IMPLICATIONS OF THE SUPREME COURT'S *VERIZON V. FCC* DECISION

*BY ADAM THIERER**

Telecommunications deregulation suffered a serious setback on May 13 when the Supreme Court handed down its eagerly awaited decision in *Verizon Communications v. Federal Communications Commission*, and held that federal regulators could continue to force incumbent local telephone companies to share elements of their networks with rivals at heavily discounted rates. Although it remains unclear how big a blow the ruling will be to ongoing industry liberalization efforts, it will certainly make the transition to a free market in telecom services more difficult than was previously expected.

The case was significant because it offered the Court the chance to rule on the constitutionality of infrastructure-sharing rules that the FCC put in place almost six years ago, and in the process, to help bring an end to the constant legal wrangling and litigation nightmare that has followed the passage of the Telecommunications Act of 1996. Importantly, this is the second major case to reach the Supreme Court regarding the FCC's implementation of the interconnection and network access provisions of the Telecom Act. In its 1999 decision, *AT&T Corp. v. Iowa Utilities Board*, the Court partially overturned the sweeping FCC mandates on the sharing of unbundled network elements (UNEs) owned by Regional Bell Operating Companies, or "Baby Bells."

The Court's latest decision in *Verizon v. FCC* looked at the other half of the equation: how to determine just compensation for the Bells when they are forced to share UNEs with competitors. Specifically, the Court reviewed the pricing methodology the FCC devised to determine what network "costs" and investments would be compensated. The cost model the FCC invented to accomplish this is known as TELRIC, which stands for "total element long-run incremental cost." This model is highly controversial because it estimates costs by imagining what it might cost to construct and operate a hypothetical, efficiently designed network from scratch. Was the FCC's cost model fair? Did it adequately compensate the Bells? Did TELRIC encourage enough industry investment? On all these questions the 7-1 majority for the Court ruled in the affirmative and vindicated the FCC's six-year effort to divine "costs" through some rather creative regulatory reasoning and controversial economic models.

As hordes of economists have pointed out in recent years, however, a fairy tale regulatory model like TELRIC does not mesh with economic reality since it fails to account for the actual costs of building and maintaining networks. As a consequence, TELRIC poses a threat to industry investment, innovation, and genuine *facilities-based* competition. Alfred Kahn, noted regulatory economist and former chairman of the Civil Aeronautics Board, has referred to the logic behind TELRIC as "regulatory arrogance" and argued in Cato's 1998 book *Regulators' Revenge,* "By their meddling, under enormous pressure to produce politically attractive results, regulators have violated the most basic tenets of efficient competition—that it should be conducted on the basis of the respective actual incremental costs of the contending parties; and it is that competition, rather than regulatory dictation, that should determine the results." Likewise, technology guru George Gilder argued in a *Wall Street Journal* editorial last August, "Like any price-control scheme, TELRIC choked off supply, taking the profits out of the multibillion-dollar venture of deploying new broadband pipes." That regulatory system, Gilder added, discourages broadband investment by "privatizing the risks and socializing the rewards." Moreover, he said, "No entrepreneurs will invest in risky, technically exacting new infrastructure when they must share it with rivals." In addition to concerns about economic efficiency and investment incentives, the Baby Bells argued that TELRIC rules represented an unconstitutional taking of their property by forcing them to surrender space on their networks at generously discounted rates that failed to compensate them for their historic investments.

Sadly, only Justice Stephen Breyer gave those arguments any credence. It should be noted that Justice Breyer was a respected expert on the law and economics of regulation long before he joined the Court and is the author of *Regulation and Its Reform*, a standard textbook for students of the regulatory process. This expertise shined through in Breyer's scathing dissent to the majority decision in which he raised the important question of whether there was any rational connection between the regulations the FCC promulgated and the Telecom Act's stated goal of deregulating this sector. As Breyer argued: "The problem before us—that of a lack of 'rational connection' between the regulations and the statute—grows out of the fact that the 1996 Act is not a typical regulatory statute asking regulators simply to seek low prices, perhaps by trying to replicate those of a hypothetically competitive market. Rather, this statute is a deregulatory statute, and it asks regulators to create prices that will induce appropriate new entry." Breyer goes on to correctly note that FCC's TELRIC pricing rule and UNE requirements, "bring about, not the competitive marketplace that the statute demands, but a highly regulated marketplace characterized by widespread sharing of facilities with innovation and technological change reflecting mandarin decision-making through regulation rather than decentralized decision-making based on the interaction of freely competitive market forces. The majority nonetheless finds the Commission's pricing rules reasonable. As a regulatory theory, that conclusion might be supportable. But under this deregulatory statute, it is not."

The majority for the Court didn't buy any of these arguments but downplayed the negative disincentives posed by such infrastructure sharing and simply deferred to the FCC's "by any means necessary" crusade to encourage new rivals to enter this marketplace. Through its actions, the agency has essentially proclaimed that a numerical nose count of new entrants is more important than network investment and genuine facilities-based competition. The wisdom of that policy has been put to the test by economic theorists and in the actual business market and has been found wanting.

In a comprehensive survey of the Competitive Local Exchange Carrier market, Brookings Institution economist Robert Crandall has found that: "CLECs are best able to produce revenue growth by building their own networks or significant parts of their own networks. CLECs that only resold the establish carriers' services were generally unable to convert investments into revenues, and these companies were likely to fail." So the Supreme Court's decision cannot change the fact that network sharing has not been a very good business model. On the other hand, the decision perpetuates that model and encourages companies to continue to petition the regulators to rig the rules in favor of generously discounted access to existing and future communications networks and technologies. One cannot help but shudder at the thought of years of additional regulatory proceedings on this matter and wonder what the implications will be for long-term investment and innovation in the U.S. telecommunication sector.

But all hope is not lost. Led by the deregulatory-minded chairman Michael Powell, the FCC is currently pursuing several proceedings that question the wisdom of some of these rules. With any luck, Powell will receive the support of his superiors in the Bush Administration in this endeavor and begin to roll back the destructive regime of price controls and infrastructure-sharing mandates that threaten the new investment and innovation in communications infrastructure that America so desperately needs.

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