IN THE SUPREME COURT OF THE UNITED STATES

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VERIZON COMMUNICATIONS, INC., :
ET AL., :
Petitioners :
v. : No. 00-511
FEDERAL COMMUNICATIONS :
COMMISSION, ET AL.; :
- - - - - - - - - - - - - - - - -X
WORLDCOM, INC., ET AL., :
Petitioners :
v. : No. 00-555
VERIZON COMMUNICATIONS, INC., :
ET AL.; :
- - - - - - - - - - - - - - - - -X
FEDERAL COMMUNICATIONS :
COMMISSION, ET AL., :
Petitioners :
v. : No. 00-587
IOWA UTILITIES BOARD, ET AL.; :
- - - - - - - - - - - - - - - - -X
AT&T CORP., :
Petitioner :
v. : No. 00-590
IOWA UTILITIES BOARD, ET AL.; :

- - - - - - - - - - - - - - - - -X
GENERAL COMMUNICATIONS, INC., :
Petitioner :
v. : No. 00-602
IOWA UTILITIES BOARD, ET AL. :
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Washington, D.C.
Wednesday, October 10, 2001

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 11:02 a.m.

APPEARANCES:

WILLIAM P. BARR, ESQ., Washington, D.C.; on behalf of the Petitioners in No. 00-511.

THEODORE B. OLSON, ESQ., Solicitor General, Department of Justice, Washington, D.C.; on behalf of the Federal Petitioners.

DONALD B. VERRILLI, JR., ESQ., Washington, D.C.; on behalf of the Petitioners in Nos. 00-555, 00-587, and 00-590.

C O N T E N T S

P R O C E E D I N G S

(11:02 a.m.)

CHIEF JUSTICE REHNQUIST: We'll hear argument next in No. 00-511, Verizon Communications v. FCC; Worldcom v. Verizon; FCC v. Iowa Utilities Board; Iowa Utilities Board v. General Communications.

Mr. Barr.

ORAL ARGUMENT OF WILLIAM P. BARR

ON BEHALF OF THE PETITIONERS IN NO. 00-511

MR. BARR: Mr. Chief Justice, and may it please the Court:

I'd like to start with a brief illustration that I think will help crystalize the legal issues, both the so-called forward-looking issues and the historical cost issues. The illustration itself starts with a forward-looking perspective.

Now, any firm that operates and builds a network incurs three costs going forward. Let's say I, the hypothetical new entrant capable of coming in today and instantaneously deploying the most efficient network possible today, I would have to expend my baseline facility costs. And let's say the FCC is right. Let's say that costs about $180 billion to reproduce the system today from scratch. Then I would face my operating costs that are dictated by the network that I just built. Let's say those are $75 billion a year. And then I would face the incremental capital investment that I would make each year to upgrade and expand the network. Let's say that's $30 billion a year.

Now, let me show why under TELRIC no firm that actually makes expenditures can recover them.

QUESTION: What -- what was your second cost, the 75?

MR. BARR: The 75 is operating costs dictated by the network that I've deployed.

QUESTION: Per year?

MR. BARR: Per year, which is how much our operating costs are per year.

QUESTION: And the first was -- was the -- the --

MR. BARR: Building the network from scratch.

QUESTION: Just -- not the -- not the debt -- debt service on building it?

MR. BARR: No.

QUESTION: But the building it.

MR. BARR: Yes.

QUESTION: That's a -- that's a one-time cost.

MR. BARR: Yes.

QUESTION: Not an annual.

MR. BARR: That's the sunk capital cost.

QUESTION: But you're using the depreciated figure, the 180 --

MR. BARR: No. I'm starting -- I'm starting -- yes. That's the -- that's the initial construction. I'm -- I'm not talking about me as the incumbent. I'm talking about someone new coming in today.

QUESTION: You -- you presented three questions. Is -- is your illustration and what you're about to discuss devoted to all three questions or to one in particular?

MR. BARR: I'm going to show -- it's devoted to all three, and I'm going to show how TELRIC does not, going forward, permit the recovery because it bases compensation, for someone who has already expended money on the network, on the imaginary cost structure of a hypothetical entrant who can be unconstrained and who's capable, at any given time, of instantaneously deploying and ubiquitously deploying a brand new network that's the most efficient at that point.

Now, if you look at my $180 billion that I've just spent on building this network, in the world of TELRIC, I now face the prospect of people springing up on a daily basis who are capable of taking advantage of any new technology and any change in demographics and configuration to beat the efficiency of my network. And my -- and -- and with that hypothesis, I won't be able to recover my costs unless I have a high rate of return and fast depreciation.

QUESTION: But we've said in -- in a number of cases, going back 50 years, that if you're talking about an unreasonable rate of return or a taking or something that has constitutional implications, you -- you can't attack the method because different methods can work out differently. You have to point to some unjust final result. And there hasn't been any final result here.

MR. BARR: Well -- well, Your Honor, I think that what the Court has done is made distinctions between ends and means. Now, there can't be discretion under the Constitution as to how much is due. That can't be discretionary or else there's -- that eviscerates the Just Compensation Clause.

What -- our view is that when you have a regime of compelled service, where the Government says, you got to spend the money to provide a mandated service, the taking occurs at the point of expenditure. And that means the Government has to give me a chance to get that -- a fair opportunity to get that money back.

Now, what the Government has discretion over is the means as to get me that money back.

QUESTION: They're probably going to be set by

State commissions, are they not?

MR. BARR: Excuse me, Your Honor?

QUESTION: Aren't -- aren't these costs and fees going to be ultimately set by State commissions applying the FCC rules?

MR. BARR: The rates themselves will be set by -- by the State commissions, implementing a methodology, and we are complaining about the methodology because --

QUESTION: Well, but that's just what the cases say you can't do, it seems to me, going back to the Stone's opinion 50 years ago, the opinion of the Court in Duquesne, that you can't attack the methodology unless you can point to something wrong in the actual fee that you're allowed or the rate that you're allowed.

MR. BARR: Well, Your Honor, I think that the Court has always reviewed methodologies. Now, sometimes rates can be evidence of a defect in a methodology, but it doesn't have to be. And in the Duquesne itself, the Court said if the methodology is not compensating you for a methodological risk to which you are exposed, that's a problem today, and that is our claim, that the methodology itself exposes us to a risk of not recovering what we spend. And -- and we are entitled to compensation for that risk.

If the taking --

QUESTION: Excuse me. Just a risk? It's -- I mean, but there's always a risk, I suppose, until you get the final determination by whoever the ratemaker is. I thought our prior cases held that so long as -- so long as it's possible under the -- under the rate structure for you to be compensated fully, you have no complaint until -- you know, until the final -- the final rate is determined. At that point, you can come in and complain, but the mere possibility that they may pick the wrong rate surely is not enough to give you a takings claim.

MR. BARR: Well, if -- if we are correct that we are entitled to a fair opportunity to recover our costs and the Government decides that they're going to spin a roulette wheel, I can't come in and say that's a problem? That exposes me to risk?

The reason we have -- why do we have methodologies set in the first place instead of later -- instead of later proceedings? We have them to set up front a promise to pay that sets investor expectations and ensures that the users, not the Government, is going to end up footing the bill. That's why we have ratemaking. And this Court has always reviewed methodologies to determine whether or not they comport with the constitutional standard and whatever Congress has directed in the statute.

Now, it's very important that we focus on the difference between the ends and the means. What is it -- what do you mean when you say, well, the Government has discretion over methodology? It can't mean that they have discretion as to how much is ultimately due. That takes the Court out of the business and just eviscerates the Just Compensation Clause.

What it means is that once it's determined that I have an -- I should get an opportunity to get my costs back, the Government can expose me to risks. The Government doesn't have to guarantee it and sign me a check. They can measure my recovery with some other formula, as you pointed out in your concurrence opinion in Duquesne, Justice Scalia. They can formulate the methodology in -- in another way. But when you formulate it in another way, when you untether recovery from historical costs or my expenditure, that creates a risk. Now, sometimes it may create an opportunity in an -- in an age of inflation. In an age of deflation, it may cause a risk.

QUESTION: But numerous cases have said that the ratemaking agency is not required to follow -- to adopt historical costs as the method of fixing rates.

MR. BARR: That's the method, but the objective has to be an opportunity of getting me back my costs.

What -- when -- when I am required to spend money by the Government -- when I'm required to spend money by the Government -- let's say it would cost the Government a billion dollars today to provide a public good and service. And the Government, instead of spending that today, which anyone would have to spend, comes to me and conscripts my private capital into building this thing for a billion dollars, and then later says, well, I don't have to worry about getting you back a billion dollars. That's not my business. I have discretion over a methodology.

The question -- what is meant by discretion on a methodology is that the Government can expose you to risk as long as it compensates you for the risk. And that's exactly what Duquesne said.

QUESTION: Now, you say this case is different from previous rate cases. In the previous rate cases, the expenditure has been made and the question is fair compensation, just compensation. You say here you're being asked to expend an additional out-of-pocket sum, and you're entitled to know what the methodology is at the outset. Is that --

MR. BARR: No. I'm saying that all the --

QUESTION: Is that your point?

