Southern Natural Gas Co.

76 FERC ¶ 61,122 (1996), *upheld in relevant part*, 198 F.3d 960 (D.C. Cir. 2000)

On January 24, 1996, Southern Natural Gas Company (Southern) filed an application for a certificate of public convenience and necessity authorizing the construction and operation of certain pipeline facilities. Three parties filed protests to the application and Alabama-Tennessee Natural Gas Company (Alabama-Tennessee) filed a motion to dismiss.

*** For all of the reasons discussed below, we will deny the non-environmental portions of the protests and Alabama-Tennessee's motion to dismiss.

I. Background and Proposal

On April 17, 1995, Southern announced an open season for requests for additional firm transportation services in order to determine whether there was sufficient demand to support an expansion of its pipeline system. Southern received requests for long-term firm transportation services that would require it to expand the capacity of its pipeline system by 76,350 Mcf per day.

As a result, Southern proposes to construct, install and operate 109.53 miles of 16-inch pipeline, 8.47 miles of 12-inch pipeline, two turbine compressor units of 4700 hp and 1600 hp, three meter stations and related appurtenant facilities in order to expand its pipeline system to provide firm transportation services to five customers. Southern proposes to provide service to these customers under its current Rate Schedule FT and subpart G of Part 284 of the Commission's Regulations as implemented under Southern's blanket transportation certificate issued in Docket No. CP88-316-000.

Three of the customers are existing shippers on the Southern system who want to increase their firm transportation contract quantities. They are Marshall County Gas District (Marshall County), DeKalb-Cherokee Counties Gas District (DeKalb-Cherokee) and Austell Gas System of Austell, Georgia (Austell). Decatur Utilities, City of Decatur, Alabama (Decatur) and Huntsville Utilities Gas System, City of Huntsville, Alabama (Huntsville), which currently receive all of their natural gas transportation services through Alabama-Tennessee, will be new shippers on the Southern system and will take most of the proposed capacity. They are both municipally-owned local distribution companies (LDCs).

These customers have executed FT Service Agreements for a total of 74,850 Mcf/day as follows:

Customer	Transportation Demand	Term of Agreement
Huntsville	40,000 Mcf/day	20 years
Decatur	25,000 Mcf/day	20 years
Marshall	4,000 Mcf/day	20 years
DeKalb-Cherokee	2,350 Mcf/day	10 years
Austell	3,500 Mcf/day	10 years

Southern states that even though the facilities will have 1,500 Mcf/day of unused capacity, the revenues from the service contracted for, using the proposed billing determinant usage, will insure that all of Southern's customers receive the entire economic benefit demonstrated in the application. Southern estimates that the total cost of the facilities will be $52.8 million.

Southern requests assurance that it will be allowed to roll-in this expansion project's costs in accordance with the terms of its Rate Schedule FT as set forth in the Seventh Revised Volume No. 1 of its FERC Gas Tariff and subpart G of Part 284 of the Commission's Regulations. Southern advanced the following reasons to support its rolled-in rate proposal:

1. The Southern system is somewhat unique in the way it has developed to serve its markets. The proposed pipeline is consistent with the historical growth of the Southern system through mainline extensions off of two parallel mainline systems. Southern further states that the proposed pipeline is indistinguishable, in every respect, from the other mainline extensions which received rolled-in rate treatment.

2. Southern states that the proposed pipeline will provide a significant long-term benefit to the Southern system. Exhibit N of the application shows that estimated revenues generated from the incremental firm transportation services will exceed the estimated cost of service of the facilities in the second year of operation. Thus, Southern claims that the proposed pipeline satisfies the financial criteria required by the Commission for rolled-in rate treatment in its statement of policy issued in Docket No. PL94-4-000 (pricing policy).

3. Southern asserts that there are several monetary system benefits that existing shippers will realize from the expansion project. First, over the primary terms of the firm transportation service agreements associated with the system expansion, the revenues generated will exceed the costs incurred by approximately $39 million. In addition, the expansion of the Southern system into the new north Alabama market will mitigate the impact of any potential future rate increases attributable to any future reductions in transportation services by existing firm shippers. Finally, Southern contends that the expansion will produce economies of scale as the north Alabama market continues to grow. The capacity of the 16-inch pipeline can be increased by 70,000 Mcf per day with the addition of compression at an estimated cost of $10 million. Exhibit N-3 shows that realization of this growth potential would increase the benefit to the system by $5.9 million per year and would result in a 2.5 percent rate reduction to Southern's existing customers.

4. Southern maintains that existing shippers will realize operational system benefits from the expansion project such as a (i) significant enhancement to system reliability for all shippers delivering gas in Rate Zones 2 and 3, (ii) the increased availability of interruptible transportation service for shippers delivering gas in Rate Zone 2 since the capacity may be available to existing shippers if it is not being utilized by the expansion shippers, (iii) access to the North Alabama Market creating substantial new opportunities for marketers and shippers on the Southern system, and (iv) DeKalb-Cherokee and Marshall County customers' obtaining firm service to serve their increasing requirements.

