

## Did The High Court Reach An Economic Low In Verizon v. FCC?

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### Abstract

The Supreme Court's decision in *Verizon v. FCC* rests on two errant interpretations of the 1996 Telecommunications Act: First, the Act represents a new form of regulation rather than a deregulatory statute; Second, Congress intended that the playing field be tilted in favor of new entrants. Under the *Chevron Doctrine*, deference is given to the controlling federal agency if there is a "rational connection" between the regulations and statutory intent. The Court ruled that the FCC's implementation of the Act survives that scrutiny. This discussion contests that finding and argues that the FCC's regulations undermine the goals of the Act.

### 1 Introduction

On May 13, 2002, the U.S. Supreme Court issued its long-awaited decision in *Verizon et al v. FCC et al* ("*Verizon v. FCC*"). The Court focused on three primary issues: (1) The FCC's pricing rules for unbundled network elements; (2) Whether the exclusion of historical costs in the pricing rules constitutes a governmental taking; and (3) Various rules for combining network elements. This discussion is focused primarily on the economic implications of the FCC's costing standards – which the Court upheld – and secondarily on the takings claim – which the Court ruled was not yet "ripe".

The Court's decision in *Verizon v. FCC* has been widely regarded as a stunning victory for the competitive local exchange carriers (CLECs) and a stinging defeat for the incumbent local exchange carriers (ILECs). The real loss with this decision, however, is likely to be the one borne by consumers. Indeed, the Court's decision in *Verizon v. FCC* set a troubling precedent – one that is destined to frustrate the goals of the 1996 Telecommunications Act ("the Act") and injure the competitive process in ways that we have yet to fully comprehend.

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There were essentially three costing standards at issue in the Court's deliberations: (i) historical/embedded costs; (ii) actual, forward-looking costs and (iii) efficient-firm, forward-looking costs. Most of the action centered on (ii) and (iii) as neither the majority nor Justice Breyer in dissent believed that the ILECs were necessarily entitled to the recovery of historical costs.<sup>1</sup> The phraseology here is important as the ILECs did not consistently argue that they were entitled to the recovery of historical costs – they were not. The real issue was whether the opportunity to recover historical costs was hopelessly undermined by the FCC's implementation of the Act.

This discussion contends that the Court erred in its decision in *Verizon v. FCC*. The majority's decision in *Verizon v. FCC* reflects: (i) a fundamental misreading of the statute; (ii) an inaccurate recounting of regulatory history; and (iii) an economic analysis that is cursory and logically flawed.

The majority does not bear sole responsibility for its decision in *Verizon v. FCC* as the ILECs' arguments, though not unprincipled, were at times lacking in principle. To wit, while their discussion of forward-looking costing principles was largely on target, they continually blurred the distinction between the entitlement to recover historical costs and the opportunity to recover historical costs. The ILECs were never guaranteed recovery of historical costs – not even under traditional, rate-of-return regulation – and their “entitlements” under price cap regulation were lesser still.<sup>2</sup> This led the ILECs to argue for an unconstitutional taking based on a deficient-earnings standard that they could not meet while failing to develop the foundation for the sustainable-price standard that was perhaps their only real prospect.

The government's arguments before the Court are deceptive in the sense that they got “the words right, but the principles wrong”. That regulation should seek to emulate a competitive market outcome and that prices should be based on marginal cost are sound regulatory principles taken directly from Kahn's (1970) classic treatise, *The Economics of Regulation*. But the FCC's charge was not to implement a new form of regulation, but rather a deregulatory statute. Prices should be based on marginal cost, but not on purely hypothetical marginal cost. (De)regulation should seek to foster a competitive market outcome, but not predetermine that outcome. The Act envisioned not the continuation of regulation but a sunset for regulation. And, perhaps most importantly, the accommodation of competitors does not imply the “subsidization” of competitors. Indeed, there is a “long and proud” tradition at the FCC of bribing competitors to enter the market while restraining incumbents and calling it “competition” (Kahn, 1984; Haring, 1984; Fowler, Halprin and

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<sup>1</sup> BellSouth, SBC and Verizon filed jointly with the Court in which they sought recovery of historical costs. Qwest filed separately and argued that actual, forward-looking cost was the proper standard. Henceforth, the term “ILECs” refers to BellSouth, SBC and Verizon.

<sup>2</sup> The ILECs seemed to downplay the significance of price cap regulation from the very beginning. The ILECs (April 9, 2001) state: “In the years leading up to the 1996 Act, some States and the FCC began to adopt a modified version of historical cost ratemaking through a system known as ‘price caps’.” This characterization is noteworthy for two reasons. First, when the 1996 Act was passed, price cap regulation was well on its way to becoming the predominant form of regulation for the Bell Operating Companies, if not for GTE (Sappington 2002 forthcoming, Table 2). Second, characterizing price caps as a variation on traditional, ratemaking principles may provide some support for setting initial network element prices on the basis of historical costs, but it also invites the Court to adopt a traditional, earnings-based standard for a taking. The majority subsequently argued that the adoption of price caps was motivated by the distrust that regulators harbored for the historical costs reported by the ILECs (*Verizon v. FCC*: 40-41).