MR. BARR: No. My -- my point is that all methodologies are the Government's promise to pay at the time it takes the property. The Government takes a property in a forced -- in -- in a regime of compelled service, the taking occurs when I spend the money. If I have $1,000 --

QUESTION: But that's true in any ratemaking case.

MR. BARR: Right.

QUESTION: And -- and the Chief Justice and Justice Scalia are saying our cases say we have to wait to see what the rate is. I thought your position was, well, this is different because we have an initial outlay that we're required to make now. I'm not trying to -- maybe I misunderstand your argument.

MR. BARR: Well, no, that's right. The reason we have methodologies and the reason I'm entitled to know that I have a fair opportunity to recover it is that I shouldn't be forced to spend money, to lay out money unless have a fair opportunity to get it back.

QUESTION: No. But your whole argument is assuming that by adopting this particular methodology, it is some kind of a necessary conclusion that at the end of the day, you're going to be getting less of a return than you would have gotten if an historic cost methodology had -- had been employed. And that simply is not true. We don't know whether that is so or not.

MR. BARR: Well, actually, you know, we do know whether it's so. I was just about to explain on the forward-looking basis. But -- but --

QUESTION: Then -- then why haven't you come in telling us about rates that you were getting that in fact are bleeding you dry. You haven't made that argument. That's not your case.

MR. BARR: Well, because I'm not -- well, there are two reasons. One, we're not complaining about a rate. A rate is evidence of a defect. It is not an -- we're not -- we're not complaining about a specific application. We're complaining about a systemic defect in the methodology.

QUESTION: And -- and I could understand your argument if that systemic defect had a -- by -- by some logical necessity, the conclusion of compensating you for what, on traditional standards of review, would be a confiscatory rate.

MR. BARR: Yes.

QUESTION: But there is no such necessity that I can find in your argument. I just don't see where that step comes in.

MR. BARR: There are --

QUESTION: You don't concede that necessity, do you?

MR. BARR: No, I don't.

QUESTION: Otherwise, you would think that a -- that spinning a -- spinning a wheel of fortune would be an adequate methodology.

MR. BARR: Right. Rates --

QUESTION: No. You wouldn't. You wouldn't concede that.

QUESTION: I -- I agree with you that -- that we would not accept a spinning wheel as -- as being adequate, although spinning a wheel might give you compensation. it might not give you compensation. Who can say?

MR. BARR: In -- in the Duquesne case, the Court said even a small shift in methodology warrants an increase in the risk of premium because you are always entitled to get pay for -- to whatever risk you're exposed to. That's what methodological risk is.

There are two things on the face of this order --

QUESTION: And where -- and where does the increase in the premium take place? It takes place in State ratemaking, doesn't it?

MR. BARR: The problem here -- the problem here in this order -- there are two --

QUESTION: But that is correct, isn't it?

That's -- that's where the --

MR. BARR: No. The -- the decision took place in the Federal proceeding, and it took place in paragraph 688 and 702 of the order. And if we could look at those paragraphs, we pointed out --

QUESTION: Where -- where do we find them?

MR. BARR: Joint appendix 385-386 and joint appendix 395.

We pointed out that if you're going to make up a world in which our compensation is constrained as if we had intense competition today, then you should use the same methodology in imputing what the rate of return and what the depreciation would be. You can't imagine I'm in a world of turbo-charged technological risk and not give me that rate of return.

On page -- at paragraph 688, the Government said, well, you know, you might be entitled to -- we understand your argument about a higher rate of return, but you don't have that competition today. And our point is you've created a dichotomy between two different worlds, a world that you say is intensely competitive, in fact, in which our network is a commodity, and a world in which you say competition will be gradual and we're still a bottleneck. They've created a dichotomy.

Then they say, you get your costs back, your direct costs back, as if you were in a world of intense competition. But when it comes to making the -- that exposes us to a methodological risk. The risk of investing a dollar in a world where you -- where you have a historical cost methodology and investing it under TELRIC is a different risk. When -- when it comes to making that adjustment, they say, you can't do that. We're going to flip-flop. We're going to pretend you're in a world of gradual competition, and that's on paragraph 702 where they say, you start with your existing closed market rate of return and your closed market depreciation, and the only time you can make an adjustment is to adjust for actual competition. Well, actual competition is a different risk because I'm being exposed to imaginary competition.

QUESTION: If all of that is true and you're exposed to so much greater risk, I assume that your costs of capital will be much higher. It will be much harder to borrow money. And so all of those risks will ultimately be reflected in the amounts that the State ratemaking agencies will have to allow you for cost of capital.

MR. BARR: The States -- the issue here is the cost of capital in the UNE business, our wholesale business. Paragraph 702 prohibits the States from taking into account our historical costs, and it says you have to set the rate of return without a view toward recovering those costs. You cannot adjust for the risk. The rule itself, rule 505, and paragraph 702 -- the whole point of a methodology is to say if -- if I'm going to shift to some other basis of compensation other than historical --

QUESTION: I don't really read 702 as saying what you say it says, Mr. Barr. Maybe I'm missing something.

MR. BARR: Well, Your Honor, it -- it does say that you use -- you start with the current rate of return and the current depreciation.

QUESTION: Correct.

MR. BARR: It says that we bear the burden in the State proceedings of showing a business risk, and then it goes on to say that the business risk relates to actual competition. And -- and, indeed, in the universal service proceeding, paragraph 254 and 5 --

QUESTION: But it also makes the very point Justice Scalia made, that we recognize the incumbent LEC's are likely to face increased risks by reason of the increased cost of capital. It does refer to --

MR. BARR: Yes. They're talking about economic costs of capital. And the key question is, which economy in this hypothetical world? Is it the real economy, or is it your hypothetical world? Their rule says, increases in rate of return are based on actual competition. We are being exposed today to our pricing as if we lived in a world of intense competition, in which our product is a commodity, where we would need a very high rate of return.

And in their universal service proceeding where the FCC applied this methodology, it applied existing closed market rate of return and existing depreciation schedules. In its opening brief on page 8, it said, we are authorizing the States to change the rate of return based on actual levels of competition, but the methodological risk is not actual competition. The methodological risk is their cost recovery rule. They're mimicking an intensely competitive market.

We gave examples in our brief where Massachusetts tried to make different rates of return and they castigated them for using a different rate of return in the wholesale business than in the retail business.

In the retail business, we are exposed to actual competition. In the wholesale business, we are exposed to hypothetical intense competition where our network is deemed to be a commodity, and that's the only price we can derive. If we sell a product in the retail market, we get an opportunity to get our historical costs. If we sell it in the wholesale market, we're deprived of that because the -- the cost is brought down without a corresponding increase.

There are two things on the face of the order -- two things on the face of the order that are blatantly illegal -- on their face, without looking at a rate.

The first is it says, we are creating a methodological risk, and we're not going to allow an adjustment of the rate of return to reflect that methodological risk. We will not even let you look at the delta, the risk of a delta between your historical costs and whatever this comes out to be.

The whole point of a methodology is you have to look at the delta. Even Smyth v. Ames said you just don't look at a reproduction cost. You have to look at in relation to historical cost.

So, number one, in the rule itself they say you cannot look at historical costs. You can't say, you know, what's the risk here between one and the other and adjust.

The second thing that is facially illegal and again has nothing to do with rates is how do they value our input. If we're right that the taking occurs at the point of dedication, at the point of expenditure, then we have a right to have our property valued when we spend it. When I spend operating costs, I have a right to a fair opportunity to get those back.

QUESTION: But that's true of any utility in those cases that we've -- we've decided over the --

MR. BARR: And they don't. They don't. What they say is when they value our expenditure, they apply -- their --

QUESTION: Just -- who is they?

MR. BARR: The FCC rule.

QUESTION: Okay.

MR. BARR: Okay. The FCC rule values our expenditures based on TELRIC, but TELRIC is the efficiency that can be achieved by someone who doesn't have a sunk network and therefore has no path dependencies and therefore whose incremental cost is going to be lower than ours. And -- and what they say is, you spend $75 billion for operating expense? Well, our TELRIC guy -- you know, he could do it for $50 billion. So, you're getting credit for $50 billion.

And then on my incremental expenditures, if I -- once I build a network and I have it in the ground, I'm path-dependent. If I build a set of telephone poles to this subdivision, and the next year a subdivision opens up over here, okay, the most efficient way for me to provide it is to maybe do a nice, big, long line over there, and that might cost me $10 million. The FCC says, we don't care because at that point in time, we're going to hypothesize that someone can build a blank slate network and do it for 5 because they have the luxury of building it to meet that capacity on a blank slate.

QUESTION: Is the Government going to tell us that there are other ways you can recover that cost through depreciation or --

MR. BARR: No, because the thing they're -- the thing they're depreciating is the TELRIC price. This is -- this is the weirdness of the Government's rule. I spend $10 billion. It's necessary, prudent. It's the most efficient way for me to produce.

QUESTION: Are they going to tell us you get it back on the cost of capital?