On July 9, 1996, Alabama-Tennessee filed a motion to dismiss Southern's certificate application or, in the alternative, to set Southern's application for hearing. * * *

In its motion to dismiss, Alabama-Tennessee urges the Commission to find that: (1) Southern's proposed extension is a lateral and that Southern must charge shippers on the lateral Part 284 rates for the mainline transportation service plus an incremental rate to recover the costs of the bypassing lateral; (2) Southern's proposed displacement of Alabama-Tennessee's markets would be unlawfully achieved through predatory

pricing and other exclusionary and anticompetitive devices intended to extend Southern's monopoly power and eliminate Alabama-Tennessee as a competitor; and (3) Southern's proposed displacement of Alabama-Tennessee's markets could have serious adverse effects—on Alabama-Tennessee, its customers, Southern's existing customers, and the environment of Northern Alabama—that would far outweigh any potential benefits. * * *

IV. Discussion

A. The Public Convenience and Necessity

1. PROTESTS AND ANSWERS

Alabama-Tennessee, Atlanta and Chattanooga, and Cullman-Jefferson contend that the proposed facilities are not required by the present or future public convenience and necessity. For example, Alabama-Tennessee submits, Southern's proposal does not represent a logical and economical choice for those customers that have signed up for long-term firm service. Alabama-Tennessee points to joint offers by it and Tennessee to Huntsville and Decatur to supply firm service for a term of the customers' choosing at a rate less than Southern's. Alabama-Tennessee contends that an independent analysis by an outside accounting firm for Huntsville estimated that Huntsville would save $13.2 million through the year 2005 under the joint offer instead of taking service under Southern's project. Alabama-Tennessee contends that its joint proposal to Decatur and Huntsville would achieve most of the competitive advantages that normally flow from introducing a new competitor into a market without the negative consequences caused by the construction of a major new pipeline project.

Alabama-Tennessee also disputes Southern's assertion that the project will provide gas sellers with access to new markets and gas consumers with new sources of supply. Alabama-Tennessee maintains that the sources feeding into the Southern system are only a fraction of the gas production sources that supply customers of Tennessee and Alabama-Tennessee and, since Alabama-Tennessee and Tennessee are open-access transporters, there is no merit to Southern's claims that there would be greater access for customers and suppliers through Southern's system. * * *

Alabama-Tennessee also maintains that the Commission must consider that Southern's project would likely have an adverse economic impact on Alabama-Tennessee's system since Decatur and Huntsville take nearly half of Alabama-Tennessee's total contract demand. Further, argues Alabama-Tennessee, granting authorization for Southern's project could adversely affect Alabama-Tennessee's ability to provide reliable service to its remaining customers—part of the public whose convenience and necessity must be served by an NGA section 7(c) certificate. * * *

Decatur and Huntsville dispute Alabama-Tennessee's assertion that the Commission must consider whether Southern's proposal represents a logical and economical choice for those customers who have signed up for long-term firm service with Southern. Huntsville maintains that the market dominance of Alabama-Tennessee, in combination with Tennessee, in the relevant part of northern Alabama has caused the rate for pipeline transportation service to Huntsville and Decatur to substantially exceed the rate for transportation service provided by other pipeline transporters to other LDCs in the same region.

Decatur and Huntsville contend that Alabama-Tennessee and Tennessee will only discount their above-market based rate when faced with the prospect of a competitive

alternative to its service. Accordingly, they submit, no matter what short-term benefits may be included in the Alabama-Tennessee/Tennessee joint offer, the only way to secure long-term benefits comes from the introduction of interstate pipeline competition in northern Alabama. * * *

The proposed project will provide the north central Alabama market with access to another source of supply, which will allow this market to enjoy the full benefits of pipeline-to-pipeline competition for the first time. The prospective shippers have entered into long-term contracts with Southern for virtually all of the capacity thereby demonstrating there is adequate market demand. Two of the shippers, Decatur and Huntsville, have made the business decision that it is in their interest to receive service from a pipeline other than Alabama-Tennessee when their current contracts expire. There have been no questions raised as to either the design and capacity of the proposed facilities or of Southern's ability to finance the project. * * *

In *Alabama-Tennessee Natural Gas Co. v. FPC,* 417 F.2d 511 (5th Cir. 1969), the court noted that NGA section 7(g) provides that "[n]othing contained in this section shall be construed as a limitation upon the power of the Commission to grant certificates of public convenience and necessity for service of an area already being served by another natural gas company." The courts have recognized that section 7(g) makes clear that competition from markets is contemplated under the Act. Further, the NGA's primary criterion for certification is the public interest.

Alabama-Tennessee's basic argument is that it and its other customers would be better off with Huntsville and Decatur as customers than without them. However, this is not the decisive test in determining the public convenience and necessity, but merely a factor. To permit this consideration to be controlling would inevitably bind a customer to its existing supplier, effectively precluding the realization of the fruits of competition. * * *

Alabama-Tennessee's assertion that the Commission must consider whether or not shippers have made a logical and economical choice in selecting service from Southern over service from Alabama-Tennessee is without merit. As Huntsville and Decatur note, the Commission has repeatedly emphasized its disinclination to second-guess the business decisions of end users. The Commission has recognized that it is not the proper forum in which to challenge the business decision of an end-user on whether it is economic to undertake direct service from a pipeline supplier, particularly when that decision has been approved by the appropriate state regulatory bodies (in this case the Huntsville Utilities Gas Board and the Huntsville City Council and the Decatur Municipal Utility Board and the Decatur City Council).

