TAKING AIM AT THE TAKINGS ARGUMENT: USING FORWARD-LOOKING PRICING METHODOLOGIES TO PRICE UNBUNDLED NETWORK ELEMENTS

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I. INTRODUCTION

Congress enacted the Telecommunications Act of 1996 ("Act" or "Telecommunications Act")1 to promote competition and encourage development and implementation of innovative telecommunications for consumers.2 In its deliberations, Congress determined that regulated monopolies had not provided American consumers with the prices and innovative technologies that a competitive industry might achieve.3 The Act opens the local exchange market and subsequently the long distance market to potential telecommunications carriers previously excluded from competing in these markets.4 The Act also mandates reforms to mechanisms that facilitate universal telecommunications service.5

Through the Act, Congress established a substantive and procedural framework by which potential competitors might enter the local exchange market. Substantively, Congress sought to encourage competition by permitting Alternative Local Exchange Carriers ("ALEC") to provide local exchange telephone service by three means. First, Congress envisioned competition through wholesale purchase and resale of an Incumbent Local Exchange Carrier's ("ILEC") existing retail assistance in the development and review of the Fifth Amendment analysis.

5 Id. § 254.
telephone services.6 Second, Congress permitted ALECs to purchase from ILECs unbundled network elements,7 either singly or in combination, in order to provide telecommunications services.8 Third, Congress permitted ALECs to erect their own network facilities and interconnect with the ILECs’ networks “for the transmission and routing of telephone exchange service and exchange access . . . at any technically feasible point within the carrier’s network.”9 Procedurally, the Act directs ALECs and ILECs to negotiate interconnection agreements.10 If the parties cannot agree on the terms for interconnection, the Act provides for the compulsory arbitration, by state commissions, of the open issues between the parties, including the determination of just and reasonable rates for interconnection and unbundled network element charges.11

The Act’s only guidance on the pricing of unbundled network elements is that rates for these elements be just, reasonable, and nondiscriminatory, and based on cost without reference to rate-of-return or other rate-based proceedings.12 In a controversial move, the Federal Communications Commission (“FCC”), on August 8, 1996, issued a First Report and Order13 establishing the methodol-

6 47 U.S.C.A. § 251(c)(4)(A) (West Supp. 1996) (mandating that ILECs have the duty “to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers”).

7 The Act defines “network element” as: “Facility or equipment used in the provision of a telecommunications service. Such term also includes features, functions, and capabilities that are provided by means of such facility or equipment, including subscriber numbers, databases, signaling systems, and information sufficient for billing and collection or used in the transmission, routing, or other provision of a telecommunications service.”

8 Id. § 251(c)(3) (mandating that ILECs “shall provide such unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service.”).

9 Id. §§ 251(c)(2)(A), 251(c)(2)(B).

10 Id. § 252(a).

11 Id. §§ 252(b), 252(c), 252(d).

12 Id. § 251(d)(1).


14 Id. paras. 618-851.

15 The FCC defines “joint costs” as “costs incurred when two or more outputs are produced in fixed proportion by the same production process (i.e., when one product is produced, a second product is generated by the same production process at no additional cost.” Id. para. 676. The FCC defines “common costs” as “costs that are incurred in connection with the production of multiple products or services, and remains [sic] unchanged as the relative proportion of those products or services varies (e.g., the salaries of corporate managers).” Id.

16 See id. para. 677. In the very long run, an ILEC’s fixed costs can be adjusted to present, not past values because the period of time will be long enough that present contracts will have expired, and plant and equipment will need replacement. Id. para. 677 n.1682.

17 “Embedded or accounting costs are costs that firms incurred in the past for providing a good or service and are recorded as past operating expenses and depreciation. Due to changes in input prices and technologies, incremental costs may differ from embedded costs of that same increment.” Id. para. 675.

18 In an attempt to overturn the FCC requirements with respect to use of the TELRIC Plus methodology and other pricing requirements, the ILECs filed suits, consolidated in the U.S. Court of Appeals for the Eighth Circuit, requesting and receiving a temporary stay of the pricing provisions of the FCC Order on the grounds that the FCC lacked jurisdiction to regulate the pricing of intrastate telecommunications services. Iowa Util. Bd. v. FCC, 4 Comm. Reg. (P&F) 1360-61 (8th Cir. Oct. 15, 1996), motion to vacate stay denied, 117 S. Ct. 429 (1996). The stay, however, did not limit the freedom of state public service commissions to weigh competing concerns and price unbundled network elements at “just and reasonable” TELRIC Plus rates in order to promote competition, consistent with the Act. See, e.g., Minnesota Pub. Util.
for unbundled network elements, however, have employed forward-looking pricing methodologies in the development of these rates. These decisions assuredly will generate constitutional challenges by incumbent carriers in the future.

This Article analyzes the Act and the FCC methodology in light of the developed takings jurisprudence and evaluates the legal and factual underpinnings of the ILECs' claim that pricing of unbundled network elements at TELRIC plus a reasonable allocation of joint and common costs constitutes a Fifth Amendment taking without just compensation. Ultimately, this Article concludes that the incumbent carriers' takings argument is premature because it precedes implementation of the full statutory scheme the Act establishes; that this statutory scheme justly compensates incumbent carriers for the use of their unbundled network elements; and that, pursuant to the relevant constitutional considerations, neither the Act nor the TELRIC Plus pricing methodology constitutes a taking without just compensation in violation of the Fifth Amendment.