Schlichting, 1986; Weisman, 1994a; Sappington and Weisman, 1996, Chapter 8; Lehman and Weisman, 2000b, Chapter 8).

Justice Souter, writing for the majority, went to great pains to point out that this was a legal decision – not an economic one – with a wide berth given to the FCC under the Chevron Doctrine.

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 FCC's pricing and additional combination rules survive that scrutiny (*Verizon v. FCC*, Majority: 69).

Justice Breyer sought to juxtapose the FCC's implementation of the Act with the express purpose of the legislation and thereby expose the absence of a "rational connection." The preamble of the Act states that the express purpose of this legislation is:

To promote competition and reduce regulation in order to secure lower prices and higher quality services for American telecommunications consumers and encourage the rapid deployment of new telecommunications technologies.

The majority saw no conflict between the FCC's costing and pricing rules for unbundled network elements and the principal goals and objectives of the Act. In contrast, Justice Breyer concluded that the FCC exceeded the deference typically granted an expert agency under Chevron:

Nonetheless, that leeway is not unlimited. It is bounded, for example, by the scope of the statute that grants authority and by the need for an agency to show a "rational connection" between the regulations and the statute's purpose (*Verizon v. FCC*, Dissent: 4).

There are six principal conclusions that follow from this analysis. First, the FCC confuses mandating the competitive outcome with fostering the competitive process; its charge was not to implement a new form of regulation, but rather a deregulatory statute that would culminate in a sunset for regulation. Second, the FCC's efficient-firm costing standard is inherently anticompetitive. Third, the Eighth Circuit was correct when it ruled that "costs" refer to the costs the ILEC actually incurs in providing unbundled network elements. Fourth, the efficient-firm costing standard gives rise to a form of "predatory costing" that can result in inefficient foreclosure. Fifth, the Court misconstrues the efficient component pricing rule (ECPR) in contending that it is not competitively-neutral. Sixth, the ILECs' takings claim failed to distinguish between price and earnings regulation and thereby invited the Court to apply an earnings standard that the ILECs ultimately could not satisfy.

The format for the remainder of this article is as follows. The distinction between the competitive process and the competitive outcome is examined in Section 2. Section 3 defines the *efficient-firm* cost standard and contests the majority's claim that this represents an entirely new form of regulation. Section 4 examines the importance of objective reality in cost measurement. Section 5 discusses the manner in which the FCC's *efficient-firm* cost standard leads to predatory costing. The majority's misinterpretation of the ECPR is examined in Section 6. The issue of governmental takings is explored in Section 7. Section 8 concludes.

## 2 Competitive process v. competitive outcome

The majority interpreted the Act as a new form of regulation rather than a deregulatory statute and there would be no recovery from this grievous error:

While the Act is like its predecessors in tying the methodology to the objectives of “just and reasonable” and nondiscriminatory rates, it is radically unlike all previous statutes in providing that rates be set “without reference to a rate-of-return or other rate-based proceeding,” §252(d)(1)(A)(i). The Act thus appears to be an explicit disavowal of the familiar public-utility model of rate regulation ... presumably still being applied by many States for retail sales, ... in favor of novel ratesetting designed to give aspiring competitors every possible incentive to enter local retail telephone markets, short of confiscating the incumbents’ property (*Verizon v. FCC*, Majority: 16-17).

The majority returns to this theme throughout its opinion in arguing that Congress intended to tilt the playing field in favor of entrants (p. 63). This is a fundamental misinterpretation of the statute that the majority invokes to justify the FCC’s implementation of the Act (FCC, 1996). In contrast, Justice Breyer clearly perceived the critical distinction between a new form of regulation and a deregulatory act:

The Telecommunications Act is not a ratemaking statute seeking better regulation. It is a deregulatory statute seeking competition. It assumes that, given modern technology, local telecommunications markets may now prove large enough for several firms to compete in the provision of some services – but not necessarily all services – without serious economic waste (*Verizon v. FCC*, Dissent: 6) ...

But 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 hypothetical competitive market. Rather, this statute is a deregulatory statute, and it asks regulators to create prices that will *induce appropriate new entry* (*Verizon v. FCC*, Dissent: 22) (emphasis added).

In other words, the majority, like the FCC,<sup>3</sup> confuses mandating the competitive outcome with fostering the competitive process (Weisman, 2000: 197).<sup>4</sup> This represents a view of the world that is the very antithesis of competition as a discovery process (Schumpeter, 1942).<sup>5</sup> In recognition of the importance of this fundamental idea, Kahn has

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<sup>3</sup> In defense of its TELRIC (total element long-run incremental cost) standard, the FCC (April 2001: 17) states that: “A primary objective of rate regulation, however, is to establish the price that would exist in a fully competitive market.” The FCC reiterates this point when it observes that: “The central objective of rate regulation has traditionally been to restore the ‘true’ market price – the price that would result through the mechanism of a truly competitive market,” (p. 29).