MR. BARR: No.

QUESTION: Or is your answer the same because it's just the capital based on the TELRIC --

MR. BARR: Their briefs talk about cost of capital. Here's the -- here's the rub. When they say, well, we're going to value that as if it's 5 because someone else could be more efficient, a hypothetical person in a perfect market could be more efficient, so we're going to give you 5. But don't worry. Something might happen to the rate of return. The rule itself says you cannot adjust the rate of return to recover the historical cost. You can't. And the rate of return they're going to give us is on the 5, not on the 10, and the depreciation is of the 5, not on the 10.

There are two defects here. We're entitled to -- to the value of what we have to spend.

What they do is they take --

QUESTION: What about costs of capital?

MR. BARR: Excuse me?

QUESTION: Can you get it back in costs of capital? What costs of capital do they allow you?

MR. BARR: They allow the cost of capital that exists in a closed market. The pricing that they give us is the pricing that they say would exist if our network were a commodity. They don't change for the risk.

In other words, if today I spend $10 billion and that's prudent and necessary, and I -- I'm in a closed market or a market that's just been opened and I get 15 percent or 12 percent, that's scenario one.

Then they turn around and say, these same facilities you're now going to have to sell to somebody else, not in the retail market where you get 15 percent on $10 billion. Now you have to sell them to your competitors, and there you're going to get 15 percent on $7 billion. And -- and the point is that the risk now that my stuff is going to be valued at 7 instead of 10 is a risk, and the only way I can get compensated is by a higher rate of return.

QUESTION: But your point there -- the answer to Justice Scalia's question, I take it, was forgetting your first problem -- that's your first problem. Right? The one you brought up at the beginning.

MR. BARR: Correct.

QUESTION: The fact that they're pretending actual competition is what makes the difference, but what the problem arises out of is the fact that they're pricing on a hypothetically perfectly competitive market.

MR. BARR: Right.

QUESTION: That's your first point.

MR. BARR: Right.

QUESTION: If that point were wrong, then the answer to Justice Scalia, I take it, would be, there's no other problem. I mean, if they did that right and they lowered your new investment from $10 million to $5 million because that was TELRIC, in principle, they could get the money back for you by giving you a higher rate of return on your -- on your TELRIC estimated cost of capital.

MR. BARR: The rule says no. But -- but if you change the rule, you theoretically could do a high enough rate of return. But it doesn't solve the problem.

QUESTION: Where does the rule say no? Give us the -- the exact text where the rule says no.

MR. BARR: Okay. Paragraph 702 of -- of the order.

QUESTION: 395?

MR. BARR: And it also asks -- it's not in the record. It's a separate ruling, but the universal service proceeding, paragraph --

QUESTION: This is -- this is on -- this is at 395 of the joint appendix?

MR. BARR: Yes.

And this is how it has been implemented by the FCC --

QUESTION: And -- and can you show us the language there?

QUESTION: Yes. Where? What's the language?

MR. BARR: That the -- that the existing rate of return and existing depreciation are reasonable starting points.

QUESTION: Starting points.

QUESTION: Yes, starting points.

QUESTION: Are you talking about rule 707?

QUESTION: That's right.

QUESTION: 702.

MR. BARR: 702.

QUESTION: Page 395.

MR. BARR: This is not a calculation starting point. This is what's in effect. Then we have the burden of showing actual competition -- actual competition. It is not a reasonable starting point even if it was a temporal exercise because we are being exposed today to intense competition through the rule.

QUESTION: Now, but you're saying rule 702 prevents you from getting back what you otherwise should have through capital costs?

MR. BARR: Yes. In fact, they've admitted it in their brief.

QUESTION: And where -- and where -- what language in rule 702 are you relying on?

MR. BARR: I'm relying on the -- on the whole first half of that paragraph where they say, you start with existing. We have the burden of showing business risk, and then the remainder of that paragraph talks about actual competition.

It's not in the record, but it is a separate order.

QUESTION: Okay. But I -- since you're -- you're relying on it heavily for a particular proposition, I think you ought to be able to come closer than you have to point out exactly what language supports your position.

MR. BARR: We recognize that incumbent LEC's are likely to face increased risks given the overall increases in competition in the industry, which might warrant an increased cost of capital. That's the standard, whether there's actual competition.

That's what they say in paragraph 688. We said, look, in the TELRIC world, we need a higher rate of return. They say USTA's argument unrealistically assumes that competitive entry would be instantaneous. The more reasonable assumption of entry occurring over time will reduce the costs associated with sunk investment.

Our point is entry is instantaneous under TELRIC because that's the hypothesis. We're priced as if there's instantaneous entry.

QUESTION: At the bottom of page 83a, toward the end of rule 702, it says, States may adjust the cost of capital if a party demonstrates to a State commission that either a higher or lower level of cost of capital is warranted without the commission conducting a rate of return or other rate-based proceeding. That would seem to allow the State commissions to -- to do what you want done.

MR. BARR: That paragraph -- I think a fair reading of that paragraph and the way it is read and applied including --

QUESTION: What about the language I just quoted to you? How do you distinguish that if you don't -- if you don't agree with me?

MR. BARR: I would distinguish it by then looking at the rule, which is rule 505, and that's on joint appendix 51 and 52. And it tells you what you cannot consider in setting forward-looking costs, including forward-looking cost of capital. And (d) says -- page 52 -- the following factors shall not be considered in a calculation of the forward-looking economic cost of an element. Embedded costs.

Now, cost of capital under (b)(2) is the cost of capital to recover the TELRIC price, not your historical price. How can --

QUESTION: But isn't -- isn't --

MR. BARR: -- (d)(1) on its face -- excuse me, Your Honor.

QUESTION: No. I just want to go back to something I don't understand. Isn't (d) -- I'm sorry. Yes. Isn't (d)(1) simply talking about the TELRIC method as opposed to the ultimate ratemaking methodology? In -- in -- I'm sorry. As opposed to the ultimate determination of what would be an appropriate rate using TELRIC valuation.

MR. BARR: That's right, and that's a directive to the State.

QUESTION: Okay.

MR. BARR: That's a directive to the State. The

States cannot --

QUESTION: But that is not -- if -- if you understand by the distinction what I understand by the distinction, it is not a directive to the State which binds them in the ultimate rate that they can set.

MR. BARR: It binds -- yes, it does bind me. The rate -- the rate cannot --

QUESTION: Then I don't understand it.

MR. BARR: They cannot consider in -- in setting the cost of capital historical costs.

QUESTION: Well, but they don't have to consider it if they give you a high enough rate on your TELRIC costs. Let's assume they have --

MR. BARR: How do they determine what's high enough, Your Honor?

QUESTION: Let's assume that your past costs were, indeed, $10 million, and they're saying, well, it's just 5 because somebody else could do it for 5 if they came in right now. So long as they give you a higher percentage on that 5, you're going to be in just as good shape as if they were giving you your 15 percent on the 10.

MR. BARR: And how do they determine what's high enough unless you have a standard?

QUESTION: They can determine on the basis of what your risk is. And -- and --

MR. BARR: The risk of what?

QUESTION: -- it's very -- it's -- your risk of continuing to put in capital which will -- which will not -- which you will not be able to have taken into account in setting the rate.

MR. BARR: Well, I think, you know, your concurrence in -- in Duquesne, Justice Scalia, made a very fundamental point, which is you can't talk about return on risk without implying a standard. What's the risk you're compensating me for? What's the risk you're compensating me for? It's the risk I'm not going to be able to recover my capital.

QUESTION: But now --

MR. BARR: How -- how can you figure that out without looking at what my capital is in relation to what you're allowing me?

QUESTION: Right. That may all be true, and I have only one question to ask, and I'm asking it. I don't know the answer, and I -- it may help or not help.

But when I read the briefs, I noticed you started with the valuation of the capital base of around $340 billion-$350 billion. And then when we look at the depreciated base, it comes to around $140 billion-$150 billion across the country.

And I got the impression from the brief, that if -- if that's the valuation -- mirabile dictu my Latin professor used to say. The rate of return is okay. That -- that however miraculously they've come to this -- to this result -- and I've read the criticisms. They give you a quarter of the telephone pole. They -- they deduct 22 percent for there being competition. They assume that the most efficient firm has the administrative costs of all the firms. They do all the things on depreciation that you say. They do the same thing on capital. And yet, somehow the result seems to be that you're earning a fair rate of return on the depreciated value of the capital, namely $140 billion-$150 billion-$160 billion, in that range.

Now -- now I'm asking a question to get an answer.

MR. BARR: That was mixing the apples and oranges. The -- that -- that's mixing the original cost of the hypothetical network with the depreciated value of our network. What's relevant is what's our capital charge that's allowed or our depreciation expense.

Before TELRIC came along, I was recovering, let's say, $340 billion over 10 years, and I'm halfway through, generally. So, I have about 170 to go in 5 years. They come along and say under your new network, you're going to get 170 because that's how much a new network would cost, not one that's half depreciated, and you get to recover that over 10 years. So, now my depreciation expense has been halved.