II. THE PRO-COMPETITION PURPOSE AND PRICING PROVISIONS OF THE TELECOMMUNICATIONS ACT OF 1996 AND FCC IMPLEMENTATION CONSTITUTE PERMITTED GOVERNMENT REGULATORY ACTION

Under established constitutional jurisprudence, a statutory scheme which justly compensates a regulated entity for any constitutionally significant diminution of property value, will not run afoul of the Fifth Amendment prohibition against takings without just compensation unless the scheme fails to substantially advance a legitimate state interest. As described below, the Act sets forth a statutory scheme which Congress has determined substantially advances legitimate state interests. ILECs cannot and have not raised any serious challenges to the propriety of the state interest or the degree to which the Act advances that interest. No constitutional infirmity appears to exist with regard to either aspect.

A. The Act

The Act's stated purpose 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 legislative history of the Act similarly states that Congress intended, "to provide for a pro-competitive, de-regulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans by opening all telecommunications markets to competition . . . ." In addition, the Act also preserves the traditional goals of universal service.

In passing the Act, Congress faced the daunting challenge of encouraging entry into local exchange markets in which the costs and risks of facilities-based entry appeared prohibitively high.


State public service commissions have been hampered by the lack of documentation of the cost studies produced by incumbent carriers. To the extent that state commissions have priced unbundled network elements in accordance with incumbent carriers' forward-looking cost studies, these studies may or may not support pro-competition prices. Many commissions have opted for temporary rates to satisfy statutory deadlines, while acknowledging that further provision and evaluation of incumbent carrier cost studies and information is necessary.

In order to reduce barriers to market entry, Congress mandated that ILECs satisfy the aforementioned interconnection requirements, in addition to selling, at wholesale, their existing services and access to unbundled network elements. The Act requires that state commissions set prices for such interconnection and sale.

B. The FCC Order

The FCC's implementation of Section 251 of the Act, embodied in its First Report and Order, reflects the FCC's intent to comply with the underlying pro-competition goals of the Act. In adopting the TELRIC Plus pricing methodology, the FCC recognized that "[a]dopting a pricing methodology based on forward-looking, economic costs best replicates, to the extent possible, the conditions of a competitive market." The FCC further stated that, as a result, the TELRIC Plus methodology "allows the requesting carrier to produce efficiently and to compete effectively, which should drive retail prices to their competitive levels." To establish the forward-looking incremental costs of unbundled network elements, the FCC first determined the network architecture that best reflected the costs a competitive provider would face in establishing its service. The FCC determined that state commissions should identify the costs associated with a telecommunication network employing the most efficient existing technology given the ILECs' existing wire center locations. These wire center locations contain the critical switching systems central to the provision of wireline telecommunications services. According to the FCC, "[t]he benchmark of forward-looking cost and existing network design most closely represents the incremental costs that incumbents actually expect to incur in making network elements available to new entrants." Moreover, the FCC believed that pricing unbundled network elements using this configuration would encourage facilities-based competition because "new entrants, by designing more efficient network configurations, [would be] able to provide the service at a lower cost than the incumbent LEC," and thus would have economic incentive to continue the deployment of innovative technologies to the benefit of consumers.

C. Legitimacy of the Regulatory Scheme

The pro-competition regulatory scheme Congress has established through the Act clearly constitutes government action within the constitutional scope of Congress' power to regulate use of private property for public purposes. As a general matter, the Constitution permits government regulation of private property put to public use, if the regulation promotes the public welfare. More
specifically, judicial precedent confirms that Congress may regulate in order to promote competition. In *Ruckelshaus v. Monsanto Co.*, the Court, for example, held that regulation permitting release of valuable trade secret data of companies under Environmental Protection Agency regulatory jurisdiction was a proper exercise of governmental authority where this release would avoid costly duplication of work, reduce significant entry barriers to the regulated market, and expedite the availability of new end-use products to consumers. The permissible governmental purpose in *Ruckelshaus* and the purpose that Congress espoused in passing the Telecommunications Act—the reduction of barriers to, and encouragement of, competition—are equivalent.

Mere enactment of a regulatory scheme will not, in itself, constitute a taking unless the statute regulating property uses "does not substantially advance legitimate state interests or denies an owner economically viable use of his land . . . ." Moreover, the Takings Clause recognizes "the government's power to regulate subject only to the dictates of 'justice and fairness.'"

In the field of utility regulation, justice and fairness exist within a "broad zone of reasonableness," and the Constitution only protects utilities "from being limited to a charge for their property serving the public which is so 'unjust' as to be confiscatory." In this regard, the Supreme Court has specifically held that rates based on the actual present value of property are constitutional. In fact, in the past the Supreme Court has taken the position that the only constitutionally permissible method for valuing property was in accordance with the actual present value of the private property put to public use, because this method best mimicked the operation of a competitive market. Later, the Court allowed other permissible pricing methodologies, including those based on "historical cost," that were accepted upon a determination that they, too, could produce results within the zone of reasonableness.

There is no impermissible constitutional taking if the government provides just compensation for private property put to public purpose. Moreover, where the statutory framework provides the mechanism for negotiation or arbitration of just compensation, but not the compensation itself, the statutory scheme nevertheless is constitutionally sound. Finally, specific constitutional challenge to an arbitration or negotiation mechanism on the grounds that this mechanism fails to provide just compensation will fail if an alternative means exists whereby an aggrieved party can state a claim against the government for recovery of just compensation. ILECs have such an alternative means. They may seek just compensation in the United States Court of Federal Claims pursuant to the Tucker Act, if the statutory scheme Congress established does not provide it.