<sup>4</sup> A thought-provoking discussion and historical account of this important distinction is provided by McNulty (1968: 649), who observes that with respect to the classical school:

their concept of competition was a disequilibrium one of market activity, with price a variable from the standpoint of the individual firm. Perfect competition, on the other hand, is an equilibrium situation in which price becomes a parameter from the standpoint of the individual firm and no market activity is possible. Thus the classical concept of competition as a guiding force, to which we earlier referred, is not only different from that of the neoclassical concept of competition as a state of affairs; the two are incompatible in a fundamental sense, reflecting precisely the difference between a condition of equilibrium and the behavioral pattern leading to it.

<sup>5</sup> As Justice Breyer poignantly observed: “The competition that the Act seeks is a process, not an end result; and a regulatory system that imposes through administrative mandate a set of prices that tries to mimic those that competition would have set does not thereby become any the less a regulatory process, nor any the more a competitive one,” (*Iowa Utilities Bd.* 525 U.S. at 424).

pointedly observed that it is the actual costs of the ILECs to which rivals should set their mark (Kahn, 2001: 6).

The majority erroneously interprets the Act to provide for the subsidization of competitors as opposed to the accommodation of competitors.<sup>6</sup> This difference in interpretation is what enables the majority to side with the government, while Justice Breyer condemns the FCC's interpretation as being inconsistent with statutory intent (*Verizon v. FCC*, Dissent: 4, 17, 25-26). Indeed, it is difficult to reconcile the majority's interpretation with the express purpose of the Act "to promote competition ... reduce regulation ... and encourage the rapid deployment of new telecommunications technologies". The fact that there is no natural sunset for regulation and that, in the presence of dynamic technological development, the combination of mandatory sharing and TELRIC prices cannot help but have a discouraging effect on investments by the CLECs and ILECs alike further underscores this point (Kahn, Tardiff and Weisman, 1999: 346-350).

Finally, the majority (*Verizon v. FCC*: 46) makes reference to dollars that have apparently been invested by CLECs in telecommunications infrastructure as somehow suggesting that the incentives for investment and innovation have not been dampened. Justice Breyer in his dissent (*Verizon v. FCC*: 14-15) correctly rebuts this argument by pointing out that it is not the absolute value of investment dollars that is significant but the change in investment dollars caused by this policy action that is critical to any determination as to whether the FCC's pricing rules have stifled investment and innovation.<sup>7</sup>

### 3 The "efficient-firm" cost standard

The *efficient-firm* cost standard essentially requires the regulator to discern what the cost structure would be for an efficient firm operating in a competitive market.<sup>8</sup> At the service level, the cost measure that reflects these characteristics has been termed TSLRIC (Total Service Long Run Incremental Cost). A definition of this term has been offered by AT&T (an entrant in the market for local telephone service):

TSLRIC is based on the costs an *efficient, cost-minimizing* competitor would incur – *i.e.*, the costs of assets that are optimally configured and sized with current technology and efficient operating

<sup>6</sup> The majority (*Verizon v. FCC*: 38) argues that offering a lease rate to the entrant that is less than the actual (presumptively-inefficient) cost of the incumbent may be justified on the grounds that doing otherwise could result in "keeping more potential entrants out". The majority goes on to note that it was "not obviously unreasonable for the FCC" to adopt such a policy.

<sup>7</sup> It is noteworthy also that a number of recent empirical studies find that price cap regulation is not associated with increased efficiency (Ai and Sappington, 2002 forthcoming; Resende, 1999). This contrasts with some of the earlier studies that found that the adoption of incentive regulation was associated with increased efficiency (Majumdar, 1997; Tardiff and Taylor, 1993). It is plausible that the network sharing provisions of the Act have, in part, been responsible for dampening incentives for the ILECs to invest in cost-reducing innovation. Investment in cost-reducing innovation reduces the ILECs' costs, but also reduces the costs incurred by rivals in purchasing these network elements. These efficiency "spillovers" enable CLECs to share in this cost-reducing innovation which may tend to reduce the ILECs' expected returns from innovation. In other words, the incumbent provider is no longer the residual claimant for its cost-reducing innovation even under pure price cap regulation. See, for example, Weisman (2002).

<sup>8</sup> For a critique of this approach, see Kahn (1998, 2001), Kahn, Tardiff and Weisman (1999) and Weisman (2000).

practices. Proper TSLRIC estimates do not simply accept the architecture, sizing, technology, or operating decisions of the ILECs as bases for calculating TSLRIC (Baumol, Ordover and Willig, 1996: paragraph 25).