QUESTION: So, what you're saying is in response to what I said, that I am wrong in saying that the TELRIC-set depreciation, capital return, and other numbers -- I am wrong in saying that they will earn you a fair rate of return on $140 billion. To the contrary, they will earn you only half the return you're entitled to on that 140.

MR. BARR: Correct.

QUESTION: And I can find that in the -- is there anything on that in the record?

MR. BARR: There's a -- well --

QUESTION: No.

MR. BARR: Well, by using the same depreciation schedule and hypothesizing a new network, that reduces my -- that reduces my capital charge.

Now, we have shown --

QUESTION: The capital charge will fall from $140 billion. A TELRIC valuation of those FCC numbers which are on the two pages that they have all -- a TELRIC valuation of that will not end up with the number 165, 7 -- 70 billion approximately. It will end up with the number 70 or 80.

MR. BARR: No. They will end up -- they will say we're going to imagine you have a new network and can depreciated it over the next 10 years, when in fact I have a network that I have 5 more years to depreciate 170 on. The effect of that is to half my recovery because in 5 years I have to buy a new switch, and I strand what I haven't yet recovered.

QUESTION: But you're saying the commission sets the depreciation period and binds the State commissions by that?

MR. BARR: The State -- well, yes. They -- the -- the commission tells the States what to do.

QUESTION: And the commission says, 5-year depreciation -- 10-year depreciation, not 5, or 5 not 10. That's -- the commission forces that on the States?

MR. BARR: Yes. The commission says --

QUESTION: Can -- can --

MR. BARR: -- economic depreciation --

QUESTION: Okay. Can you point to a -- a commission statement to that effect?

MR. BARR: Yes. This is -- this is a separate proceeding, but it's their application of TELRIC.

QUESTION: Okay.

MR. BARR: In the universal service. They say the rate of return must either be --

QUESTION: What are you reading from?

MR. BARR: Paragraph 250 of that order. It's a -- it's a published opinion, but it's not part of the record.

QUESTION: It's not in the record?

MR. BARR: It's not in the joint appendix, but it's a -- it's the parallel proceeding to this where they were setting TELRIC for our universal service prices.

The first sentence of paragraph 4: The rate of return must be either the authorized Federal rate of return on the interstate or the State-prescribed rate. In other words, they're saying it has to be -- the same rate of return as you have in the retail business has to be in the wholesale business.

QUESTION: Or -- or the State -- was this last part, or the State-prescribed rate?

MR. BARR: Retail rate. The retail rate.

QUESTION: Well, but would you read again the sentence?

MR. BARR: Yes. It has to be either the Federal interstate -- that's a retail rate. Okay? And the only risk there --

QUESTION: Let's not intersperse. Let's just read it.

MR. BARR: Or the State's prescribed rate of return for intrastate -- intrastate services. These are retail rates based on the --

QUESTION: These are -- these are rates of return. Now, tell me how it is that that -- those statements with respect to rates of return determine a depreciation period.

MR. BARR: Well, the next paragraph, paragraph 5, says that we agree with those commentators that argue that currently authorized lines should be used because the high cost areas are unlikely to face a serious competitive threat. Again, they are using existing depreciation based on a world of gradual competition in our retail business and they are applying it to prices that they are formulating based on the hypothesis of radical competition that has commoditized our product and reduced our direct cost by half.

Now, the fact is this is a bifurcated proceeding. The Feds set the methodology. The States set the rates. The Federal Government has told the States what to do, and you'll see in our brief that example where the State tries to use a different rate of return, the FCC slaps them down. It's very clear.

Now, they've made an admission in their own brief on page -- on their reply brief, which -- on -- on page 12, note 8. And they say that the -- the risk is not just the -- this is footnote 8. It says, the risk is not just the risk of actual competition, but obviously you have to have a methodological risk adjustment.

QUESTION: What part of footnote 8 are you relying on?

MR. BARR: That second consideration is notwithstanding the incumbent's contrary suggestion implicit in any determination of the true economic cost of capital.

Our problem is that's not what the order said. That's a post hoc brief. And if this Court were to rule that the rate of return has to be adjusted based on the hypothesis of actual competition, that takes care of part of the problem. But that's not what the rule says. It's not what it was implemented as, and now they are making this concession in their brief. Now, that's only part of the problem.

The other problem under forward-looking is they're using it to value our network at the time of dedication, and our expenditures -- as I explained, when we spend money, they act as if we're not really spending that amount of money. We're somebody else. And what they're using is the Government coming up and taking someone's property and saying I'm going to mimic away your opportunity to recover it. I'm going to imagine it in a world in which you do not have the opportunity of recovering your property.

If that -- if that is the principle, that the Government can take property and then in the name of mimicking competition, say, you're not going to have the opportunity recover it, what's the limiting principle of that rule? You can mimic -- when I put in $1,000, I need the opportunity to get it back. That's what I'm surrendering, to deploy it, to redeploy it, to use my wits to enhance and preserve its value. When I expend the money into a regime of compelled service, that's when those opportunities go away. And that's the point of the taking. I'm locked into spending the money. The Government tells me who to serve, what to charge, what quality to provide, and I can't redeploy it elsewhere.

In that circumstance, the Government can't say, now I'm going to define your opportunity in this business as an opportunity that doesn't give you the opportunity to recover your cost. Because then that's just a roving license to go around, take property, and say, now I'm going to imagine you don't have the opportunity to recover it.

The Just Compensation Clause says, if you take away $1,000, you're taking my opportunity as to that $1,000. You have to give me back an opportunity as to

$1,000. And if this is -- if this is how you value property -- I mean, this Court has been very clear, if you're going to invoke a market, it better be a real market. You have to have a real observable market. And this Court has held that when the Government comes along and takes assets like this, it's the opportunity cost.

This case is just like Monongahela. There the State gave a company a franchise to build a lock and dam and gave it tolls to recoup its costs. So, it had a franchise, a State franchise with tolls. The Federal Government said, we think this thing is worth X, appropriated the money, and took the lock and dam. The Court said, well, wait a minute. You've come and taken this lock and dam. Opportunity costs. You can't just make up a value for it.

QUESTION: But here -- here no property is taken in the condemnation sense of the word. That was a condemnation proceeding. Just compensation. No property of yours is actually taken here in that sense, is it?

MR. BARR: No, that's wrong in two respects. First, there's actual occupation of our facilities to our exclusion. They can occupy and exclude us from use of our facilities.

QUESTION: Well, have they done so?

MR. BARR: Yes, 6 percent of our lines have been taken in this respect.

Now, but in any event, we have an -- I mean, this is a utility case. This is not a regulatory taking. And the quid pro quo for us having spent all this money is an expectancy. That creates an expectation interest.

QUESTION: Yes, but I don't think it comes under the Just Compensation Clause. The cases involved -- you know, go back to Smyth against Ames -- have not talked in terms of just compensation. They've talked in terms of fair return and due process. There is a constitutional principle involved, but I don't think it's the Just Compensation Clause.

MR. BARR: Well, Your Honor, I respectfully disagree because I think the reason -- when you dedicate property and there's a taking, the reason the Government has to come up with a methodology to pay is precisely because it has to promise to pay at the point of the dedication. The methodology is the promise to pay. It's saying, you put this in, here's how you're going to get your money back. That's why we have ratemaking. It is the Government's promise to pay. It creates an expectation. And here they promise -- and this takes us --

QUESTION: You're saying every -- every breach of contract by the Government is a taking. I mean, that

-- that's a little extreme, isn't it? I mean, every time --

MR. BARR: This Court has recognized --

QUESTION: Every time the Government enters a contract, it creates an expectation, and whenever the Government breaks a contract, it's a -- it's a taking.

MR. BARR: It's not a contract, Your Honor. This is a dedication by a utility, and there are three things going on here, which this Court has always recognized create a property interest, such as in -- in Russell v. Sebastian.

Number one, the Government requires us to serve. This is compelled. Okay?

Number two --

QUESTION: Compelled because you agreed to it. That was part of the contract. You put up the money and you'll -- you'll have to serve and we'll provide you with a reasonable rate of return. That was the deal.

MR. BARR: A return in order to give us a fair opportunity to get our money back.

And in determining what the methodology was for our initial investment, the Government said, okay, guys, you put in all this money -- and now I'm shifting to the historical part of the case. You put in all this money, and here's the deal. You will be -- you will not have the risk of devaluation, and therefore, we're not going to pay you a high rate of return. So, we got low rates of return for all these years.

And now they're retroactively saying, we're changing our mind. We're going to -- we're going to start revaluing your property and we're going to apply that against your historical cost.

QUESTION: Mr. Barr, may I ask -- one piece of this case is you made this investment for your local telephone business. That -- that continues. That's not touched by anything we're talking about now. You get that rate on your -- what is the vast majority of your business. That investment -- you get that rate set by the local public utility commissions as -- as always. Isn't that so? So, your telephone service business isn't touched by any of this.

MR. BARR: These use the same facilities. So, this is occupying the facilities we use for our retail, and then it deprives us of using --

QUESTION: But you're getting back the lion's share.