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36 Id. at 1015 ("Such a procompetitive purpose is well within the police power of Congress.").
37 *Id.*
38 *Florida Power Corp.*, 480 U.S. 245-47 (no taking exists where government, as a means to prevent anticompetitive practices by monopolistic utilities, requires a utility under contract with cable television operators to permit use of utility poles at lower government-set prices if these prices provide just compensation); Metropolitan Transp. Auth. v. ICC, 792 F.2d 287 (2d Cir. 1983) ("[T]o foster competition the [government] can order a [railroad] carrier to give another carrier trackage or terminal rights").
39 *Agins*, 447 U.S. at 260 (citations omitted).
42 *Duquesne*, 488 U.S. at 308 (citing *Smyth v. Ames*, 169 U.S. 466 (1898)).
43 Id. at 1008.
44 Id. at 310 (noting that in *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), the Court abandoned the notion that the actual present value method was the only constitutionally acceptable method of fixing utility rates).
45 *See*, *e.g.*, *FCC v. Florida Power Corp.*, 480 U.S. 245, 253 (1987).
47 *Id.* at 1018-19.
48 *See* 28 U.S.C. § 1491 (1994). Under the Tucker Act, the United States Court of Federal Claims has "jurisdiction to render judgment upon any claim against the United States founded either upon the Constitution, or any Act of Congress or any regulation of an executive department, or upon any express or implied contract with the United States, or for liquidated or unliquidated damages in cases not sounding in
cordingly, ILECs may not challenge the state commissions’ application of TELRIC Plus or other forward-looking pricing methodologies on grounds that it violates the Fifth Amendment. Their challenges to the state commissions’ actions must be on grounds that the established rates do not comply with the Act.\(^49\)

III. ANY CHALLENGE TO THE JUSTNESS OF THE COMPENSATION PROVIDED UNDER THE ACT IS PREMATURE PENDING IMPLEMENTATION OF THE STATUTORY SCHEME

Any constitutional challenge to the justness of the compensation provided under the Act is premature pending implementation of the overall statutory scheme because the Act expressly provides a mechanism through which ILECs may receive just compensation. As the Court noted in *Ruckelshaus*, "[t]he Fifth Amendment does not require that compensation precede the taking."\(^50\) In the instant case, the statutory framework of the Act substantially increases the benefits afforded the ILECs under the existing regulatory framework by providing the ILECs revenue opportunities in three specific areas, none of which were available prior to passage of the Act. These benefits would appear to compensate ILECs fairly for economic impacts resulting from the opening of local exchange markets. First, Sections 251 and 252 permit ILECs to collect revenue from market entrants for interconnection with ILEC networks and the entrants use of unbundled network elements.\(^51\) Specifically, the TELRIC Plus methodology set forth in the *FCC Order* ensures that these revenues will compensate ILECs for all forward-looking economic costs of providing unbundled network elements.\(^52\) These economic costs, by definition, include the costs of capital necessary to attract investment.\(^53\) In addition, the FCC has required that the prices of unbundled network elements provide a reasonable allocation of the ILECs joint and common costs.\(^54\) In competitive markets, the price consumers will pay for goods or services tends toward the economic costs of these products.\(^55\) Thus, the TELRIC Plus methodology is intended and expected to provide ILECs with a constitutionally sufficient approximation of the fair market value of their property in a competitive market.\(^56\)

Second, Section 271 permits the ILECs to vie for a share of the lucrative long distance market.\(^57\) Given consumers’ well-developed and long-time brand name identification with their local exchange service providers and given the universally recognized allure of “one-stop shopping,”\(^58\) ILECs may be expected to garner a significant share of the long distance market for consumers within their local exchange territories within a short time of entering the market. A recent Merrill Lynch analysis clearly articulates the enormous financial impact of the ILECs’ entry into the long distance market:

> GTE . . . intends to gain 10% of its $4.8 billion addressable long distance market within 12 months with negligible cost to the bottom line . . . . [T]he company believes its long distance effort will generate positive earnings impact in 1997, which reflects, in our view, the remarkably attractive economics facing an [sic] RBOC entering an adjacent market (long distance). How often

> § 271(c). To provide long distance service in-region, the RBOC must demonstrate that it is offering access and interconnection to its network to a competing local exchange provider pursuant to an agreement approved by the state public service commission, or upon proving that no competing provider has requested access to the incumbent carriers network. Id. §§ 271(c)(1)(A), 271(c)(1)(B). The RBOC also must demonstrate compliance with a competitive checklist that ensures that the RBOC has offered access and interconnection with its network on nondiscriminatory terms required by the Act. Id. §§ 271(c)(2)(A)(ii), 271(c)(2)(B).

> “One-stop shopping” refers to the capability of a single telecommunications provider to offer consumers both local and long distance service. See, e.g., Samuel F. Cullari, Comment, *Divestiture II: Is the Local Loop Ripe for Competition*, 3 COMMLAW CONSPECTUS 175, 181 (1995) (commenting on Ameritech Corp.’s restructuring plan to “create twelve individual business units, each dedicated to a specific task . . . [and] all under the single Ameritech name”).
is it that an industry wakes up one day, finds its addressable market expanded by 40% and can launch the new service without noticeable dilution and achieve positive earnings by the second year.\(^{59}\)

Third, Section 273 permits the RBOCs to engage in the manufacture and sale of telecommunications equipment, effective on the date of an RBOC's entry into the long distance market pursuant to Section 271.\(^{60}\) RBOCs have made repeated attempts to gain entry into these markets since divestiture in 1984.\(^{61}\) This suggests that the RBOCs believe manufacture and sales of telecommunications equipment has significant revenue potential.