This approach requires the regulator to be omniscient – that is to say, to determine what constitutes an efficient, cost-minimizing competitor and thus represents a major departure from the price cap approach (Kahn, 2001; Weisman, 2000).<sup>9</sup> It also opens the door to endless speculation as to how (in)efficient the incumbent provider might be (Tardiff, 2002; Kahn, Tardiff and Weisman, 1999). In other words, regulators determine what the efficient costs are for the ILEC without recognition of their existing network technologies and topologies as if they were writing on a “blank slate” (Kahn, 1998: 89-96).<sup>10</sup>

The TELRIC approach is not, as the majority suggests, a “novel” form of rate-setting, but rather an old form of regulation in different clothing. The informational asymmetries between the regulated firm and the regulator figured prominently in the pervasive adoption of price cap regulation. In contrast, the efficient-firm cost standard requires the regulator to know precisely how efficient the regulated firm could be. Kahn (1998: 92) poses the obvious question: Why should we bother to let the messy and uncertain competitive process determine the outcome when we can determine at the very outset what those results would be and prescribe them now?<sup>11</sup> Presumably, the regulator could simply direct the regulated firm to produce in accordance with the most efficient production methods.

The majority is correct in pointing out that price caps may not provide incentives for efficiency as strong as those provided by competitive markets. The real issue here centers on the magnitude of the difference between the ILEC cost estimates and those proffered under the efficient-firm cost standard.<sup>12</sup> In other words, is it plausible to believe that the ILEC cost estimates could be that much higher than those of the ideally-efficient firm, particularly when the majority of these firms have been operating under conditions approximating pure price cap regulation (ILECs, June 8, 2001: 18)?

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<sup>9</sup> The FCC (June, 2001: 6) observes that “One of TELRIC’s principal objectives is to ensure an incumbent’s opportunity, when leasing network elements to others, to recover the full forward-looking cost of those elements (including the cost of capital) over their useful lives”. This represents a significant change from traditional regulatory prescription that provided for an opportunity to recover historical costs.

<sup>10</sup> The ILECs (June 8, 2001: 40) make this point forcefully: “At bottom, TELRIC represents the audacious claim that the government can dictate market value where no market exists. At the same time, it can eliminate any reference to the only real-world measure of value—the actual costs of production.” The ILECs (April 9, 2001: 10) point out that “TELRIC had its intended effect: it produced massive price reductions from historical costs. The FCC itself set ‘proxy prices’ that it said approximated TELRIC, and they resulted in 60% discounts from historical costs.”

<sup>11</sup> The FCC (July 2001: 4) views TELRIC as “providing the best approximation of an incumbent’s forward-looking cost of providing network elements to itself and others, if the incumbent acted rationally in a competitive market”.

<sup>12</sup> Dale Lehman has suggested to me in private correspondence that it is difficult to envision how the Court could have found the FCC’s costing rules to be unlawful on methodological grounds alone. His argument, which is an intriguing one, is that such a determination would require the Court to make a judgment as to how much speculation is “too much” in a forward-looking cost study. Without evidence on the actual rates, the Court would not be able to affect such a determination. The FCC (July 2001: 6) in note 3 expresses a similar sentiment when it observes that: “Any forward-looking cost methodology is necessarily predictive, and thus ‘hypothetical,’ to the extent that it must, for example, establish appropriate depreciation rates and cost of capital. ... the fact that a rate methodology involves predictive judgments does not render it economically untenable”.

There are persistent questions as well concerning the ILECs' incentives to misreport costs in order to secure a competitive advantage. These are legitimate concerns that should not be given short shrift. For example, the majority observes that:

Even if incumbents have built and are operating leased elements at economically efficient costs, the temptation would remain to overstate book costs to ratemaking commissions and so perpetuate the intractable problems that led to the price-cap innovation (*Verizon v. FCC*, Majority: 40-41).

Again, the majority fails to recognize that the Act is a deregulatory statute and the incentives that may have been present to overstate costs under traditional, rate-of-return regulation are not necessarily present to the same degree in this context. For example, if the ILEC overstates its costs, CLECs may decide to build rather than lease and the ILEC will be hampered by an artificially-high cost floor. Conversely, if the ILEC understates its costs, CLECs may decide to lease rather than build and the ILEC has served only to stimulate demand for leased elements at below-cost rates (Weisman, 2000, Section IV).<sup>13</sup>

The majority contends (*Verizon v. FCC*: 50) that the ILECs are incorrect in their blanket assertion that TELRIC will be below their actual, forward-looking costs. This is noteworthy given the range of cost estimates that have been filed in regulatory proceedings (Tardiff, 2002; Kahn, Tardiff and Weisman, 1999). It follows that if the ILECs do not have an incentive to misreport their costs, the great disparity between the ILECs' estimates of forward-looking costs and those proffered by the CLECs must be explained by the *efficient-firm* cost standard.

The majority cites a single instance in New York in which the Commission did not support the use of the least-expensive technology for setting the prices for local loops (*Verizon v. FCC*, Majority: 50). The significance of the majority's ability to find a single instance in which a state Commission deviated from these principles is unclear, particularly when the majority is silent as to whether the resulting forward-looking cost estimate was above or below actual, forward-looking cost.

