Policy Brief

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The Supreme Court's Decision on FCC Pricing Rules

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On May 13, the Supreme Court released a decision regarding the Federal Communications Commission's (FCC) Implementation of the Telecommunications Act of 1996 ("Act"). Most stories reported the decision as "competitors win, incumbents lose." In this brief we provide a more analytical view of exactly what the decision said, what the next steps are and what might happen. We have tried to keep this unbiased, but need to disclose that one of us, (Rosston) was intimately involved in the writing of the FCC rules that were upheld by the Court when he served as FCC Deputy Chief Economist prior to coming to SIEPR, and the other (Noll) actively supported the FCC's basic approach in both publications and an amicus submission in FCC proceedings.

The Telecommunications Act of 1996

The Act was intended to open telecommunications markets to competition. Because of the breakup of AT&T in 1984, the Regional Bell Operating Companies or RBOCs (e.g., Pacific Bell) were prevented from providing long distance service. At the same time, competitors faced significant entry barriers in providing local services. The Act hoped to break down these barriers and to allow the RBOCs to provide long distance services. Unfortunately, the Act was a mish-mash. One congressman quipped to FCC Chairman Reed Hundt "How'd you like that Act we gave you? We put everything in it. Then we put its opposite in." While humorous, this quip signaled the litigation that was to ensue because of the opaqueness of the statute. Moreover, while masquerading as the buzz-word du jour, deregulation, the Act created an elaborate labyrinth of regulatory rules and called upon the FCC to issue still more regulations within 6 months of the passage of the Act. Consequently, the recent Court decision, more than 6 years after the passage of the Act, will not be the end of the wrangling about these issues -- at best, it resolves one important but small part of the controversy over the Act's implementation.

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The Act required the RBOCs to open their local networks to competitors. In return, when the RBOCs satisfy a 14-point checklist about the openness of their local markets in a particular state plus a vaguely worded "public interest" standard, they get long distance approval in that state. RBOCs have satisfied the competitive checklist and received long distance approval in a handful of states (not including California). More long distance entry approvals are expected later this year and next.

The opening of local markets to competition means that the incumbents have to make sure that competitors have the opportunity to enter their local markets in each of the three ways envisioned in the Act: through facilities-based competition (e.g. digging up downtown streets and laying your own fiber-optic cables); through resale (rebranding of the incumbent's local services); and through the use of "unbundled network elements or UNEs (pronounced "you-knees"). UNEs are the piece parts of the telephone network -- the loop that connects your phone to the local switch, the pieces at each end of the loop that make the connections, the switch, transport between local switches, etc. Initially the FCC required incumbents to provide seven different UNEs, but the number remains in dispute and could either shrink or grow, depending on which functions and physical components are defined to constitute basic local access. The Act requires that competitors be allowed to buy any number and combination of these UNEs to construct their own local network, but is unclear as to whether incumbents or competitors are responsible for combining these elements in cases in which the competitors seek to acquire more than one UNE but less than the complete local access service, including switching.

To make all forms of facilities-based competition viable, the Act required interconnection between networks and cost-based reciprocal payments between networks for the exchange of calls. If an entrant could not complete calls onto and receive calls from the incumbent’s network, the new competitor would be unlikely to survive, so the Act required that incumbents allow competitors to connect to their network. Industry participants have fought over whether calls to Internet service providers qualify for reciprocal compensation, but that is not part of this case and we won't address it here. Resale was also not a part of the case (and is not a particularly controversial or substantial part of the competitive landscape).

The primary focus of the case was on UNEs. The two primary concerns were: How should they be priced? And how much work should the incumbent have to do to put them together for competitors?

The FCC Implementation of the Act

The FCC proposed the use of forward looking economic costs to price the network elements. Incumbents think that this methodology leads to prices that are too low and argue that it won't compensate them for either past investments prudently incurred or the cost of future risky investments. The FCC came up with a new term, Total Element Long Run Incremental Cost, or TELRIC for the forward-looking economic costing methodology. The TELRIC methodology means that the cost of the element should be based on the cost of building an efficient network. The FCC's theory was that this is the type of pricing that occurs in competitive markets: just as computers are worth less when newer, better computers come out, the value of elements, if they were competitively supplied would reflect the costs of a new entrant supplying elements efficiently.

The incumbents want to be compensated fully for their past investments and claim that TELRIC will not do that. The pricing part of the case was decided on a 7-1 vote, with Justice Breyer dissenting (Justice O'Connor did not participate because she apparently owns stock in AT&T and has not participated in any of the telecommunications cases in front of the Court). The combination aspect of the decision was decided on a 6-2 basis with Justices Breyer and Scalia dissenting.

The main arguments in the pricing dissent were that the TELRIC pricing principle requires the use of state-of-the-art equipment and network design so, Justice Breyer believes, the incumbent could not recoup its investments in the network. At the same time, the dissent argues that the entrants

would have no incentive to invest in their own network infrastructure if they are able to buy UNEs at prices equal to the cost of the most efficient network provider.

The combination dissent focused on whether incumbents are responsible for bundling, and was based on the "plain language" of the statute, which says that entrants can lease elements and combine the elements. The dissent argues that the statute does not require the incumbents to perform the combinations.