In addition, Section 254 requires that every provider of interstate telecommunications services contribute on "an equitable and nondiscriminatory basis" to federal and state universal service support mechanisms.\(^{62}\) These contributions subsidize the cost of service incurred by telecommunications carriers for the provision of service in rural or other high cost service areas and reduce the need for ILECs to recover monopoly rents on other services in order to recover network costs.\(^{63}\)

Finally, the existence of any economic impact of the Act is predicated on the actions of consumers. To the extent consumers show strong brand allegiance to the ILECs, the sale of unbundled network elements may not come to pass. Any calculation of economic impact on the ILEC's over-all operations requires speculation as to the magnitude of these sales. Such speculation, however, provides no basis of support for the ILECs' takings claims.

All of the above-listed revenue streams constitute the mechanism by which ILECs may receive revenue compensating for the imposition of regulatory restrictions on the pricing of unbundled network elements. On balance, these revenue benefits may in fact increase the profitability of the ILECs. As GTE notes in its 1995 Annual Report, "[t]he gains [under the Act] will far outweigh the losses. We'll gain from strong market growth, by entering the long-distance and home-entertainment markets, and as a wholesaler of wireline and wireless services."\(^{64}\) Additionally, BellSouth notes that "[a]s a result of the 1996 Act, BellSouth is freed from many of the laws, regulations and judicial restrictions . . . that [previously] constrained the provision of voice, data and video communications throughout its wireline service territory and elsewhere."\(^{65}\) Moreover, Southern New England Telephone, which entered the long distance market three years ago, now has a 30% market share in Connecticut.\(^{66}\) The Act also has permitted the Baby Bells\(^{67}\) to begin immediate sale of long-distance service to cellular customers.\(^{68}\) Southwest Bell Communications already has secured 43% of the long distance market share with regard to its existing cellular custom-

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\(^{63}\) As stated by Congress, consumers in rural, insular and high cost areas should have access to "telecommunications and information services . . . that are reasonably comparable to those services provided in urban areas" at comparable rates. Id. § 254(b)(3). In a monopoly environment, the public policy to make available universal services to all has led to the pricing of some services at economically inefficient (and competitively unsustainable) high levels, under the theory that such pricing was necessary to subsidize the provision of universal service. FCC Order, supra note 13, para 5. To the extent that pricing of unbundled network elements at economically efficient, pro-competition prices eliminates inefficient cross subsidization of universal service, Congress envisioned competitively neutral contributions to state and federal universal service funds which would compensate an ILEC (or any other carrier providing services to rural, insular and high cost areas) for certain costs in excess of the subsidized rate. 47 U.S.C.A. § 254(d) (West Supp. 1996); see also House Conf. Report, supra note 2, at 131.

\(^{64}\) GTE 1995 Annual Report, supra note 24, at 8.

\(^{65}\) BellSouth 1996 Notice, supra note 24, at A-15.


\(^{67}\) The 1982 divestiture of AT&T, pursuant to court order, created seven regional bell operating companies (RBOCs). United States v. AT&T Co., 552 F. Supp. 131 (D.D.C. 1982), aff’d sub nom. Maryland v. United States, 460 U.S. 1001 (1983). These seven companies, Pacific Telesis, SouthWestern Bell, US West, BellSouth, Bell Atlantic, NYNEX, and Ameritech, are commonly known as the "baby bells."

ers.\(^69\)

None of the compensatory aspects of the statutory framework are fully implemented at the present time. Many state commissions have yet even to establish permanent prices for interconnection and unbundled network elements.\(^70\) Moreover, these commissions have scarcely begun Section 271 proceedings to determine whether the ILECs have satisfied the Act's conditions for entry into the long-distance market.\(^71\) In addition, ILEC manufacture and sale of telecommunications equipment pursuant to the Act will not occur until the FCC has made the requisite Section 271 approvals triggering these rights. Finally, the FCC and state commissions have not completed universal services proceedings designed to adjust subsidies for service to rural or other high cost service areas.\(^72\) As a threshold matter, therefore, until the statutory scheme is fully implemented, any assessment of whether specific regulations concerning pricing of unbundled network elements effect a taking without just compensation is premature.

IV. APPLICATION OF THE TELRIC PLUS METHODOLOGY, IN AND OF ITSELF, JUSTLY COMPENSATES ILECS FOR USE OF UNBUNDLED NETWORK ELEMENTS

As discussed above, the Telecommunications Act establishes a statutory framework that will, when implemented, fully compensate ILECs for restrictions placed on the pricing of unbundled network elements.\(^73\) However, while Sections 251 and 252 prohibit ILECs, in the name of competition, from charging monopoly rents for unbundled network elements, these sections also mandate that market entrants pay full value (and thus provide just compensation) for these elements at cost-based rates.\(^74\) Accordingly, prices charged to market entrants for unbundled network elements, alone, will constitute just compensation for use of those elements.

Arguing to the contrary, the ILECs have stressed the need to account for the historical costs and valuation of their property in assessing whether application of the TELRIC Plus methodology provides just compensation for the alleged taking.\(^75\) The Supreme Court, however, has observed that the Constitution does not require that property be valued at original purchase price, particularly where the current market value of the property is different from the original price:

[T]he due process clause never has been held by this Court to require a commission to fix rates . . . on the historical valuation of a property whose history and current financial statements showed the value no longer to exist . . . . The due process clause has been applied to prevent governmental destruction of existing economic values. It has not and cannot be applied to insure values or to restore values that have been lost by the operation of economic forces.\(^76\)

A simple example demonstrates the rationality of the Court's position: A homeowner purchases a home at an original cost of $200,000. At some subsequent time, the value of his home has fallen to $150,000 because, in the market, the home can be replicated, or a like home purchased, for $150,000. The government takes his property in order to construct a critical government facility. If the government pays the homeowner $150,000, it compensates him fully for the current economic

\(^69\) Kupfer, supra note 66, at 138.