#### 4 Costs must have objective reality

The *efficient-firm* cost standard, by its very nature, lends itself to a great deal of speculation as to just how inefficient the ILECs might be. The Eighth Circuit ruled in *Iowa Utilities Bd. v. FCC* that "costs" refer to those costs the ILEC would actually incur in providing network elements.<sup>14</sup> Could it meaningfully be otherwise? Moreover, in the law and economics literature, "costs" have traditionally referred to those costs that the firm actually incurred or expected to incur in supplying a product or service – unless demonstrably imprudently incurred – and not simply by reference to some "blank-slate" estimate of what costs should have been.

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<sup>13</sup> This argument is not an affirmative statement that the ILECs did not overstate their costs—merely the observation that it would not have been plainly rational for them to have done so. Elsewhere (Weisman, 2000), I have suggested that it would perhaps be a meaningful exercise to examine the ILECs' costing methods in those markets in which their incentives are to have low price floors (*e.g.*, intraLATA toll and special access) and compare them with the costing methods they employ for network elements, after adjusting for differences in the incremental block of output, etc.

<sup>14</sup> Moreover, in Section 252(d)(3), the Telecommunication Act calls for resale discounts equated to the "costs that will be avoided" by the ILECs—which can mean only the costs that they would *actually* avoid in selling the services at wholesale.

The majority opinion contains an expansive discussion of the inefficiencies built into the FCC's TELRIC approach, including fixed wire center locations and lags in price adjustments. The natural question concerns why it is necessarily better to start with ideally-efficient costs and build in inefficiencies rather than start with actual, forward-looking costs – as these are known to be attainable – and rely upon the competitive process to reveal efficiencies. The issue of financial viability for the ILECs is more than just a theoretical possibility. For example, Tardiff (2002) presents data from a recent arbitration case in which the ILEC's forward-looking cost estimate for local loops was \$22, whereas the corresponding CLEC estimate was \$6.50.

There are some other notable subtleties as well. When the ILECs originally built their networks, it is reasonable to believe that they did not (and in fact could not) foresee the degree to which they would have to interconnect with rivals or supply wholesale services in addition to retail services.<sup>15</sup> Hence, it is quite likely that the networks that they constructed were not optimally configured for the degree of interconnection and network sharing that is now required of them under the Act. These “historical” constraints are yet another casualty of the “blank-slate” approach to cost measurement adopted by the FCC.

Tardiff (2002) contends that secondary markets may not be sufficiently developed to allow for a proper valuation of plant and equipment of an older vintage. This makes it more difficult for the ILECs to conform with the instantaneous-replacement of technology inherent in the *efficient-firm* approach. In competitive markets, prices do not adjust instantaneously to the development of a new technology. The price dynamics will reflect the degree to which the new technology is adopted throughout the industry. Hence, the actual rate of technology adoption may be somewhat slower than that suggested by TELRIC. Tardiff suggests that in the absence of secondary markets, embedded costs may provide a useful benchmark for testing the reasonableness of various forward-looking cost measures.<sup>16</sup>

## 5 Predatory costing<sup>17</sup>

The purpose of this section is to examine the paradox that can arise when the costing standard for the pricing of network elements is not identical to the costing standard for

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<sup>15</sup> Kahn and Shew (1987: 230-231) raise a closely-related issue. They suggest that the cost of ordering a car without a bumper may actually exceed the cost of ordering a car with a bumper. Since most consumers demand bumpers on cars, the collective-consumption decisions of consumers would naturally lead to a production process that is optimally configured to produce cars in this manner. A car ordered without a bumper would then necessitate additional labor to remove the bumper from the car—or require a separate production process that resulted in the sacrifice of scale economies—thereby adding to its costs. The cost methods mandated by the FCC would seem to contend that perfect competition would set prices on the basis of the cost of the hypothetical system set up, ideally to produce cars without bumpers; but that calculation would clearly have to take into account the likely levels of demand for the two alternative products and the consequent likelihood of the TELRIC charge for cars without bumpers having to be much higher, reflecting lesser economies of scale, than the integrated models.

<sup>16</sup> Lehman (1998) conducts a simulation analysis of the relationship between embedded costs and forward-looking costs to determine whether unbundled network elements are priced below cost. His findings indicate that, unless one appeals to a speculative costing standard, there is a high probability that the average price of unbundled loops is below actual, forward-looking cost. See also Chapter 6 in Lehman and Weisman (2000b).

<sup>17</sup> This section borrows from Weisman (2000).



establishing competitive price floors – the ILEC’s actual, forward-looking costs. Suppose that the *efficient-firm* cost standard is used to establish competitive price floors. This is akin to having no meaningful competitive price floor, whatsoever, because the ILEC’s price floor is limited only by its own speculation as to how efficient it might be. Suppose now that the cost standards are disparate – the *efficient-firm* cost standard for pricing unbundled network elements and the firm’s actual, forward-looking costs for setting price floors. In this case, the ILEC may be foreclosed by a less efficient CLEC using the ILEC’s own network. This can occur because the ILEC cannot set a retail price below its actual, forward-looking costs, whereas rivals can purchase network elements at prices based on ideally-efficient, forward-looking costs. To protect against these inefficient market outcomes, it is necessary that the cost standard for both applications (pricing network elements and establishing competitive price floors) be the same, the ILEC’s actual, forward-looking costs.