The Court majority rejected both dissenting arguments. The majority found that the TELRIC approach is flexible and can lead to a wide range of prices. State PUCs are responsible for setting element prices, and as a legal matter they can adjust the cost of capital to account for risk, can adjust depreciation rates to account for the advance of technology, and can adjust "fill factors" to account for growth in the network. Nothing in TELRIC necessarily says that incumbents won't be fully compensated, nor that TELRIC will necessarily produce prices lower than historic depreciated costs. Moreover, should a state implement TELRIC in a manner that undercompensates incumbents as the dissenters fear, incumbents can appeal to both the FCC and the courts to reject these prices.

As a result, the Court found that the incumbents' arguments against TELRIC were not convincing and their arguments in favor of alternative pricing methodologies had problems that the Court believed would have limited local telephone competition. In the end, the Court's opinion said that they believed the Commission has enough discretion to pick the forward-looking cost methodology over the others: "Whether the FCC picked the best way to set these rates is the stuff of debate for economists and regulators versed in the technology of telecommunications and microeconomic pricing theory. The job of judges is to ask whether the Commission made choices reasonably within the pale of statutory possibility in deciding what and how items must be leased and the way to set rates for leasing them."

The second major part of the Court's majority decision involved combining of UNEs. Some competitors may want to use unbundled loops whereas others may want unbundled switching services. And, some may want both. The incumbents generally provide loop and switching services together to their end user customers so that "combining" them is a matter of a natural course of business for them. The question for the Court was whether they had to combine separate elements for their competitors.

The economic argument put forth by the FCC and competitors was that it was efficient for the incumbent to do the combining rather than to increase overall costs by forcing the new competitor to do the combining. But the FCC said that the incumbent could charge a cost-based rate to do the combining. The incumbents argued that the language of the statute said that they had to allow competitors to combine elements, but that they did not have to combine them for the competitors.

The Court upheld the FCC's ruling that "If the carrier is unable to combine the elements, incumbent must do so." "Unable" may become the telecom equivalent of "is" over the next year: the meaning will be subject to much debate. Right now, this means that the competitors can request combinations of elements, even if the incumbent does not combine them itself. The question that will be the subject of debate in the future for this provision is what *unable* means -- does it mean that it holds when the competitor does not have access to the network (an incumbent may be unwilling to allow a competitor to attach an unbundled loop to the incumbent's switch itself)? Or does it hold also when the competitor is less well-suited to do so while it is physically possible -- in other words, when it is possible, but the cost is so prohibitive that it would not happen without reliance on the incumbent?

What is next?

The immediate impact of this decision is not likely to be large as most state PUCs have already adopted TELRIC pricing

principles for setting UNE rates; a decision the other way would have set more change in motion. The immediate impact is to provide some degree of certainty for incumbents and new entrants about the pricing principles that will be used in the future.

While TELRIC has been upheld as a pricing methodology, the FCC and state regulators retain a great deal of discretion over precisely what it means and how it will be implemented. These fights are sure to continue in state PUCs and, eventually, the FCC, which has the authority to review and to block state pricing decisions on the basis of their conformance to the Act and FCC rules.

The FCC is in the midst of reviewing specifically which UNEs need to be provided to competitors by the incumbents. Predictably, the incumbents have put forth arguments to limit the specific UNEs they must provide and the new competitors have pushed to expand the scope and packaging of the UNEs provided.

This proceeding is part of a "triennial review" of the elements "necessary" for competitors to be able to provide competitive local telephone service and of the meaning of the "check-list" that must be satisfied if incumbents are to be allowed to offer long distance service.

Despite the high-profile bankruptcies of companies like Northpoint and Rhythms, competitors have made some inroads into the local exchange. But the progress is slow, and much of the local competition relies on UNEs. As of June 2001, excluding wireless, the FCC reported that competitors provided about 9% of local telephone lines: about 3% over their own facilities, about 2% using resale and about 4% using UNEs. Of the UNEs, more than half were incumbent provided combinations of loops and switching services (UNE-platform or UNE-P).

According to the FCC, the UNE-P approach was the fastest growing segment of the competitors' lines. The Court's decision makes this competitive alternative more stable. However, it does highlight the question about the future of facilities-based competition -- will competitors choose to rely on regulated rates for UNEs or use UNEs as a stepping stone to start local networks that eventually will be replaced with full, facilities based competitive systems, eventually eliminating the need for regulation of local telephone service? This question is high on the list of concerns for the FCC. Competitors argue that they have and are investing large sums in their own facilities and will use the UNEs as a stepping stone to their own facilities. The incumbents argue that competitors have no incentive to build their own facilities while they get a free ride on the risky investments made by the incumbents. Still another possibility is that, because of the growth of wireless technology, no competitor would ever build a large, wireline local network of the regulatory rules. If so, the investment incentives created by the FCC's rules are irrelevant.

Due to the Court's decision, for the next few years the FCC undoubtedly will continue to require that incumbents provide at least some UNEs at TELRIC rates. Thus, the decision permits a test of whether the stepping stone theory of local access entry works. While the outcome of this experiment is uncertain, the two most likely results are both good for consumers. The first is that wireline competition emerges from UNE-based entrants, and the second is that wireless services make local telephone access competitive even if wireline competition remains very limited. Had the Court ruled the other way, only the second of these good outcomes would have been possible.

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