MR. BARR: Well, yes, but that's like going to GM and saying give away your Chevys because you're still making money.

QUESTION: And then there's another piece of it that I'd like you to tell me how it fits in, and that is the quid pro quo of you can get into for the first time a new business, that you can get into the long distance business. Doesn't that have some kind of value?

MR. BARR: No. I think if there was going to be some quid pro quo in the statute, Congress has to define it. Otherwise the Government agency can go up to someone and say, you know, we waived some procedure for you in the INS, and therefore now we're going to take away your car. Their quid pro quo has to be spelled out by Congress.

But in any event, we didn't get a special favor. It said, once you purge yourself of any defect, you can act like everybody else.

One final point that's very critical here, which is the language in the statute in 252, which goes on -- it doesn't say just -- just and reasonable in 251(c). It says just and reasonable. This says something else in addition as opposed to Hope where the Court said there was no further specification of how rates were to be determined. It says, here determinations of rate have to be based on the cost of providing.

That provision can only make sense and only has an office in the statute if it is somehow delimiting how just and reasonable rates are to be determined. The Government's view is, just and reasonable, that gives us all the discretion in the world. There's other language here, and that can only be reasonable -- reasonably --

QUESTION: Well, no. It also argues that the word cost is ambiguous.

MR. BARR: Not in the context -- you have cost and you have value methodologies. If the office of that statute -- of that provision is to delimit discretion as to what kind of methodology -- the -- cost on its face refers to a cost-based methodology, not a value methodology.

I reserve the balance of my time.

QUESTION: Very well, Mr. Barr.

General Olson, we'll hear from you.

ORAL ARGUMENT OF THEODORE B. OLSON

ON BEHALF OF THE FEDERAL PETITIONERS

MR. OLSON: Mr. Chief Justice, and may it please the Court:

The colloquy that we have just heard illustrates why this Court has said over and over again in the context of ratemaking, in precisely the context we're talking about here, that the Court evaluates results not methodologies; impacts, not means; and consequences, not techniques.

QUESTION: Do you think that really means that you could come up here with a -- with a -- with an FCC scheme that says we're going to spin a wheel, and if it lands in the right place, you're going to get a good rate, if it lands in another place, you're going to get a bad rate?

MR. OLSON: Well, there might be --

QUESTION: We couldn't say that that is irrational and -- and -- does -- is not designed to provide a fair rate of return? Don't you have the burden of showing that this is at least designed to -- to provide a fair rate of return?

MR. OLSON: This Court has said that the challenger of a rate has a heavy burden to make a convincing case that the outcome is confiscatory. Now, that burden can't be achieved -- Justice Ginsburg's questions at the end of this colloquy illustrate that there are a number -- and -- and the questions about depreciation and cost of capital illustrate all of the things that -- the reasons why this Court has avoided deciding whether a methodology is acceptable or not.

QUESTION: You -- you can't meet that burden with a wheel. You can't meet that burden with a wheel. You're really saying that you can come up with a wheel and just say, well, you know, you can't prove that you're not going to get a fair return. That can't be right.

MR. OLSON: Well, the -- the person who

challenges the way the commission is setting rates has to -- has to present to this Court an explanation for why that the system that's developed, whether it's spinning a wheel or whatever -- and I -- I won't engage in that hypothetical because we've got a several hundred page record that looked into various different arguments with respect to various different methods of recovery. It listened to various -- the FCC listened to various different experts. It listened to the incumbent local exchange carriers' various different theories. It has explained why it did. It developed a forward-looking technology, a method of evaluating the entry fees that would be based upon the statute.

QUESTION: But it -- it seems to me that necessarily a hypothetically most efficient market will invariably, necessarily result in a rate that is less than their actual cost.

MR. OLSON: Well, no, I don't agree.

QUESTION: I mean, it just -- that just has to be.

MR. OLSON: No, it does have to be. And this Court should wait to see whether that really happens or not.

In the first place, this Court has said over and over again that the ratemaker has the responsibility and obligation and right under the Constitution to consider the goals of the statute, different theories, mixed -- mixed methodologies, and all of those things so that the Court -- we can't determine -- there's a lot of allegations in the briefs and in this entire case about the draconian impact of this methodology.

But as the colloquy that took place here with respect to both depreciation and return of capital illustrated, in the precise paragraphs that my opponent cited with respect to these things illustrate the point. Once the forward method -- forward-looking technology method is applied, the State -- the States are determining the rates which these carriers will receive for the elements. And they may be only elements of the system. They get to continue to operate the system, to make profit, to reimburse themselves for whatever costs they've embedded. They've said that they're not challenging the rates. They're not challenging the outcome because once the forward-looking technology that the FCC specified in detail after long, detailed, methodical consideration -- said that then the States will look at questions of depreciation and cost of capital.

The paragraph that you read back, Mr. Chief Justice, the sentence in paragraph 702, which is on page 396 of the joint appendix, specifically says, States may adjust the cost of capital if a party demonstrates to a State commission that either a higher or lower level of cost of capital is warranted, et cetera, et cetera.

QUESTION: Warranted by what standard?

MR. OLSON: By the circumstances and -- and the constitutional obligation to set a reasonable rate under the statute considering this methodology and limited by the constitutional standard that this Court has articulated as the lowest reasonable rate, a rate that is not confiscatory.

QUESTION: Are actual -- are actual costs relevant in determining --

MR. OLSON: Well, this Court --

QUESTION: -- what's ultimately reasonable?

MR. OLSON: Well, this Court has repeatedly said that it has refused to constitutionalize the embedded cost or historical cost formulation. Most recently it said that in the Duquesne case.

QUESTION: But warranted must have some specific standard. There must be some principle by which we can see if it's warranted. And -- and their contention is that when you automatically guarantee them a lower than -- than cost -- than cost recovery, it must necessarily be unwarranted.

MR. OLSON: That argument is made, but it's not substantiated by anything in the record in -- in this long, elaborate TELRIC articulation of -- of numerous standards, both with respect to cost of capital and depreciation because the very next paragraph --

QUESTION: Never mind the next paragraph. What about the end of that sentence that -- that you didn't read?

MR. OLSON: Well, but that says --

QUESTION: -- a higher or lower level of cost of capital is warranted without that commission conducting a rate-of-return or other rate-based proceeding. And the argument is made -- and it seems to me a reasonable one -- that that, in effect, says, without looking at embedded costs because that's what a rate-based proceeding has -- has traditionally been. In other words, that -- that sentence suggests that you cannot set the -- the higher level -- higher or lower level cost of capital on the basis of how much embedded cost the utility has.

MR. OLSON: Well, it must say that because that's precisely what it said in the statute. Section 47 U.S.C. 252(d)(1), which is replicated on the joint appendix at pages 21 to 23. Congress specifically said now that based upon the cost -- and by the way, it is cost of providing, not cost. It says cost of providing -- parentheses, determined without reference to a rate-of-return or other rate-based proceeding. So, the fact that the FCC put that in its calculation of cost of capital was required by the statute.

QUESTION: I don't care if it's required by the statute or not. I care whether it -- it gives these people any shot at getting back the -- the capital that they've invested, with a promise by the Government, that they'd be able to get a fair return on it. I don't care if it's required by the statute or required by the FCC.

MR. OLSON: Well, you may not, Justice Scalia, but the -- but the cases presented on alternative bases -- the heavy burden that the local exchange carriers must carry here is proving that the embedded cost, historic cost requirement is either in the statute or in the Constitution. We demonstrate in our briefs -- and it's relatively clear that it's not required by the statute, and we submit it's not required by the Constitution either because --

QUESTION: You're saying it doesn't matter if they -- if they end up not getting a fair return on billions of dollars that have been invested with the Government's assurance that they -- that they get a fair return. Is that what you're saying? It doesn't matter.

MR. OLSON: I'm not saying that. I'm saying that ultimately this Court may have to decide whether it gets a fair rate of return for what it is losing, the detriment it gives up when it allows competition to utilize some small portion of their networks under various different, carefully calibrated circumstances. They cannot make that case yet.

And by the way, this TELRIC system has been in effect for several years already. It has been applied with depreciation rates. And I was going to point out that there is latitude in the State commissions to set a depreciation rate -- this is in paragraph 703 -- that reflects the true changes in economic value of an asset and a cost of capital that appropriately reflects the risks incurred by an investor, and so forth. Once you've seen the application of that, then you can determine whether or not there's been anything lost.

This is -- and Justice Ginsburg's point I have to return to. This is for use in certain markets by certain competitors of certain elements of the incumbent exchange system. If they're interested in recovering whatever the number is of $120 billion or $150 billion worth of embedded costs, are they expected -- do they have a reasonable right to expect that they will recover that out of the -- the fees paid for the elements that are used in a system that is intended to fulfill the congressional goals -- and if these are unconstitutional, that's a separate question, but the congressional goals that the commission was required to dedicate itself to is to promote competition, reduce regulation, lower prices, and encourage the rapid deployment of new telecommunications technologies.

