing methodology is struck down and the FCC is required to allow incumbents a more reasonable measure of their costs, the decision could have a significant impact on competition in the local telephone market. Where forward-looking cost methodologies have been used to allow competing carriers to use incumbents' facilities at lower prices, the FCC's regime has dramatically skewed the entry strategies of new competitors, who have no incentive to build their own facilities. Rejection of the FCC's forward-looking cost methodology would make entry by means of purchased network elements, rather than competitors' own facilities, a less attractive option. It therefore would tend to diminish resale-based competition and to encourage facilities-based competition, with corresponding benefits to consumers, including increased innovation and price competition.

Lynn Charytan	**202-663-6455**	**lcharytan@wilmer.com**
John Harwood	**202-663-6333**	**jharwood@wilmer.com**
William Lake	**202-663-6725**	**wlake@wilmer.com**
Daniel Phythyon	**202-663-6545**	**dphythyon@wilmer.com**
William Richardson	**202-663-6038**	**wrichardson@wilmer.com**