A stylized example may prove instructive in illustrating the precise nature of the problem. Suppose that each unit of local telephone service requires one unit of the local loop, one unit of switching, and one unit of a self-supplied input, which we generically refer to as integration. Suppose that the ILEC’s actual, forward looking costs of providing one unit each of the local loop, switching, and integration are \$20, \$4, and \$2, respectively. Upon application of the *efficient-firm* cost standard, the regulator concludes that the necessary inputs (local loops and switching) could actually be produced for \$15 and \$3, respectively. These are the prices that entrants would pay for the inputs necessary to provide local telephone service. Finally, suppose that the cost to the entrant of self-supplying the integration function is \$4. In utilizing the ILEC’s network, the CLEC can supply one unit of local telephone service for \$22 (including the cost of the self-supplied input). Yet, the ILEC cannot price below \$26 because the competitive price floor is established on the basis of its actual, forward-looking costs. Hence, the CLEC can set a retail price anywhere between \$22 and \$26, realize a positive margin and still foreclose the relatively-efficient ILEC. It is in this sense that the *efficient-firm* standard constitutes a form of predatory costing.

There may be a temptation to dismiss this problem as mere theoretical musing on grounds that the regulator can simply allow the ILEC to establish a price floor on the basis of the *efficient-firm* cost standard and thereby promote competitive parity with the CLEC. A moment’s reflection should convince the reader that this does not solve the problem. Alternative providers of wholesale market inputs would now have a potentially valid claim of predation against both the regulatory authority and the ILEC because the prices charged for the network elements are set below the ILEC’s actual, forward-looking costs.

To illustrate further the problems created by the use of disparate cost standards, we need only recognize that in another state of the world – say one in which the CLEC is a facilities-based provider – any attempt by the ILEC to price its services on the basis of what its incremental costs might be at some future point in time, when it may be more efficient than it is today, would be met with immediate cries of predation from the entrant, and rightfully so (Kahn, 2001: 12).

The Court did not address the problem of predatory costing in its decision in *Verizon v. FCC*, either because it did not accept as unequivocal the ILECs’ claim that TELRIC would produce forward-looking costs below the ILECs’ own actual, forward-looking costs, or because it provided yet another opportunity to tilt the playing field in favor of the CLECs.

And yet, in a very real sense, the predatory-costing paradox is one of the most troubling aspects of the *efficient-firm* approach.

## 6 Efficient component pricing

There remains so much confusion over the proper interpretation of the efficient component pricing rule (ECPR) that one must wonder whether E-C-P-R really means “economics that confuses policymakers and regulators.” The majority opinion is no exception. It may therefore prove instructive to briefly review the various interpretations of the ECPR and its implications for the economic issues before the Court.

The ECPR requires that the price of the wholesale service (unbundled network element) be set equal to the direct incremental cost of providing the wholesale service plus the net contribution foregone (opportunity cost) in not providing the downstream retail service. In its original form, the ECPR postulated that the opportunity cost would be measured with respect to pre-entry, monopoly prices (Baumol and Sidak, 1994; Baumol, Ordover and Willig, 1997). Subsequent interpretations, for example, Sidak and Spulber (1997), argue that the opportunity cost measure should depend upon actual downstream prices.<sup>18</sup> Much of the confusion over the ECPR centers on these two different interpretations.

There are two key elements to the ECPR: (i) The amount of the mark-up above incremental cost; and (ii) The parity of the mark-up across wholesale and retail services. The competitive neutrality of the ECPR depends only on (ii) (Kahn and Taylor, 1994: 228-230).

The majority dutifully notes the two different interpretations of the ECPR, but fails to recognize that the amount of the mark-up is irrelevant to the question of competitive neutrality. For example, in note 32, with reference to the dynamic adjustment of opportunity costs, the majority observes “that this would not cure the distortions caused by passing any difference between retail price and most efficient cost back to the incumbents as a lease premium.” The intimation or stronger is that somehow this confers a competitive advantage upon the ILEC vis-à-vis the CLECs.<sup>19</sup> This is incorrect. The amount of the regulatory-approved mark-up will influence the level of downstream prices (and hence the size of the market), but it is of no consequence for competitive neutrality as long as the parity of the mark-up between wholesale and retail prices is maintained. The majority’s reasoning underlying the dismissal of the ECPR is therefore fallacious.

## 7 The hopeless takings issue

If there was one issue before the Court on which there was unanimity of opinion it was that the ILECs did not have a valid takings claim. The Eighth Circuit had previously reached the very same conclusion. The majority (*Verizon v. FCC*: 25) was steadfast in its

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<sup>18</sup> This interpretation gave rise to the acronym M-ECPR, where the “M” indicates a market-based measure of opportunity cost.