\(^70\) FCC Order, supra note 13, para. 22.

\(^71\) As of January 1997, the FCC has received only one Section 271 application to provide in-region long distance services. Letter from Kelly R. Walsh, Executive Vice President and General Counsel, Ameritech Michigan, to William F. Caston, Acting Secretary, Federal Communications Commission (Jan. 2, 1997) (on file with the CommLaw Conspectus). This is not surprising given the uncertainty and delay in the completion of interconnection agreements, in part created by the Eighth Circuit's stay of the FCC's pricing rules. See supra note 17. Such agreements are required, inter alia, as part of the competitive checklist under Section 271 that RBOCs must meet to receive FCC approval of in-region long distance services. 47 U.S.C.A. § 271(c)(2)(B) (West Supp. 1996). Ameritech withdrew its application on February 11, 1997 after the FCC ruled that Ameritech had not met the competitive checklist under Section 271. Ameritech Withdraws Petition to Offer Long Distance in Mich., Communications Daily, Feb. 12, 1997, at 1.


\(^73\) See supra text and accompanying notes 58-65.


value of his property. If, however, the government pays the homeowner $200,000, this amount compensates him not only for the value of the property, but also for losses sustained solely because of economic forces permitting replication or purchase of the home for less money.77

The historic, embedded book values which the ILECs seek are not reflective of current market values. Recent arbitration proceedings throughout the country have established this fact.78 This is because the technology currently in place is not the technology of the future. With or without competition, it is inevitable that the current networks will be updated and replaced with technologically advanced equipment. It is the cost of this equipment that ultimately defines the market value prices competitors will charge and consumers will pay in the local exchange market.79 Both ILECs and ALECs agree that these costs will be less than the costs ILECs have incurred to install their existing embedded networks.80 The mere fact that the ILECs' property values have diminished due to market forces (e.g., advances in technology), implicates no constitutional concerns; thus no takings claim will arise if ILECs receive compensation equal to the current fair market value of their networks but less than their historic costs.

V. PRICING UNBUNDLED NETWORK ELEMENTS AT TELRIC PLUS DOES NOT CONSTITUTE A TAKING

The Fifth Amendment of the Constitution requires that "private property [not] be taken for public use, without just compensation."81 As noted above, legitimate government action justly compensated implicates no constitutional concerns.82 The ILECs have raised no general constitutional challenges to the statutory scheme Congress has enacted. This may reflect the ILECs recognition of the legitimacy of the government purpose and the fact that the multiple facets of the Act's statutory scheme do in fact provide just compensation for any perceived taking.

The ILECs base their takings claim on their assertion that use of the TELRIC Plus methodology will deny them recoupment through unbundled network revenues of all historic and/or embedded costs and profit, contrary to the reasonable expectations of their investors.83 To ensure that a taking does not occur, the ILECs argue that the pricing methodology must guarantee the recovery of all prudently incurred costs of investing in local networks.84 The incumbent carriers also contend that the Takings Clause requires state public service commissions and the FCC to allow the carriers sufficient recovery of invested capital "to maintain its credit, to attract capital, and to ensure a return that will be commensurate with investments of a similar risk."85 The incumbent carriers point to the Supreme Court's statements in Federal Power Commission. v. Hope Natural Gas Co.86 that the utility's rates must provide for capital costs as well as operating expenses.87 In Hope Natural Gas, the Court stated that "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."88

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77 The decision to open the local exchange market to competition (and corresponding market forces) is separate from the selection of the TELRIC Plus pricing methodology. While the perceived free market value of unbundled network elements in a competitive environment is conceptually related to the economics of forward-looking pricing, it is not causally related to the use of the TELRIC Plus. Thus, any diminishment in ILEC property values resulting from competition is not properly compensable as a taking without just compensation arising from use of the TELRIC Plus methodology. The ILECs do not claim that Congressional action to permit competition, itself, implicates the Fifth Amendment takings clause. In fact, they cannot because the Act establishes a scheme providing compensation for property that may be devalued. See supra text and accompanying notes 53-65.


79 See FCC Order, supra note 13, para. 640.

80 See id. paras. 639-40. For example, fiber optic Digital Loop Carrier technologies available today are more cost effective than the copper wire loops previously employed. In addition, ILECs continue to carry the costs related to older telephone loop architectures such as those utilized to provide multiple party lines. These architectures often contain thousands of feet of cable that can no longer serve its intended use given the predominance of single party lines in the telecommunication networks of today.

81 U.S. CONST. amend. V.

82 See supra text accompanying note 45.

83 GTE Takings Report, supra note 75, at 32-33.

84 Id.

85 Id. at 16.

86 320 U.S. 591 (1944).

87 GTE Takings Report, supra note 75, at 15 (citing to Hope Natural Gas, 320 U.S. at 603).

88 Hope Natural Gas, 320 U.S. at 603.
The TELRIC Plus methodology specifically excludes contribution to embedded costs in excess of forward-looking costs.\textsuperscript{89} Unbundled network element revenues, therefore, may not recover all historic costs of producing these elements.\textsuperscript{90} This is consistent, however, with takings law which permits the establishment of rates that are just, reasonable, non-confiscatory, and reflective of market values. Analysis of the incumbent carrier's claims at varying levels demonstrates that use of the TELRIC Plus pricing methodology does not give rise to an unconstitutional taking, and complies with Supreme Court case law for state regulatory actions.