B. Rate Issues

1. ADVANCED DETERMINATION OF RATES

In its protest and its motion to dismiss, Alabama-Tennessee cites Commission precedent and policy for the proposition that pipelines must charge incremental rates for (a) market-area delivery laterals and (b) pipeline facilities that would bypass or otherwise displace a competitor's markets. Since Southern's proposed extension would be a market-area lateral that would displace Alabama-Tennessee's markets, Alabama-Tennessee contends, Southern's proposed rolled-in rates would flout the Commission's policies on both accounts. Further, Alabama-Tennessee argues, Southern is required

to charge shippers on the lateral Part 284 rates for the mainline transportation service in addition to the incremental rate.

Alabama-Tennessee contends that *Algonquin Gas Transmission Company (Algonquin),* 71 FERC ¶ 61,069, clarified, 71 FERC ¶ 61,366 (1995), controls the result in this proceeding. In *Algonquin*, the Commission concluded that the two customers to be served by a new lateral should pay both an incremental rate for service on the lateral and a rolled-in rate for service on Algonquin's mainline. * * *

In its protest, Alabama-Tennessee cites the Commission's policy statement on pricing the cost of new gas transmission facilities (pricing policy) to support its argument that Southern's proposed facilities are laterals whose costs must be recovered on an incremental basis from the shippers who use them. Alabama-Tennessee points out that the Commission stated in the pricing policy that it will presume that a project involving the construction of a downstream lateral for the benefit of one or only a small number of customers should be priced incrementally. In addition, Alabama-Tennessee contends, Southern's proposed extension would not be integrated into its existing mainline system as required for rolled-in rates under the pricing policy. * * *

Alabama-Tennessee also alleges that Southern's request for rolled-in rate treatment is inconsistent with Southern's tariff which provides that unless new facilities provide a benefit to all shippers using Southern's system, the cost of any such facilities necessary to serve a shipper must be paid by that shipper. However, Southern's exhibit N shows that the four shippers who would receive the sole benefit would pay for only about 40 percent of the $52.8 million estimated cost of the new facilities over the 20-year contract term.

Further, Alabama-Tennessee contends that the Commission must consider the impact of rolled-in rates on Alabama-Tennessee's other customers. Mr. Williams states that approval of rolled-in rates for Southern's proposal would create unsubscribed capacity on Alabama-Tennessee's system that could increase Alabama-Tennessee's rates by as much as 69 percent.

Southern has shown that any rate increase will be well below 5 percent and its existing customers will receive financial and operational system benefits. Therefore, we find that absent significant changes, it may roll-in the costs of the facilities in its next rate case.

We have reviewed both Southern's and Alabama-Tennessee's cost/revenue studies, and believe that Southern's cost/benefit analysis, with the adjustments discussed below, will properly reflect the level of system benefits of the proposed project. * * *

For the same reason, the appropriate rate of return should be the system rate of return which is 10.77 percent approved by the Commission as part of Southern's March 15, 1995 settlement in Docket No. RP89-224, et al., rather than the 9.25 percent overall rate of return used by Southern in its application which is project specific.

Our cost/revenue analysis, with the above adjustments, shows that the project's long-term (20 years) system benefit is $25 million rather than the $39 million estimated by Southern. * * * Alabama-Tennessee's assertion that the proposed project is a lateral and thus does not qualify for rolled-in treatment under the policy statement is without merit. As Southern notes, its system generally consists of two parallel mainlines with 15 mainline extensions totaling nearly 1350 miles and serving 66 firm shippers at 196

delivery points. The proposed facilities are similar to Southern's other mainline extensions that have been granted rolled-in rate treatment. Since Southern has demonstrated that the project will increase its rates by less than 5 percent and provide system benefits for existing customers, we see no reason to require a rate treatment different from the rolled-in rate treatment applied to Southern's other expansion projects. * * *

Alabama-Tennessee argues that incremental rates are required for a pipeline bypass project like the Southern proposal as a matter of Commission policy. Citing *Kansas Power and Light Co. v. FERC (KP&L)*, Alabama-Tennessee maintains that a presumption in favor of incremental rates for bypass projects is a corollary of the Commission's responsibility to ensure that bypass projects do not entail wasteful duplication of facilities and cause unnecessary costs to be passed on to consumers. 891 F.2d 939, 943 (D.C. Cir. 1989) Citing *Mojave Pipeline Company (Mojave)*, 72 FERC ¶ 61,172 (1995). Alabama-Tennessee maintains that the Commission, in following *KP&L*, has found that a bypass project does not constitute a wasteful duplication of facilities if the bypassing consumers pay for the cost of the proposed facilities. Thus, Alabama-Tennessee argues, the Commission should deny Southern's proposed bypass which would be subsidized at the expense of captive ratepayers through rolled-in rates.

Alabama-Tennessee argues that incremental rates are required for a pipeline bypass project citing among other cases *Mojave*. However, in the rehearing of *Mojave* the Commission pointed out that the principles of the pricing policy apply to bypass facilities. The Commission also stated that bypass facilities will not automatically be deemed to be a wasteful duplication of effort in the event that the end-user does not reimburse the pipeline for all of the facilities. The court has upheld the Commission's determination on this issue.