<sup>19</sup> Weisman (2001) shows that the ECPR is the only access pricing rule that simultaneously protects against a price-squeeze and eliminates the incentive for the ILEC to engage in sabotage or non-price discrimination.

conviction that the issue of an unconstitutional taking was not “ripe.” Writing for the majority, Justice Souter observed that the Court has never recognized the legitimacy of a taking before the fact:

This want of any rate to be reviewed is significant, given that this Court has never considered a taking challenge on a ratesetting methodology without being presented with specific rate orders alleged to be confiscatory (*Verizon v. FCC*, Majority: 53).

The majority was apparently not resolute in its opposition to considering a credible argument that the FCC’s methodology could result in a taking:

Granted, the Court has never strictly held that a utility must have rates in hand before it can claim that the adoption of a new method of setting rates will necessarily produce an unconstitutional taking, but that has been the implication of much the Court has said (*Verizon v. FCC*, Majority: 53).

The two major takings cases to come before the Court were *Hope* and *Duquesne*. Both of these cases involved public utilities operating under traditional, rate-of-return regulation. In fact, the Court has never heard a takings case for a firm subject to price regulation. The ILECs failed to make this distinction and the Court was not prepared to make it for them.<sup>20</sup> This begs the question as to how the ILECs could ever have believed that they could prevail on a takings claim – at least one that required a showing of an earnings deficiency of such magnitude as to threaten their financial integrity – when no specific rate or financial information was presented to the Court.<sup>21</sup> What had been taken from the ILECs was the opportunity under price cap regulation to earn on the merits in a manner that was largely, if not completely, independent of their actual financial condition (Weisman, 2002 forthcoming). In other words, the standard for a taking under price cap regulation is not one that requires the showing of an earnings deficiency of such a magnitude as to threaten the viability of the enterprise.

The majority erred as well in its analysis of the takings issue on a number of different fronts. First, there are significant irreversibilities at play here. What is the remedy after the fact when CLECs have built their networks in reliance upon the continuation of a certain government policy? In other words, can what has been given to the CLECs actually be taken away without raising yet another takings issue? The takings issues before the Court in *Verizon v. FCC* were materially different than those in *Hope* and *Duquesne*, not only because the incumbent firms were operating predominantly under price cap regulation, but because the services and rates in question were at the wholesale rather than the retail level. Consequently, the market distortions resulting from a mid-course correction in this case are likely to be far more disruptive in comparison with a scenario in which a remedy may require retail customers to pay somewhat more for telephone service or electricity.

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<sup>20</sup> The ILECs (April 9, 2001: 24) contend that the rates set under Section 252 of the Act must be fully compensatory. It is the passage that follows that seems to blur the distinction between price and earnings regulation. “Its core command—as with any utility ratemaking regime—is not only that incumbents should receive full compensation, but also that they should receive full compensation *through the rates*. The very objective of a utility ratemaking regime is to avoid future government liability for an uncompensated taking by requiring the regulator to design rates that will fully compensate the utility.”

<sup>21</sup> The FCC (June, 2001: 13) observes that “the incumbents have continued to enjoy generous returns, on both their interstate and intrastate activities, in the years since they were required to lease network elements at rates based on forward-looking costs”. The FCC continues with the observation that “Verizon has made no effort to show that the ‘overall impact’ of the FCC’s adoption of a forward-looking methodology to determine the rates at which network elements are leased leaves incumbents with a constitutionally inadequate return, even as measured under a historical cost methodology” (p. 31).

The ILECs argued that the FCC's implementation of the Act represents a switch in regulatory rate methodologies of the sort prohibited under *Duquesne*. The Court rejected this argument out-of-hand:

First of all, there was no “switch” of methodologies, since the wholesale market for leasing network elements is something brand new under the 1996 Act. There was no replacement of any predecessor methods, much less an opportunistic switch “back and forth.” And to the extent that the incumbents argue that there was at least an expectation that some historically anchored cost-of-service method would set wholesale lease rates, no such promise was ever made (*Verizon v. FCC*, Majority: 57).

The validity of the ILECs' claims of entitlement to recovery of historical costs under traditional, rate-of-return regulation, much less price cap regulation, has been noted previously. The majority's claim, however, that there was no opportunistic switch in rate methodologies is erroneous because it fails to recognize the manner in which artificially-low network element prices can undermine the prevailing retail price structure.<sup>22</sup>

Regulators extracted “entry fees” from the ILECs in the form of infrastructure commitments, rates refunds and bill credits for the privilege of operating under price cap regulation.<sup>23</sup> The ILECs, in turn, agreed to bear greater risk under price cap regulation in exchange for the prospect of greater reward. The risk that they agreed to bear, however, is not that of the regulator's own making – a difference akin to that which distinguishes the arsonist's match from the strike of a lightning bolt. This distinction is paramount because the majority's decision in *Verizon v. FCC* purportedly gives state regulators the discretion to set prices for network elements so low as to render the price-cap constraint non-binding – the market price will lie below the price cap.<sup>24</sup> In other words, the prevailing retail price structure is rendered unsustainable. Yet, incredibly the majority claims that there was no switch in rate methodologies. Presumably, the Court, in refereeing a basketball game in which the rules clearly state that the basket cannot be raised, would not be troubled by a unilateral lowering of the floor!