A. Use of TELRIC Plus Does Not Constitute a "Categorical" Taking

The Supreme Court in \textit{Lucas v. South Carolina Coastal Council}\textsuperscript{91} identified only two categorical instances in which governmental action goes beyond regulation and effects a taking requiring just compensation where the governmental action: (1) results in physical appropriation; or (2) deprives the owner of "all economically beneficial or productive use of [property]."\textsuperscript{92} Application of the TELRIC Plus pricing methodology, developed in accordance with the Act's admonition that rates be "just, reasonable and nondiscriminatory," does not result in a "categorical" taking under \textit{Lucas}. Even considering only those revenues generated through TELRIC-based unbundled network element prices, the ILECs, under the Act, receive compensation for the market value of their property. Indeed, the ILECs' network elements have multiple economic uses. Not only may ILECs make money on the sale of these elements to market entrants, but the ILEC itself uses these network elements to provide a myriad of telecommunication service packages to existing ILEC retail customers. These services also may be sold individually to market entrants as wholesale services subject to resale. In addition, elements bundled into service offerings also generate considerable revenues through access charges levied against long distance carriers seeking to transport and terminate long distance calls on the ILECs' networks.

Where no "categorical" taking exists, the determination of what constitutes a compensable taking requires an intensely factual inquiry, for which, the Supreme Court has oft noted, no established formula exists:\textsuperscript{93}

While this Court has recognized that the "Fifth Amendment's guarantee is designed to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole," this Court, quite simply, has been unable to develop any "set formula" for determining when "justice and fairness" require that economic injuries caused by public action be compensated by the government, rather than remain disproportionately concentrated on a few persons.\textsuperscript{94} This lack of rigid criteria has led the Supreme Court to focus on two primary factors in determining the existence of a taking requiring just compensation: (1) the economic impact of the regulatory scheme; and (2) the extent to which the scheme impairs distinct investment-backed expectations.\textsuperscript{95}

B. Any Negative Economic Impact Is Not Sufficient to Constitute a Taking

"[I]n a wide variety of contexts th[e] government may execute laws or programs that adversely affect recognized economic values" without its action constituting a taking.\textsuperscript{96} Under the \textit{Lucas} calculus, however, the Court will consider evidence of economic impact in considering whether government regulatory action constitutes

\textsuperscript{89} \textit{See} FCC Order, \textit{supra} note 13, paras. 704-06.

\textsuperscript{90} \textit{Id.} para. 706 ("regulation does not and should not guarantee full recovery of [an ILECs'] embedded costs").

\textsuperscript{91} 505 U.S. 1003 (1992).

\textsuperscript{92} \textit{Id.} at 1015. The \textit{Lucas} Court held that a categorical taking had occurred where the owner was required "to sacrifice all economically beneficial uses in the name of the common good." \textit{Id.} at 1019 (emphasis in original). \textit{See also} Love-ladies Harbor, Inc. \textit{v. United States}, 28 F.3d 1171, 1182 (Fed. Cir. 1994) (finding that "this is a case in which the owner of the relevant parcel was deprived of all economically feasible use") (emphasis added).


\textsuperscript{94} \textit{Id.} at 123-24.

\textsuperscript{95} \textit{See} Lucas, 505 U.S. at 1019 n.8 (quoting \textit{Penn Central}, 438 U.S. at 124); \textit{Ruckelshaus v. Monsanto Co.}, 467 U.S. 986, 1005 (1984); \textit{see also} \textit{Penn Central}, 438 U.S. at 124 (treating, as a third factor, the character of the governmental action as physical invasion or mere regulatory adjustment of the "benefits and burdens of economic life to promote the common good").

\textsuperscript{96} \textit{Penn Central}, 438 U.S. at 124 (recognizing that the government's exercise of its power to tax for the general welfare is an "obvious" example of a noncompensable economic impact).
a taking requiring just compensation. Compensation may be necessary where the regulatory scheme effects a "partial taking" resulting in the loss of some, but not all, the property's value. While a claimant alleging economic impact may not receive compensation for a mere diminution in the economic use of property, loss of somewhat greater value may constitute a partial taking.

Significantly, it is the overall impact of a regulatory scheme and not merely the impact of a particular requirement therein that determines the extent to which economic impact is present. In *Colorado Springs*, the United States District Court for the District of Columbia considered the claim, brought by an agricultural Production Credit Association against the Farm Credit Administration, that forced contribution of funds to less healthy agricultural financial institutions under the Agricultural Credit Act of 1987 constituted a taking pursuant to the Fifth Amendment. In determining that no taking without just compensation had occurred, the District Court considered the "significant number of provisions in the Act that moderate and mitigate the economic impact" of the statute at issue. In attempting to demonstrate economic impact, a claimant bears the heavy burden of demonstrating that the regulatory decision, in its entirety, is both unjust and unreasonable.

Reliance on lack of profitability in one portion of a business establishes no taking. As the Supreme Court in *Hope Natural Gas* observed, "[i]t is not theory but the impact of the rate order which counts. If the *total effect* of the rate order cannot be said to be unreasonable, judicial inquiry . . . is at an end." Thus, in considering the effect of the government action, the effect of the entire regulatory scheme must be taken into account – the prices for unbundled network elements, the revenue from resale, the revenue from long distance, and any other compensation the ILEC receives as owner of the unbundled network elements.

The ILECs rely on the Supreme Court's statements in *Brooks-Scanlon Co. v. Railroad Commission of Louisiana* for the proposition that a statutory scheme effects a taking if it causes a regulated entity to lose money in any facet of its business operations. *Brooks-Scanlon*, however, simply stands for the proposition that a regulated entity must be permitted to go out of business rather than operate, in its entirety, at a loss. If it remains in business, the regulated entity may nevertheless be compelled to continue service in a particular area of its business even though operation of this activity involves a loss. As noted by the Court, "the Constitution does not confer upon the company the right to continue to enjoy the [regulatory] franchise or indeterminate permit and escape from the burdens incident to its use."