C. Anticompetitive Arguments

In its protest, Alabama-Tennessee notes that the Commission's approvals of bypass projects have always been based on the assumption that market forces operating in an environment of fair competition will promote the most efficient allocation of supplies and transportation capacity. Alabama-Tennessee maintains that no such assumption is possible here given Southern's rolled-in rate proposal. Alabama-Tennessee contends that, in a bypass case such as this one, the Commission must be especially watchful because "unrestrained competition in a case of natural monopoly may lead to wasteful duplication of facilities, and unnecessary costs will be passed on to customers."

Alabama-Tennessee argues that the recently approved incremental rates for a mainline expansion to displace a portion of Southern's existing market in *Transcontinental Gas Pipe Line Corporation (Transco)* 75 FERC ¶ 61,072, at p. 61,225, 61,227 (1996) and principles of fair competition suggest that the Commission should similarly require Southern to charge incremental rates for its proposed extension that would displace almost half of Alabama-Tennessee's existing market.

In its motion to dismiss, Alabama-Tennessee states that the Commission has recognized that it may only approve proposed bypass projects that are not anticompetitive or unduly discriminatory. Further, it maintains, the Commission must consider antitrust issues in determining the public convenience and necessity. Alabama-Tennessee argues that Southern's proposed displacement of Alabama-Tennessee's markets would be unlawfully achieved through predatory pricing and other exclusionary and anticompetitive devices intended to extend Southern's monopoly power and eliminate Alabama-Tennessee as a competitor.

Alabama-Tennessee contends that Southern's proposal is consistent with its past behavior of taking extraordinary steps over the years to limit competition including adamant opposition to the Commission's bypass policies and its refusal to interconnect with other competitor pipelines. Alabama-Tennessee alleges that Southern is using its monopoly position in other markets to subsidize, through rolled-in rates and other related anticompetitive devices, a project that cannot compete on its own merits.

According to Alabama-Tennessee, if Southern's proposed extension were priced on an incremental basis, it would not be economic or competitive with the service being provided by Alabama-Tennessee. Mr. Williams testifies that Southern is offering transportation services to Decatur and Huntsville at a price below the cost of those services. Alabama-Tennessee argues that Southern's proposal to compete for Alabama-Tennessee's market is the epitome of unlawful below-cost, predatory pricing by a monopolist. Alabama-Tennessee contends that this predatory pricing violates antitrust laws.

Furthermore, Alabama-Tennessee contends, Southern's use of long-term contracts is a related anticompetitive device designed to lock up the firm demand of Alabama-Tennessee's two largest customers for 20 years. Such contracts, it maintains, exclude competition and thus violate antitrust laws. For example, submits Alabama-Tennessee, contracts in excess of ten years that "locked up a large portion of the [relevant] market" from competitors were found to "represent classic examples of artificially created barriers to effective entry into and competition within the market" in violation of sections 1 and 2 of the Sherman Act in *Twin City Sportservice, Inc. v. Charles O. Finley & Company (Twin City)*. 676 F.2d 1291, 1391, 1304 (9th Cir. 1982).

Alabama-Tennessee argues that Southern's proposal would preclude Alabama-Tennessee from competing for the business of its two largest customers for 20 years, completely locking it out of a substantial portion of its existing market for that entire period. Furthermore, by using below-cost pricing in combination with long-term contracts, Southern would position itself not only to lock up Alabama-Tennessee's largest customers, but also, over the next ten years as Alabama-Tennessee's other contracts expire, to undermine Alabama-Tennessee's ability to compete and thereby potentially to monopolize the Northern Alabama market. Having lost its two largest customers, Alabama-Tennessee would have substantial stranded costs. Any attempt by Alabama-Tennessee to recover those stranded costs by raising the rates of its remaining customers would almost certainly be met by further customer defections to Southern, giving it a monopoly. Furthermore, Southern's proposed extension has a capacity that exceeds the firm contracted capacity and could be doubled with minimum cost raising the possibility that the excess capacity is intended to permit Southern to capitalize on its predatory conduct by establishing a monopoly in the Northern Alabama market. ***

Alabama-Tennessee alleges that Southern's proposal to roll-in the costs of its proposed facilities amounts to predatory pricing and thus violates federal antitrust laws. This allegation is without merit. Southern's rate proposal has met the Commission's requirement under the pricing policy. Under the Commission's pricing policy, the Commission applies a presumption in favor of rolled-in rates when the rate increases to existing customers from rolling-in the new facilities' cost is five percent or less and the pipeline makes a showing of system benefits. Southern has made such a showing. Further, the antitrust laws were enacted for "the protection of competition, not com-

petitors." In this regard, Alabama-Tennessee states that it made a better offer to Decatur and Huntsville than did Southern. Yet these LDCs accepted Southern's offer and rejected Alabama-Tennessee's. If Southern's rates meet the requirements of Commission regulation and policy and its prospective customers freely choose Southern's offer over Alabama-Tennessee's, it is difficult to see where any anticompetitive behavior exists. Further, Decatur and Huntsville currently are captive customers of Alabama-Tennessee and welcome the competition for their business represented by Southern's proposal. ***