There is a critical distinction between accommodating competitive entry – which the Act does – and promoting it artificially, which the majority's interpretation of the statute condones.<sup>25</sup> In general, the ILECs are not entitled to remedy for losses due to competition. The ILECs may, however, be entitled to remedy for losses due to competition that was propagated artificially. It is generally held that the objective of economic regulation is to emulate a competitive market outcome (Kahn, 1970: 17; Bonbright, 1961: Chapter VI). Hence, it is important to recognize that the issue here is not the introduction of competition

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<sup>22</sup> Lehman and Weisman (2000a, 2000b) investigate whether unbundled network element prices are endogenously influenced by the form of regulation under which the regulated firm operates. They find that unbundled local loop rates are significantly lower (in excess of \$3 per month) in price cap states than in states that practice some form of earnings regulation, *ceteris paribus*. Moreover, the Texas Public Utility Commission explicitly stated on the public record that it could unilaterally reduce network element prices with impunity because Southwestern Bell was operating under price cap regulation. Lehman and Weisman (2000a: 346) in note 11.

<sup>23</sup> This contests the majority's suggestion (*Verizon v. FCC*: 40-41) that the ILECs were somehow dragged kicking and screaming into price cap regulation in order to remedy problems with cost misreporting.

<sup>24</sup> It is instructive to conceive of the regulated firm as being subject to two constraints—the price cap constraint and the competitive market constraint. At any point in time, only one of these constraints will bind. The key issue here centers on whether the FCC's particular interpretation of the Act rendered the competitive market constraint binding, but not the price cap constraint. Should this be the case, the ILECs may well have a valid claim that the FCC's implementation of the statute constituted an opportunistic switch in regulatory regimes of the sort prohibited under *Duquesne*.

<sup>25</sup> See note 6 *infra*.

*per se*, but rather the artificial propagation of that competition through “regulator-assisted” forms of entry that undermine the prevailing retail price structure. In other words, the validity of a takings claim is not independent of the origins of the competitive market forces that reduce the ILECs’ earnings. Once it is established that prices for network elements are less than the ILEC’s actual, forward-looking costs, there is the possibility, if not the likelihood, of a taking. This may explain the majority’s sweeping dismissal of the ILECs’ claims (and a substantial body of evidence) that TELRIC would produce prices that were less than actual, forward-looking costs.

The regulated firm is the residual claimant under price cap regulation. This has a precise and unambiguous meaning. Specifically, it means that the firm is price regulated rather than earnings regulated. Hence, provided that the price cap constraint is satisfied, any opportunity to earn on the merits that is denied the regulated firm admits the possibility of a confiscatory act and hence a taking. It follows that an action by the regulator that constitutes a taking under price cap regulation may not constitute a taking under earnings regulation and vice versa. The ILECs failed to put this *sustainable-price standard* before the Court. As a result, they found themselves hamstrung by a *deficient earnings-standard* along the lines of *Hope* and *Duquesne* – a standard they presumably could not satisfy. What the ILECs failed to argue was that what had actually been taken from them by the FCC’s implementation of the Act was the opportunity under price cap regulation to earn on the merits in a manner that is largely, if not completely, independent of their actual financial condition.<sup>26</sup>

## 8 Conclusion

The question posed at the outset of this discussion must now be answered with a resounding “yes”. There is perhaps some solace in Justice Souter’s concession that the Court was not making an economic evaluation of the FCC’s implementation of the Act, but, in fact, a legal one. That said, the economic principles that the Court upheld in *Verizon v. FCC* – particularly the *efficient-firm* cost standard – are not of such a nature as to be easily overcome. A dangerous precedent has been set – one that is destined to frustrate the goals of the Act and injure the competitive process in ways that we have yet to fully comprehend.

It is noteworthy that the majority did not say that the “bad” outcome that the critics predicted – inefficient foreclosure, increased regulation and reduced innovation – would not occur, merely that it may not occur. This is significant because it was the probability of a “bad” outcome that was perhaps close (but not equal) to unity that arguably allowed the majority to rationalize its wholesale retreat to *Chevron*.

With the possible exception of Justice Breyer, who distinguished himself in a penetrating dissent, this was not the Court’s finest hour – not even close. That said, the ILECs failed to make the case that they had to make. The ILECs wavered in their approach – never quite sure whether to embrace the entitlements of traditional, rate-of-return

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<sup>26</sup> Tim Tardiff has suggested to me in private correspondence that the ILECs should perhaps not be faulted for failing to adopt a strategy of such recent vintage. This is a fair point. I would note in passing, however, that the idea that regulators could use competitive entry strategically to circumvent the price cap commitment was discussed at least as early as Weisman (1994b).

regulation or the promises of price cap regulation. In the end, they were foiled less by the Court than by their own dearth of conviction.

The high Court has now spoken in the case of *Verizon v. FCC*, marking the end of a long and protracted legal journey. While the FCC's implementation of the 1996 Telecommunications Act survives the Court's scrutiny and is therefore considered "good law", questions remain as to whether it also constitutes "sound economics".

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