The ILECs can demonstrate no financial burden, as a preliminary matter, because all compensatory mechanisms of the Act are not yet implemented and because no substantial level of competition requiring sales of unbundled net-

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97 Lucas, 505 U.S. at 1015.
98 Loveladies Harbor, 28 F.3d at 1180; Florida Rock Indus., Inc. v. United States, 18 F.3d 1560, 1572 (Fed. Cir. 1994).
99 The term "mere diminution" refers to a decreases in property value resulting from shared economic impacts... in which the property owner has in a sense been compensated by the public program adjusting the benefits and burdens of economic life to promote the common good. "Loveladies Harbor, 28 F.3d at 1180 (quoting Penn Central, 438 U.S. at 124).
100 Florida Rock, 18 F.3d at 1568 (noting that the inquiry for a "partial taking" is whether "there was some (but not a total) reduction in the overall market value of plaintiff's property as a result of the regulatory imposition") (emphasis in original).
103 Id. at 13 (quoting Connolly v. Pension Benefit Guaranty Corp., 475 U.S. 211, 225 (1986)).
work elements at TELRIC-based prices yet exists in the local exchange market.\footnote{112} In addition, under \textit{Hope Natural Gas}, no economic impact can arise simply from the use of the TELRIC Plus methodology. Only the end result, the impact of the use of TELRIC Plus, in connection with the other economic impacts of the act, may create a basis for a takings claim.\footnote{113} In any event, absent implementation of the entire new statutory scheme, any takings claim is premature.

Even if the ILECs' takings claim were not premature, Supreme Court precedent suggests that, under the regulatory takings analysis, a severe financial burden would only exist if the agency's chosen rate-making methodology produced rates so low as to leave insufficient operating capital or impede the ILECs' ability to raise future capital.\footnote{114} In \textit{Illinois Bell Telephone Co. v. FCC},\footnote{115} the \textit{D.C. Circuit} examined an ILEC's assertion that the TELRIC rate formula was confiscatory because it excluded part of the carrier's original investment from the rate base.\footnote{116} The Court rejected this contention, noting that "[t]here simply has been no demonstration that the FCC's rate base policy threatens the financial integrity of [the incumbent carriers] or otherwise impedes their ability to attract capital."\footnote{117} Accordingly, the court held that the FCC was under no obligation to base rates on all historical costs for investments prudent when made.\footnote{118}

Similarly, the TELRIC Plus methodology will not deny the ability to attract capital. Despite the fact that the ILECs have, in recent years, written off billions of dollars of embedded investment to conform deprecations lives with those in the competitive market,\footnote{119} these write-offs have not resulted in greatly reduced stock prices or otherwise impeded ILECs' abilities to raise capital.\footnote{120} In fact, while write-offs have decreased dividends for the years in which they are taken, Wall Street has generally applauded these efforts as preparation for inevitable competition. Where, as here, the ILECs have had every opportunity to submit evidence of any sharp decline in share prices, their silence in this regard speaks loudly.\footnote{121} Moreover, because the TELRIC Plus methodology by definition includes the costs of attracting capital, use of this methodology, going forward, ensures that no economic hardship of constitutional proportions will arise.

C. TELRIC Plus Pricing Does Not Frustrate Reasonable Investment-Backed Expectations

The second factor is the extent to which the "regulation . . . interfere[s] with [the] distinct investment-backed expectations" of the individuals upon which the statutory burden is placed.\footnote{122} Any such reasonable expectation must be based

\footnotesize{\textit{Act}, Universal Service, CC Dkt. No. 96-45; and Interstate Access Charge Reform, CC Dkt. Nos. 96-262, 94-1, 91-215, and 96-263.\footnote{112} Although a number of states have adopted TELRIC Plus, or a similar methodology, \textit{FCC Order}, supra note 15, para. 681, actual use in the marketplace has been slow because of challenges to its constitutionality, even on the state level. \textit{See GTE Takings Report}, supra note 75.\footnote{113} \textit{See Federal Power Comm'n v. Hope Natural Gas Co.}, 320 U.S. 591, 602 (1944) ("[i]t is not theory but the impact of the rate order which counts;" rather, it is only necessary that the "total effect" be just and reasonable).\footnote{114} \textit{See Duquesne Light Co. v. Barach}, 488 U.S. 299, 312 (1989). The Supreme Court reviewed a state-imposed rate order and found that it was not constitutionally objectionable. The Court found that "[n]o argument has been made that these slightly reduced rates jeopardize the financial integrity of the companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital." \textit{Id.} The Court further found that there had been no demonstration "that these rates are inadequate to compensate current equity holders for the risk associated with their investments under a modified prudent investment scheme." \textit{Id.} at 312.\footnote{115} 988 F.2d 1254 (D.C. Cir. 1993).\footnote{116} \textit{Id.} at 1258.\footnote{117} \textit{Id.; see also Duquesne}, 488 U.S. at 312 (exclusion of certain prudent investment costs does not render rate order constitutionally infirm).\footnote{118} \textit{Illinois Bell}, 988 F.2d at 1263.\footnote{119} \textit{See, e.g., BellSouth 1996 Notice}, supra note 24, at A-20-A-26-27; \textit{GTE 1995 Annual Report}, supra note 24, at 32-33.\footnote{119} \textit{In re Southwestern Bell Telephone Co. Memorandum Opinion and Order}, 7 FCC Rcd. 2906, para. 40 (1992) (rejecting claim that rule was confiscatory on grounds that ILEC "made no showing that supports a finding that it is unable to attract capital.")\footnote{120} To the contrary, since passage of the Act, Wall Street reports that the ILECs have experienced robust revenue and earnings-per-share growth. \textit{See, e.g., Merrill Lynch, Pierce, Fenner & Smith, Inc., United States Telecom Services RBOCs & GTE 2} (Feb. 19, 1997). As of the fourth quarter of 1996, RBOC/GTE share prices were, in fact, outperforming the market. \textit{Id.} at 4. Moreover, investment risk ratings have remained constant, and Merrill Lynch, at least, rates investment in the ILECs as "Accumulate or higher." \textit{Id.} at 3. Significantly, Wall Street perceived passage of the Act as "a very pro-RBOC rewrite of telecommunications regulation." \textit{Merrill Lynch, Pierce, Fenner & Smith, Inc., United States Telecom Services - RBOCs & GTE 2} (Feb. 23, 1996). As a result, Wall Street predicts an improved outlook for the ILECs and "the opposite for the larger long distance companies." \textit{Id.} at cover page (emphasis added).\footnote{122} \textit{Lucas v. South Carolina Coastal Council}, 505 U.S. 1003, 1019 n.8 (1992); \textit{Ruckelshaus v. Monsanto Co.}, 467 U.S. 986, 1005 (1984); \textit{Penn Central Transp. Co. v. New York
on other than a "unilateral expectation or an abstract need," and it is not enough that a new duty imposed on a regulated entity "upsets otherwise settled expectations." As the Court noted in Connolly, "[t]hose who do business in the regulated field cannot object if the legislative scheme is buttressed by subsequent amendments to achieve the legislative end" – an expectation is reasonable only if based on an "explicit governmental guarantee.