Furthermore, although Alabama-Tennessee argues that without Southern's alleged below-cost pricing there would be no valid business reason for pipeline customers to enter into such long-term contracts under present industry conditions, long-term contracts are traditional in the natural gas industry for contracts involving the construction of new facilities. ***

Finally, we cannot help but note that Alabama-Tennessee has vigorously opposed bypass proposals in the past and in this proceeding is seeking to deprive end-users along the route of Southern's proposed extension from the benefits associated with pipeline to pipeline competition in Northern Alabama. Nevertheless, the Commission has consistently approved the construction of duplicate facilities to effectuate the commercial choices that customers have made. This reflects the Commission's belief that competition ultimately benefits natural gas consumers by resulting in improved services at lower costs.

G. Stranded Costs

In its motion to dismiss, Alabama-Tennessee argues that Southern's proposed displacement of Alabama-Tennessee's markets could have serious adverse effects—on Alabama-Tennessee, its customers, Southern's existing customers (described above), and the affected environment of Northern Alabama—that would far outweigh any potential benefits.

Mr. Williams states that if the Commission approves Southern's proposal, Alabama-Tennessee would lose 47 percent of its total system contract demand and annual revenues. The stranded costs of the unsubscribed capacity that would be created would total almost $2.7 million per year and more than $50 million over the proposed 20-year term of service. Mr. Williams states that a significant part of the projected revenue losses could not be mitigated since Alabama-Tennessee is a small pipeline with an effective mainline length of only 130 miles and just four firm shippers, including Decatur and Huntsville, with contract demands in excess of 10,000 Dth per day.

Alabama-Tennessee submits that the Commission should decide whether and how the stranded costs should be imposed and the consequences of any such decision before it takes any action that would result in such unsubscribed capacity and stranded costs. Alabama-Tennessee maintains that the stranded costs could not be imposed on the defecting shippers or its remaining customers, since the Commission has not approved unilateral exit fees. The remaining customers of Alabama-Tennessee are small municipalities and industrial end-users and would be either unable or unwilling to shoulder these costs as a practical matter. In any event, points out Alabama-Tennessee, the Commission has not permitted a pipeline with unsubscribed capacity to shift such stranded costs to the remaining customers.

Nor, according to Alabama-Tennessee, could the stranded costs be reasonably or responsibly imposed on Alabama-Tennessee. First, there would be little opportunity for Alabama-Tennessee to make use of the unsubscribed capacity since it is surrounded by other major pipelines and has few potential markets adjacent to its pipeline. The ability of Alabama-Tennessee and captive customers to absorb all of the stranded costs is also problematic in view of Alabama-Tennessee's relatively small size and the high costs of its compliance with Commission-imposed operating and reporting requirements.

These, argues Alabama-Tennessee, are precisely the circumstances in which the Commission must control market entry to protect consumers from wasteful duplication of facilities and concomitant unnecessary costs. Alabama-Tennessee maintains that to ensure that the unnecessary costs will not be passed on to consumers, the Commission should dismiss Southern's application. ***

In *El Paso Natural Gas Company*, the Commission held that when historic customers terminate service at the end of their contracts it is not appropriate to expect the remaining customers to pay for all of the remaining costs of the pipeline. 72 FERC ¶ 61,083 (1995). ***

The Commission's longstanding policy has been to allow pipelines to compete for markets and to uphold the results of that competition absent a showing of anticompetitive or unfair competition. As indicated elsewhere, we find no evidence of unfair competition in the record here. As to Alabama-Tennessee's arguments regarding stranded costs, it presents a worst-case scenario in predicting the possible outcome of our approval of Southern's proposal. Rather than shifting the costs of unsubscribed capacity to the remaining shippers, Alabama-Tennessee has some obligation to attempt to develop new business opportunities to make use of its unused capacity. Alabama-Tennessee may also attempt to recoup some of its costs by marketing its turned-back capacity. Although there is nothing in Alabama-Tennessee's filings to indicate that it has pursued such an approach or done anything to mitigate the impact of the costs of the unsubscribed capacity, Huntsville and Decatur point to a number of new business opportunities for Alabama-Tennessee in northern Alabama. Under the circumstances, the Commission will not intervene to protect Alabama-Tennessee from the economic results of fair competition in the marketplace. In that regard, we note that both Huntsville and Decatur state that they intend to maintain their existing interconnects with Alabama-Tennessee on a permanent basis so that Alabama-Tennessee will be able to compete to provide any additional requirements that they may have that are not covered by the contract with Southern. * * *

V. Conclusion

Upon consideration of the record, the Commission makes a preliminary finding that Southern's proposal, as modified and conditioned herein, is required by the public convenience and necessity. Southern's proposal, as it relates to all nonenvironmental aspects, satisfies the requirements for issuance under the Commission's regulations. ***

Certification of New Interstate Natural Gas Pipeline Facilities

88 F.E.R.C. ¶ 61,227 (1999), on rehearing 90 F.E.R.C. ¶ 61,128 (2000) and on subsequent rehearing 92 F.E.R.C. ¶ 61,094 (2000)