This Court has said over and over again that when the ratemaker --

QUESTION: And not compensate investors. Since it spelled out those four and said nothing about compensating investors, that doesn't have to be taken into account.

MR. OLSON: It -- it -- that's correct. The statute says nothing about compensating investors. It says a just and reasonable and nondiscriminatory rate based upon the -- the various factors of the cost of providing the service.

Now, the Eighth Circuit looked at that and said something to the effect that, well, the -- the cost of carrying the extra load with respect to these elements -- that would be an -- something called an incremental cost or a marginal cost. It might be considerably lower. It might reimburse them in some way for some portion of their capital costs.

And by the way, Congress does know how to deal with this issue when it -- when it's necessary. In the

Pole Attachments Act, which is 47 U.S.C. 224 I think, that the Court considered last week, the -- the statute specifically refers to an allocation for a cost of capital of the telephone pole or the conduit or the right-of-way. It didn't say that in this statute. It said, costs of providing the service.

And then it had that exclusion that you mentioned, Justice Scalia, about rate of return, suggesting that the traditional embedded cost rates, to the extent that they are often used in ratemaking, wasn't necessarily what the Congress had in mind.

What this Court said in its decision, when it visited this case 4 years ago, is that this statute is in some respects a model of ambiguity, and the Court went -- went on pointedly to say, at the end of that decision, Congress well knows what it's doing when it writes ambiguous provisions. And the word cost, and the word value, and the word rate of return, and things like that in ratemaking cases are ambiguous, and they mean lots of different things under lots of different circumstances. Those ambiguities will be clarified and implemented and filled out by the regulators to whom authority has been given.

What happened in this case, I submit, is what Congress properly did. What this Court said in -- I think it was in the Duquesne case -- that these are hopelessly complex calculations that have to go into making rates and deciding what is a fair, just, reasonable, nondiscriminatory rate of return in the ratemaking context. Especially something as complicated as this, especially where you're trying to bring in new competition in a regulated market, especially when you're giving in exchange in part in the statute for allowing competitors to come into the local telephone markets, giving the local telephone companies, which up to that point had been precluded from being in the long distance market and they were being precluded from competing from other local carriers, they were given access to those two markets in exchange, when all of those complexities are taken into consideration, Congress was not going to be -- able to resolve all those things.

So, what it did is it turned it over to an expert agency which exists for the very purpose of solving these problems, just like State commissions have the authority. In this case a methodology was developed by the FCC doing exactly what it should have done, listened to the experts, listening to the competing concerns, and the developed a methodology which is forward-looking, which this Court -- Court has never rejected.

In fact, in the Duquesne case, in footnote 10 at the very end of the Duquesne case, the Court suggested that that may be an entirely appropriate methodology. In footnote --

QUESTION: Sure, depending on how it's applied. General Olson --

MR. OLSON: Yes.

QUESTION: -- assume -- assume -- and I'm sure you -- you don't agree with it, but assume that I -- that I think this system has to not just be the spinning of a wheel, but it has to contain in it some -- some assurance that they'll get a fair rate of return on money that they have invested, with the Government's assurance that they get a fair rate of return. Assuming that that's the case, what is there in this -- in this methodology that enables them to get a fair rate of return on their sunk capital?

MR. OLSON: The problem, Justice --

QUESTION: Just point to me the provision that shows --

MR. OLSON: The problem is --

QUESTION: -- where that will be taken into account --

MR. OLSON: -- a fair --

QUESTION: -- at all. Is it ever anywhere taken into account?

MR. OLSON: It is not taken into account what their embedded costs are with respect to portions of their network that may or may not have anything to do with the provision of the service or the network element involved here. We're talking about loops. We're talking about telephone numbers. We're talking about information used for billing. Whether or not those facilities or those network elements have anything to do with an embedded cost for a plant that was built 30 years ago for X billion dollars is something that's not discernible at the time the statute is written.

QUESTION: Well, you're saying some of the costs shouldn't be counted. Let's just take the costs that you agree should be counted. Let's just take the embedded costs that do relate -- that do relate to these services.

MR. OLSON: Well, I can't determine what those are. I don't know how the telephone companies have been allocating those costs on their books. I suspect that they do not allocate those costs on an element-by-element basis on their books with respect to this thing. At the end of the day --

QUESTION: That's always been the case.

MR. OLSON: That has always been the case, and that --

QUESTION: It's always been the case with ratemaking methodology. So, you -- you can come up now and say, it's always been so difficult. We've done it pretty badly. So, we're going to solve the problem by just forgetting about giving --

MR. OLSON: No, Justice Scalia. You said in your concurring opinion in the Duquesne case, we look at -- we look at consequences, not techniques. The balance of the Court said in that case, we look at the impact, not at the methodology.

We don't know what the consequences are yet. We don't know what the -- what the impact on the local exchange --

QUESTION: Now you're back to spinning a wheel. You -- you've departed from my -- from my hypothesis, assuming that I don't believe that spinning a wheel is okay. What you're telling me is spinning a wheel is okay.

MR. OLSON: No, I'm not saying that spinning a wheel is okay. What I'm saying is that neither the Constitution nor the statute put prudent investment -- prudent investment rule in this ratemaking statute or the statute that authorized ratemaking and --

QUESTION: We refused to adopt that in Duquesne.

MR. OLSON: Precisely. In fact, that's why I was going to say -- and put in a footnote, which I think is extremely footnote -- footnote 10 said, constitutionalizing the prudent investment rule would foreclose a return to some form of the fair value rule, just as its practical problems may be diminishing. Now, TELRIC is a version of the fair market rule.

The emergent -- as the Court went on to say in the Duquesne case, the emergent market for wholesale electric energy could provide a readily available, objective basis for determining the value of utility assets. In other words, the Court was foreseeing in a way the same argument that we were having today. That's why the Court rejected constitutionalizing the prudent investment rule, and that's why the Court signaled that there were other methods that would be available, including fair market methods that -- that might, in fact, be very practical and functional.

This is a situation where I -- I -- and I want to emphasize that we're dealing with a statute that didn't require the prudent investment rule. We're dealing with decisions that go -- by this Court that go back 100 years that have said, don't constitutionalize any particular methodology.

But that is precisely what the -- the local exchange carriers are arguing for. There are a number of premises in their argument to you --

QUESTION: To say that you don't constitutionalize the prudent investment rule is not to say that any methodology will go, even one that does not enable somebody who has made investments under a commitment from the Government to allow a fair return, to recover that fair return. I mean, the -- the two are not -- are not mutually exclusive.

MR. OLSON: Well, that -- that's one of the things that I was -- that Mr. Barr said that I think the Court would take issue with. And I think one of the Justices in a question did. I think it may have been you, Justice Scalia. They weren't required to spend the money. They were given an opportunity to invest in an industry, in exchange for which they received a monopoly for a long period of time.

Now, the Congress of the United States has decided that we have to have competition, it would be wise to have competition in the local telephone market. They were never promised in any constitutional sense or any contractual sense -- and they don't even allege that, and Mr. Barr said he didn't allege that there was a contract -- that they would recover every nickel of their investments.

In the Duquesne case, for example, the argument was made these were reasonable and these were prudent investments in nuclear facilities, and yet the State of Pennsylvania developed a system that did not allow them to recover those prudent investments unless they were actually being used in the delivery of energy products. And the argument was made we have a promise or you have a constitutional obligation or you have some sort of requirement to allow us to recover those costs. The State of -- the Supreme Court of Pennsylvania said no.

QUESTION: Well, what is the baseline standard that the utilities are entitled to rely upon?

MR. OLSON: They're --

QUESTION: It's not like telling GM to give away Chevrolets. We know -- we know that. A utility is different. Why is it different and what is the baseline constitutional standard that they are -- or fair compensation standard that they are entitled to rely upon?

MR. OLSON: The baseline constitutional standard, at the end of the day, once you can look at the results, is this a non-confiscatory result. Is the lowest -- this Court has said -- it's the Hope Natural Gas case, a number of cases before that, a number of cases after that. It's in the Smyth case. In -- in that the ultimate outcome is a -- the lowest reasonable rate which is the lowest non-confiscatory rate. That is what they are entitled to in the Constitution under the decisions of this Court.

Now, what the Court also --

QUESTION: Why isn't it confiscatory to say that we're going to make you use your capital plant, which costs $140 billion, and we're going to allow you to depreciate it as though it were only $70 billion? Why isn't that confiscatory?

MR. OLSON: Or the Court -- the Congress might have said, with respect to a transportation company, you had it -- you've had the taxi service all to yourself for all these many years and now we're going to allow other -- some competition in there, and -- and you've got some monopolistic facility, and we're going to let your competitors use some piece of it. Now, you're not going to be -- and -- and we can determine what the value of that is in a competitive market, and we're going to allow you to recover some portion of the value.

This Court has repeatedly said under the Fifth Amendment, to the extent that that is applicable -- and I believe it is fundamentally -- to the ratemaking cases and the utility cases -- that it's a fair market value at the time of the taking. Mr. Barr says the taking occurs is -- when we were required to expend the money. Now, that is not when the taking occurs. The taking occurs, if at all, when they have to surrender some portion of their system to allow someone else to use it.