The mere existence of benefits and obligations established under a particular regulatory scheme creates no reasonable expectation that the government will not alter these benefits and obligations to the detriment of individual property values. This is particularly true in industries that "long ha[ve] been the focus of great public concern and significant government regulation." Moreover, when the statutory scheme regulates interdependent entities such as the ILECs and long distance providers, any single entity may, in fact, expect regulatory changes for the good of the whole which may adversely affect an individual entity.

The ILECs argue that state commissions, through a regulatory compact, have promised them recovery of all embedded costs plus profit, and according to the ILECs, this regulatory compact gives rise to reasonable investment-backed expectations. As noted above, however, under established Supreme Court precedent, no reasonable investment-backed expectation may be reasonable only if based on an "explicit governmental guarantee." The ILECs argue that state commissions, through a regulatory compact, have promised them recovery of all embedded costs plus profit, and according to the ILECs, this regulatory compact gives rise to reasonable investment-backed expectations.

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Finally, investors have been on notice, at least since divestiture, of the possibility that regulators would seek competition, at least where the "natural monopoly" has given way to the economic or technological possibility of competition. According to some commentators, the move toward competition in telecommunications industry has been evident since the 1950s. In 1971, the FCC determined that new carriers could enter the interexchange market, signifying clear governmental intent to permit competition in telecommunications. No later than 1994, Competitive Access Providers ("CAPs") and other competitors such as cellular, new wireless technologies (such as Personal Communications Services), and cable provided the unmistakable capability to compete for areas of the ILECs' market in the local exchanges. In 1994, FCC Chairman Hundt affirmed the Commission's commitment to "introducing competition into the local exchange market.

Thus, as BellSouth recognized in price cap regulation proceedings begun over a year and a half ago:

[i]n a monopoly environment, the regulator established a rate of return and a revenue requirement which provided the opportunity for the utility to recover its investment over the life of such investment. Today, with the changes in technology and accelerating competition, the regulator can no longer reasonably predict or provide this opportunity.

As a result of the pervasive and long-standing governmental interest in the possibility of effective competition in telecommunications markets and specifically in the local exchange market since divestiture of AT&T, no reasonable ILEC investor could have expected that the local exchange market would remain a monopoly forever. Moreover, investors are on present notice of the advent of competition and use of TELRIC Plus to price unbundled network elements in the local exchange market. As previously indicated, ILEC investors have not experienced significant economic impacts of the Act to date. Accordingly, any future losses they may experience will be due only to unreasonable investor-backed expectations and implicate no constitutional concerns.

VI. CONCLUSION

The Telecommunications Act of 1996 seeks to encourage competition in all facets of the telecommunications industry. The changes brought about by this statute significantly adjust the burdens and benefits which the regulatory framework accords industry participants, permitting long distance carriers and other would-be entrants into local markets and allowing ILECs reciprocal entry into the long distance market.

Interpreting the Act, many state commissions have priced unbundled network elements using forward-looking pricing methodologies including TELRIC Plus (which the FCC determined simulates prices that would be paid in a competitive market). ILEC claims that cost-based TELRIC Plus rates effect a taking without just compensation are without merit. First, these arguments are premature because they precede implementation of the full statutory scheme the Act establishes. Second, the statutory scheme justly compensates incumbent carriers for the use of their unbundled network elements both through cost-based TELRIC Plus rates, alone, and through the other rights and privileges afforded ILECs under the Act. Finally, consideration of: (1) economic impacts due to the Act; and (2) the basis for investment-backed expectations of continued monopoly rents suggests that the statutory scheme has resulted in no significant, negative economic harm to ILECs and that investors no longer may claim reasonable investment-backed expectations in the status quo. Accordingly, neither the Act nor the TELRIC Plus pricing methodology constitutes a taking without just compensation in violation of the Fifth Amendment.

140 See Cullari, supra note 58, at 175.
141 See Cullari, supra note 58, at 175.
143 Chairman Reed Hundt, Toward Regulation that Fosters Competition, 39 FED. COM. L. J. 265, 266 (1994).