*** Accordingly, the Commission is issuing this policy statement to provide the industry with guidance as to how the Commission will evaluate proposals for certificating new construction. This should provide more certainty about how the Commission will evaluate new construction projects that are proposed to meet growth in the demand for natural gas at the same time that some existing pipelines are concerned about the potential for capacity turnback. In considering the impact of new construction projects on existing pipelines, the Commission's goal is to appropriately consider the enhancement of competitive transportation alternatives, the possibility of overbuilding, the avoidance of unnecessary disruption of the environment, and the unneeded exercise of eminent domain. ***

I. Comments Received on the NOPR

*** The Commission asked commenters to offer views on three options: One option would be for the Commission to authorize all applications that at a minimum meet the regulatory requirements, then let the market pick winners and losers. Another would be for the Commission to select a single project to serve a given market and exclude all other competitors. Another possible option would be for the Commission to approve an environmentally acceptable right-of-way and let potential builders compete for a certificate. ***

III. Evaluation of Current Policy

A. Current Policy

Section 1(b) of the Natural Gas Act (NGA), 15 U.S.C. § 717, gives the Commission jurisdiction over the transportation of natural gas in interstate commerce and the natural gas companies providing that transportation. Section 7(c) of the NGA, 15 U.S.C. § 717h, provides that no natural gas company shall transport natural gas or construct any facilities for such transportation without a certificate of public convenience and necessity issued by the Commission.

In reaching a final determination on whether a project will be in the public convenience and necessity, the Commission performs a flexible balancing process during which it weighs the factors presented in a particular application. Among the factors that the Commission considers in the balancing process are the proposal's market support, economic, operational, and competitive benefits, and environmental impact.

Under the Commission's current certificate policy, an applicant for a certificate of public convenience and necessity to construct a new pipeline project must show market support through contractual commitments for at least 25 percent of the capacity for the application to be processed by the Commission. An applicant showing 10-year firm commitments for all of its capacity, and/or that revenues will exceed costs is eligible to receive a traditional certificate of public convenience and necessity.

An applicant unable to show the required level of commitment may still receive a certificate but it will be subject to a condition putting the applicant "at risk." In other words, if the project revenues fail to recover the costs, the pipeline rather than its customers will be responsible for the unrecovered costs. ***

Generally, under the current policy, the Commission does not deny an application because of the possible economic impact of a proposed project on existing pipelines the same market or on the existing pipelines' customers. In addition, the Commission gives equal weight to contracts between an applicant and its affiliates and an applicant

and unrelated third parties and does not look behind the contracts to determine whether the customer commitments represent genuine growth in market demand.

Under section 7(h) of the NGA, 15 U.S.C. § 717f(h), a pipeline with a Commission-issued certificate has the right to exercise eminent domain to acquire the land necessary to construct and operate its proposed new pipeline when it cannot reach a voluntary agreement with the landowner. In recent years, this has resulted in landowners becoming increasingly active before the Commission. Landowners and communities often object both to the taking of land and to the reduction of their land's value due to a pipeline's right-of-way running through the property. As part of its environmental review of pipeline projects, the Commission's environmental staff works to take these landowners' concerns into account, and to mitigate adverse impacts where possible and feasible.

Under the pricing policy for new facilities in Docket No. PL94-4-000, see *Pricing Policy for New and Existing Facilities Constructed by Interstate Natural Gas Pipelines*, 71 FERC ¶ 61,241 (1995), the Commission determines, in the certificate proceeding authorizing the facilities' construction, the appropriate pricing for the facilities. Generally, the Commission applies a presumption in favor of rolled-in rates (rolling-in the expansion costs with the existing facilities' costs) when the cost impact of the new facilities would result in a rate impact on existing customers of five percent or less, and some system benefits would occur. Existing customers generally bear these rate increases without being allowed to adjust their volumes.

When a pipeline proposes to charge a cost-based incremental rate (establishing separate costs-of-service and separate rates for the existing and expansion facilities) higher than its existing generally applicable rates, the Commission usually approves the proposal. However, the Commission generally will not accept a proposed incremental rate that is lower than the pipeline's existing generally applicable Part 284 rate.

B. Drawbacks of the Current Policy

1. Reliance on Contracts to Demonstrate Demand

Currently, the Commission uses the percentage of capacity under long-term contracts as the only measure of the demand for a proposed project. Many of the commenters have argued that this is too narrow a test. The reliance solely on long-term contracts to demonstrate demand does not test for all the public benefits that can be achieved by a proposed project. The public benefits may include such factors as the environmental advantages of gas over other fuels, lower fuel costs, access to new supply sources or the connection of new supply to the interstate grid, the elimination of pipeline facility constraints, better service from access to competitive transportation options, and the need for an adequate pipeline infrastructure. The amount of capacity under contract is not a good indicator of all these benefits.

The amount of capacity under contract also is not a sufficient indicator by itself of the need for a project, because the industry has been moving to a practice of relying on short-term contracts, and pipeline capacity is often managed by an entity that is not the actual purchaser of the gas. Using contracts as the primary indicator of market support for the proposed pipeline project also raises additional issues when the contracts are held by pipeline affiliates. Thus, the test relying on the percent of capacity contracted does not reflect the reality of the natural gas industry's structure and presents difficult issues.