QUESTION: I want to be -- I want to be sure I have a chance to ask you a different question. I want to know what, in your opinion, the FCC was driving at when it chose this particular methodology. What in your opinion -- after all, they had four of five possibilities. What basic economic question were they trying to answer when they chose this one as opposed to a different one?

MR. OLSON: What they wanted to do with the -- they wanted to accomplish a number of goals, which are set forth in the preface of the statute, which I alluded to before, which is to reduce prices, to inspire competition --

QUESTION: I don't want -- I -- I would like a little bit less generality than that, if -- if you can give it to me. What was their object? What did they hope that the rates set this way, rather than set, for example, another way, would achieve?

MR. OLSON: Well, they -- they explained that one of the important considerations -- and it's hard to not deal in some generality --

QUESTION: Yes.

MR. OLSON: -- this area does. But one of the important objectives that they hoped to achieve was to develop a pricing methodology that would encourage new entrants to come into the market and pay fees that would allow them to enter the market at competitive rates and encourage them to develop new technologies --

QUESTION: All right. If that's basically the objective, to get them to enter when they should enter -- is that fair? To get them enter when economically they should enter, not when economically it'd be wasteful for them to enter.

MR. OLSON: Yes, I think that's a fair premise.

QUESTION: All right. If that's a fair premise, why wouldn't they choose a system that would give them the following answer? Price. Look at the service that the newcomer wants to buy from the incumbent. Try to charge a price so that it reflects the real resources that that incumbent will have to spend -- him, not some hypothetical person -- to provide that service. Perfect answer because if you can get it, then obviously if that number is higher than it will cost the incumbent in real resources to provide it, he'll build it himself. And if it's lower, he'll buy it. The perfect economic answer. Why would they not try, at least, to answer that question?

MR. OLSON: Well, it seems to me that they did try to answer that question, Justice Breyer.

QUESTION: Fine. Okay. Then you're right where I think you --

MR. OLSON: All right. But as you pointed out in your -- in your dissent, your partial dissent in the other -- the other time this case was before this Court, there are a variety of different methodologies that various different economists look at and think that they can accomplish those kind of objectives. But this Court has said that we leave that to the regulators to do, and if at the end of the day, there's some level of confiscation, then we can adjudicate that.

QUESTION: I'm not worried about confiscation.

MR. OLSON: All right. Now --

QUESTION: I'm worried about the following. If that's what they're trying to do, then how could it possibly do that, to write an order that says the depreciation rate and the rate of return that you are going to charge is going to be based upon not what it will cost you, but rather, what it will cost some hypothetical firm that isn't there, let alone saying the same thing in respect to telephone poles, in respect to wires, in respect to efficiency of administration, in respect to a 22 percent discount for a competition that doesn't exist? In other words, how did it even come close to answering that question to look not at the cost of this firm, but at the cost of some hypothetical firm that by definition doesn't exist?

MR. OLSON: Well, in the first place, we're not talking about replicating an entire firm. We're talking about replicating particular elements that are available to the -- to the firms that wish to interconnect. And the FCC made it clear that we're not talking about -- we're not talking about hypotheticals any more than the embedded cost system would require allocating hypothetical portions of something that happened 30 years ago to a rate for -- for a particular small portion of a product that may have nothing to do with that.

What the FCC's order does -- and it explains this in relatively elaborate detail that it's talking about a reasonably available, efficient product in the marketplace that's comparable that can perform a service that's equivalent to the -- the element that may have been built 5 years ago and may be obsolete today or partially obsolete today and may not be efficient. Because if we don't do it that way, we will encourage non-competition or -- or prices that are inefficient based upon old services.

And this was actually addressed by Justice Brandeis in the -- in the famous concurring opinion. And he says at the very end of his -- his opinion, he says that -- that surely the cost of an equally efficient substitute must be the maximum of the rate base if prudent investment is to be rejected as a measure.

Now, what the FCC did in this case, it made a compromise. It took the wire centers as they existed, and they used the other elements based upon these reasonably efficient, effective, available alternatives.

Now, the FCC has been criticized. Well, you're -- you're theoretically inconsistent. You should have done it all this way or all that way. The fact is that this Court has said again and again that the ratemaker may make compromises, may have to balance one benefit to the incumbent with one benefit for the competitors.

It may -- it doesn't have to be -- the Duquesne case and I think the Hope case involved challenges of methodological inconsistency, and the Court brushed right past that properly because the ratemakers, to solve this hopelessly complex problem, might have to pick something from column A and column B.

Now, at the end of the line, I want to make one important point, that even after the State commissions get finished with the process, the FCC included in its order a provision -- it's paragraph 739 -- that specifically said -- and this is page joint appendix 422. This is after the application of TELRIC and after reasonable depreciation rates are set. And they haven't been -- so they have been set in some places, and they haven't been set in others. And there have been takings -- cases brought by the -- the incumbent carriers. No court, as far as I know, has upheld a taking yet. And costs of capital. There's lots of flexibility.

At the end of the day, paragraph 739 says, incumbent local exchange carriers may seek relief from the commission's pricing methodology if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates.

So, TELRIC and the FCC's regulation provided lots of opportunities to get to the end of the day the right result in a manner that achieved these various conflicting goals of Congress. It did it in a way which might not be the best way, although it looks to me like a very conscientious effort to import competition, bring down prices, and to promote technology.

But at the end of the day, after the commissions do their job, the expertise that you were talking about in your dissenting opinion -- at the end of the day the incumbent commission -- exchange carriers can come to court and say it was confiscatory, and they have a remedy. Or before that, they may go to the FCC and they have an opportunity to present their case to the FCC.

This, it strikes me, is the way it should be done. It may not be perfect. But in this ratemaking area, this is the way it should be done. The expertise was given to the agency that has the expertise, and they were given an opportunity to fulfill the goals of Congress under the constitutional standards set by this Court.

Thank you.

QUESTION: Thank you, General Olson.

Mr. Verrilli, we'll hear from you.

ORAL ARGUMENT OF DONALD B. VERRILLI, JR.

ON BEHALF OF THE PETITIONERS

IN NOS. 00-555, 00-587, AND 00-590

MR. VERRILLI: Mr. Chief Justice, and may it please the Court:

I'd like to begin by trying to answer Justice Breyer's question as to why TELRIC was a sensible policy choice by the FCC, and in so doing, I hope also to be able to address Justice Kennedy's concern about whether TELRIC underestimates the cost that a company will face going forward. And then if I -- if I can, I'd like to turn to Justice Scalia's question about whether TELRIC offers a fair opportunity to recover embedded costs.

Paragraph 679 of the local competition order is where the FCC spells out in detail what its rationales were. And what the FCC said in paragraph 679 is that it wanted to adopt TELRIC to send -- to send the right signals to new entrants about when to buy and when to build and to prevent anti-competitive behavior by the incumbent with respect to the pricing of network elements. And that's critical from our perspective.

As a retail matter, the incumbents have every right, under the State law and Federal antitrust laws, to price their retail offerings in these new competitive markets at their long-run incremental costs. That's what the State laws say. That's what the antitrust laws say. And therefore, if they could charge us the historical costs for these key inputs -- the historical costs for key inputs, when they can charge retail based on their long-run incremental costs, we could never compete using --

QUESTION: My question is, by the way, blank slate. I wasn't doubting that they could charge forward-looking costs. I was doubting -- I find it difficult to reconcile what the State -- and I think this for me is the issue. I mean, in 679, they have a correct statement of the goal, and -- and then all these criticisms, which you're well aware of, suggest that by choosing blank slate, rather than this company's, this incumbent company's long-run incremental costs, they've departed so far that -- give them all the expertise you want -- it's still awfully hard to uphold them. I mean, that's basically the argument. And if you're going to --

MR. VERRILLI: Yes, thank you. And -- and that's just not right. And their own experts, Professor Kahn, in particular -- and this is at page 155 of the joint appendix -- concedes that that's not right, that if you set the depreciation and cost of capital appropriately to reflect the risks of -- existing in the TELRIC world, then TELRIC will provide the full compensation. Now, Professor Kahn concedes that. I believe Mr. Barr acknowledged that at the beginning of his argument. It all comes down to what those depreciation rates and costs of capital are.

And what the FCC said very clearly is that the States set depreciation rates. That's in paragraph 29. The regulation itself says that they must be economic depreciation. That means they must account for the full loss in value as a result of technological change.

And in paragraph 702 of the order, the FCC said we expect States to set depreciation rates that take this into account, that take this risk into account.

QUESTION: But my question -- I don't want to distract you because others had a different question -- had nothing to do with confiscation. My question was based -- I'm leaving that totally to the side. Phrase, wildly incorrect set of economic signals to achieve the 739 goals, for the reasons that you've heard and are listed in the briefs.

MR. VERRILLI: But if depreciation and cost of capital are set right, it won't do that, Justice Breyer, and I believe that is what Professor Kahn conceded, their expert.