In addition, the current policy's preference for contracts with 10-year terms biases customer choices toward longer term contracts. Of course, there are other elements of the Commission's policies that also have this effect. However, eliminating a specific requirement for a contract of a particular length is more consistent with the Commission's regulatory objective to provide appropriate incentives for efficient customer choices and the optimal level of construction, without biasing those choices through regulatory policies.

Finally, by relying almost exclusively on contract standards to establish the market need for a new project, the current policy makes it difficult to articulate to landowners and community interests why their land must be used for a new pipeline project.

All of these concerns raise difficult questions of establishing the public need for the project.

2. The Pricing of New Facilities

As the industry becomes more competitive the Commission needs to adapt its policies to ensure that they provide the correct regulatory incentives to achieve the Commission's policy goals and objectives. All of the Commission's natural gas policy goals and objectives are affected by its pricing policy, but directly affected are the goals of fostering competitive markets, protecting captive customers, and providing incentives for the optimal level of construction and efficient customer choice. The current pricing policy focuses primarily on the interests of the expanding pipeline and its existing and new shippers, giving little weight to the interests of competing pipelines or their captive customers. As a result, it no longer fits well with an industry that is increasingly characterized by competition between pipelines.

The current pricing policy sends the wrong price signals, as some commenters have argued, by masking the real cost of the expansions. This can result in overbuilding of capacity and subsidization of an incumbent pipeline in its competition with potential new entrants for expanding markets. The pricing policy's bias for rolled-in pricing also is inconsistent with a policy that encourages competition while seeking to provide incentives for the optimal level of construction and customer choice. This is because rolled-in pricing often results in projects that are subsidized by existing ratepayers. Under this policy the true costs of the project are not seen by the market or the new customers, leading to inefficient investment and contracting decisions. This in turn can exacerbate adverse environmental impacts, distort competition between pipelines for new customers, and financially penalize existing customers of expanding pipelines and of pipelines affected by the expansion.

Under existing policy, shippers' rates may change for a number of reasons. These include rolling-in of an expansion's costs, changes in the discounts given other customers, or changes in the contract quantities flowing on the system. As a customer's rates change in a rate case, it is generally unable to change its volumes, even though it may be paying more for capacity. This results in shippers bearing substantial risks of rate changes which they may be ill equipped to bear.

III. The New Policy

A. Summary of the Policy

As a result of the Commission's reassessment of its current policy, the Commission has decided to announce the criteria, set forth below, that it will use in deciding whether to authorize the construction of major new pipeline facilities. This section

summarizes the analytical steps the Commission will use under this policy to balance the public benefits against the potential adverse consequences of an application for new pipeline construction. Each of these steps is described in greater detail in the later sections of this policy statement.

Once a certificate application is filed, the threshold question applicable to existing pipelines is whether the project can proceed without subsidies from their existing customers. As discussed below, this will usually mean that the project would be incrementally priced, if but by an existing pipeline, but there are cases where rolled in pricing would prevent subsidization of the project by the existing customers. If the project cannot be built without subsidies, the Commission will deny the application.

The next step is to determine whether the applicant has made efforts to eliminate or minimize any adverse effects the project might have on the existing customers of the pipeline proposing the project, existing pipelines in the market and their captive customers, or landowners and communities affected by the route of the new pipeline. These three interests are discussed in more detail below. This is not intended to be a decisional step in the process for the Commission. Rather, this is a point where the Commission will review the efforts made by the applicant and could assist the applicant in finding ways to mitigate the effects, but the choice of how to structure the project at this stage is left to the applicant's discretion.

If the proposed project will not have any adverse effect on the existing customers of the expanding pipeline, existing pipelines in the market and their captive customers, or the economic interests of landowners and communities affected by the route of the new pipeline, then no balancing of benefits against adverse effects would be necessary. The Commission would proceed, as it does under current practice, to a preliminary determination or a final order depending on the time required to complete an environmental assessment (EA) or environmental impact statement (EIS) (whichever is required in the case).

If residual adverse effects on the three interests are identified, after efforts have been made to minimize them, then the Commission will proceed to evaluate the project by balancing the evidence of public benefits to be achieved against the residual adverse effects. This is essentially an economic test. Only when the benefits outweigh the adverse effects on economic interests will the Commission then proceed to complete the environmental analysis where other interests are considered. It is possible at this stage for the Commission to identify conditions that it could impose on the certificate that would further minimize or eliminate adverse impacts and take those into account in balancing the benefits against the adverse effects. If the result of the balancing is a conclusion that the public benefits outweigh the adverse effects then the next steps would be the same as for a project that had no adverse effects. That is, if the EA or EIS would take more than approximately 180 days then a preliminary determination could be issued, followed by the EA or EIS and the final order. If the EA would take less time, then it would be combined with the final order.

B. The Threshold Requirement—No Financial Subsidies

The threshold requirement in establishing the public convenience and necessity for existing pipelines proposing an expansion project is that the pipeline must be prepared to financially support the project without relying on subsidization from its existing customers. This does not mean that the project sponsor has to bear all the financial risk of the project; the risk can be shared with the new customers in preconstruction

contracts, but it cannot be shifted to existing customers. For new pipeline companies, without existing customers, this requirement will have no application.