And that is why, Justice Kennedy, the rate going forward, the TELRIC rate going forward, will not necessarily be lower than the cost that the incumbents incurred going forward, because a rate, after all, is a product of three things: the cost structure, the depreciation rate -- in other words, how few years you recover it -- and the cost of capital -- in other words, what the risk adjustment is. So, it could well be that the rates would be the same or higher depending on how depreciation and cost of capital are set.

QUESTION: You're -- you're not asserting that the States can -- can kick up the cost of capital rate on the basis of -- of the fact that the utility is not -- is not getting depreciation on its sunk costs.

MR. VERRILLI: It -- the -- the -- separate two questions out. I think there's two -- two points to be made in there, Justice Scalia.

With respect to what -- what the cost of capital ought to be set at, under the regs and under the FCC's order, is to reflect the risks of operating in the system.

QUESTION: Right.

MR. VERRILLI: So, I think it does do what Mr. Barr claims it doesn't do. I think it very clearly does do that.

Now, with respect to their sunk or embedded costs, I think it's a different question because the issue here is whether the TELRIC in operation will produce rates and returns, then in operation don't cover the -- the undepreciated costs still on their books. And the FCC made a specific finding -- that ultimately, Justice Scalia, is a much more empirical than a methodological question. It is possible, as a matter of logic and methodology, for TELRIC to do so, depending on how the inputs are set. And therefore, it is an empirical question whether it will, in fact, do so.

The FCC in the notice of proposed rulemaking in this case specifically asked the incumbents for evidence as to what that gap would be. The incumbents produced nothing. Nothing. The FCC made a finding in paragraph 707 of the order that there was no evidence in the record to support the proposition that the adoption of TELRIC would result in significant stranded costs.

But the FCC did more than that. It extended an invitation to the incumbents to come back with proof that there would, indeed, be significant stranded costs. That invitation has been outstanding for 5 years now. The incumbents have come back with nothing.

But that's not all. The way this statute operates is the FCC produced a methodology, which is then applied in the States, in the States according to these rules, setting depreciation rates, setting costs of capital. Every State in the Union has had a proceeding of that kind. This statute in section 252(b)(6) makes those proceedings reviewable in Federal district court. Therefore, in every State in the Union, the incumbents have had the opportunity to demonstrate that in application TELRIC will produce rates that don't recover significant amounts of stranded cost.

They have not succeeded anywhere in the country. Indeed, in the vast majority of States, they haven't even tried. And the reason is because there isn't a big gap.

QUESTION: If -- if that -- assuming that, his -- Mr. Barr's argument, I take it, was that paragraph 702 put -- read in any disclaimers you want, and they have loads of them. But it says the starting point is existing depreciation rates and capital rates, and that couldn't be right. And in addition, it strongly suggests if it doesn't state -- and it does state -- that you change those in respect to new competition coming in while the correct statement would be change it from the beginning because whether new competition comes in or not is beside the point. You're setting in TELRIC the imaginary rate that would be set by new competition, and therefore, obviously you can't have existing depreciation rates. I mean, I take it I may not have paraphrased it correctly, but I think that's basically his point.

MR. VERRILLI: No, I think it's right. That is his argument. But it's not what paragraph 702 says and it's not what happened in operation. The States have set depreciation rates that are downward departures. California, for example, cut the switching depreciation rates in half. So, it's just not the case that that's what's happened out there in the real world.

And there are dozens of -- there have been dozens of opportunities for this case to be proven on the basis of a real rate in Federal district court. And there -- as I said, in the few cases where it has even been attempted, it has been rejected, and most of the time it hasn't even been tried.

And if -- let me try to get back, if I could, to that 340/180 comparison that's in the briefs and we've had some discussion about. Here's why TELRIC doesn't produce the kinds of results that -- that example suggests. It's because the 340 is way, way too high. The 340 is everything in the entire network and the entire corporate superstructure that goes with it. And that is not all devoted to the production of local telephone service. It's -- there are -- tens of billions of dollars of that are devoted to creating capacity for long distance service. Billions and billions of dollars additionally are devoted to capacity for video service, for CENTREX service, for other services that wouldn't be reflected in TELRIC rates.

There are just -- you'd have this huge allocation problem if you take this. And this I think shows why TELRIC is the practical answer here as well as the fair one. You would have a massive allocation problem if you took that 340 because, first of all, you'd have to figure out how many tens and tens of billions of dollars got taken out for all these services that have nothing to do with providing local telephone service.

Then of the $45 billion in that 342 that's devoted to corporate overhead, you would need to figure out how much of that is appropriately devoted to -- to the local telephone service.

QUESTION: And that used to be done all the time, of course, to decide between local and -- and long distance phone rates. Right?

MR. VERRILLI: Well, no, but there's a --

QUESTION: I mean, it's not as though --

MR. VERRILLI: I'm sorry, Justice Scalia.

QUESTION: It is not as though we didn't -- haven't been pretending to do that for years and years.

MR. VERRILLI: But -- but, Justice Scalia, a significant amount of that goes to retail which can't be allocated here. And then when you get done with all that, then you've got to take out the billions of dollars in phantom assets that the FCC's most recent audit of their books identified. And then when you get done with that, then you've got to decide how much of that was actually prudently incurred. And when you get done with that very long process, that number is going to come way, way down.

Now, on the other side, the 180 is too low. And the FCC specifically said it was too low and warned against using it for exactly the comparison that Mr. Barr used it for because it's designed to calculate universal service subsidies at the very most basic low level. So, that comparison just doesn't hold up. And so, the undepreciated part of the comparison, Justice Breyer, doesn't hold up either because the number is not going to be -- the undepreciated number of everything is $140 billion-$150 billion. But the undepreciated part of what they entitled to recovery under TELRIC is going to be a much smaller number than that number because you'd have to take out everything I just described. So, it just doesn't wash.

There may be some difference with respect to some of the elements. Switching costs have come down. Of course, loop costs have not come down, and the loop costs are 48 percent, according to the FCC in this order, of the overall cost of providing service. And those have been stable over time.

So, the fact is you just don't have a huge problem. You don't have a big gap. And that's why, Justice Scalia, when you adopt one methodology, when you adopt this methodology here, given the fact that it is an empirical matter, there's no reason to think there's a huge gap. There's no reason to think that the outcome will necessarily preclude them the opportunity of earning a fair return.

And that's why I think this case is an easier one than Duquesne because at least in Duquesne, you knew how much wasn't going to be recovered as a result of the switch in methodology. Here, you don't know how much isn't going to be recovered, but what you do know, based on the facts that I've just conveyed to the Court, is that it's not going to be a very big number, even if you assume that all elements are leased.

And of course, as Justice Ginsburg's question pointed out, only 3 percent -- it's not 6 percent. The FCC's most recent figures are 3 percent -- 3 percent -- of the local network is being leased.

Which leads me to a practical point here, that if the world were the way the incumbents were describing it, it would be a very different place in fact than it is. We would be making all the money. They would be in trouble. The reality is --

(Laughter.)

MR. VERRILLI: -- they are making all the money and we are in trouble.

And the reason for that -- and -- and, indeed, they would be derelict in their responsibilities to their shareholders if they weren't taking advantage of this gigantic regulatory arbitrage opportunity to go into each other's local markets and take away all the customers. But they're not doing that. The reason they're not doing that is because the opportunity doesn't exist. This -- the thing that's a fantasy, the thing that's hypothetical in this case is the claims they are making about what this system is and the way it works.

Thank you.

QUESTION: Thank you, Mr. Verrilli.

Mr. Barr, you have a minute remaining.

REBUTTAL ARGUMENT OF WILLIAM P. BARR

ON BEHALF OF THE PETITIONERS IN NO. 00-511

MR. BARR: The Constitution doesn't dictate a methodology, but what it does say is that whatever methodology is selected, it ultimately has to be judged by this Court as to whether it provides us a fair opportunity to recover our costs. And therefore, if it creates a methodological risk, it has to compensate us for a methodological risk.

We did show rates. And the Government's position here is because this is a bifurcated proceeding, we have challenged rates. The Government has taken the position -- the Fourth Circuit has held -- we cannot challenge a methodology. We can only challenge whether the rate conforms to the Federal methodology.

This is the only place we can get review of the underlying problem, which is the methodology. This is an Ashwander case, and the Government itself in paragraph 705 says that our interpretation of based on the cost of providing is permissible. What we're saying is the statute dictates the methodology here and avoids the constitutional problem.

But even if you didn't find that, this rate -- this methodology does create a methodological risk, and we have shown that we're not compensated for it. We have shown rates in our -- in our -- in the record that halve our recovery, halve our revenue. That is the typical instance.

They've had 5 years to show one State -- and, you know, it doesn't matter if there's one State. The question is what's the risk of any State that comes close to allowing us to recover our prudent investment. And you can look through the record and you can't find one. We have shown in Virginia and New York -- New York is a classic. Our loop rate -- our cost is $33.

CHIEF JUSTICE REHNQUIST: Thank you, Mr. Barr.

The case is submitted.

(Whereupon, at 12:29 p.m., the case in the above-entitled matter was submitted.)