The requirement that the project be able to stand on its own financially without subsidies changes the current pricing policy which has a presumption in favor of rolled-in pricing. Eliminating the subsidization usually inherent in rolled-in rates recognizes that a policy of incrementally pricing facilities sends the proper price signals to the market. With a policy of incremental pricing, the market will then decide whether a project is financially viable. The commenters were divided on whether the Commission should change its current pricing policy. A number of commenters, however, urged the Commission to allow the market to decide which projects should be built, and this requirement is a way of accomplishing that result.

The requirement helps to address all of the interests that could be adversely affected. Existing customers of the expanding pipeline should not have to subsidize a project that does not serve them. Landowners should not be subject to eminent domain for projects that are not financially viable and therefore may not be viable in the marketplace. Existing pipelines should not have to compete against new entrants into their markets whose projects receive a financial subsidy (via rolled-in rates), and neither pipeline's captive customers should have to shoulder the costs of unused capacity that results from competing projects that are not financially viable.

This is the only condition that uniformly serves to avoid adverse effects on all of the relevant interests and therefore should be a test for all proposed expansion projects by existing pipelines. It will be the predicate for the rest of the evaluation of a new project by an existing pipeline.

A requirement that the new project must be financially viable without subsidies does not eliminate the possibility that in some instances the project costs should be rolled into the rates of existing customers. In most instances incremental pricing will avoid subsidies for the new project, but the situation may be different in cases of inexpensive expansibility that is made possible because of earlier, costly construction. In that instance, because the existing customers bear the cost of the earlier, more costly construction in their rates, incremental pricing could result in the new customers receiving a subsidy from the existing customers because the new customers would not face the full cost of the construction that makes their new service possible. The issue of the rate treatment for such cheap expansibility is one that always should be resolved in advance, before the construction of the pipeline.

This policy leaves the pipeline responsible for the costs of new capacity that is not fully utilized and obviates the need for an "at risk" condition because it accomplishes the same purpose. Under this policy the pipeline bears the risk for any new capacity that is under-utilized, unless, as recommended by a number of commenters, it contracts with the new customers to share that risk by specifying what will happen to rates and volumes under specific circumstances. If the pipeline finds that new shippers are unwilling to share this risk, this may indicate to the pipeline that others do not share its vision of future demand. Similarly, the risks of construction cost over-runs should not be the responsibility of the pipeline's existing customers but should be apportioned between the pipeline and the new customers in their service contracts. Thus, in pipeline contracts for service on newly constructed facilities, pipelines should not rely on

standard "Memphis clauses", but should reach agreement with new shippers concerning who will bear the risks of underutilization of capacity and cost overruns and the rate treatment for "cheap expansibility."[13]

In sum, if an applicant can show that the project is financially viable without subsidies, then it will have established the first indicator of public benefit. Companies willing to invest in a project, without financial subsidies, will have shown an important indicator of market-based need for a project. Incremental pricing will also lead to the correct price signals for the new project and provide the appropriate incentive for the optimal level of construction. This can avoid unnecessary adverse impacts on landowners or existing pipelines and their captive customers. Therefore, this will be the threshold requirement for establishing that a project will satisfy the public convenience and necessity standard.

C. Factors to be Balanced in Assessing the Public Convenience and Necessity

*** Depending on the type of project, there are three major interests that may be adversely affected by approval of major certificate projects, and that must be considered by the Commission. These are: the interests of the applicant's existing customers, the interests of competing existing pipelines and their captive customers, and the interests of landowners and surrounding communities. There are other interests that may need to be separately considered in a certificate proceeding, such as environmental interests. ***

a. Interests of existing customers of the pipeline applicant

The interests of the existing customers of the expanding pipeline may be adversely affected if the expansion results in their rates being increased or if the expansion causes a degradation in service.

b. Interests of Existing Pipelines that Already Serve the Market and their Captive Customers

Pipelines that already serve the market into which the new capacity would be built are affected by the potential loss of market share and the possibility that they may be left with unsubscribed capacity investment. The Commission need not protect pipeline competitors from the effects of competition, but it does have an obligation to ensure fair competition. Recognizing the impact of a new project on existing pipelines serving the market is not synonymous with protecting incumbent pipelines from the risk of loss of market share to a new entrant, but rather, is a recognition that the impact on the incumbent pipeline is an interest to be taken into account in deciding whether to certificate a new project. The interests of the existing pipeline's captive customers are slightly different from the interests of the pipeline. The interests of the captive customers of the existing pipelines are affected because, under the Commission's current rate model, they can be asked to pay for the unsubscribed capacity in their rates.

c. Interests of landowners and the surrounding communities

Landowners whose land would be condemned for the new pipeline right-of-way, under eminent domain rights conveyed by the Commission's certificate, have an interest as does the community surrounding the right-of-way. The interest of these groups is to avoid unnecessary construction, and any adverse effects on their property associated

[13] "Memphis clause" refers to an agreement that the pipeline may change the rate during the term of the contract by making rate filings under NGA section 4.

with a permanent right-of- way. In some cases, the interests of the surrounding community may be represented by state or local agencies. Traditionally, the interests of the landowners and the surrounding community have been considered synonymous with the environmental impacts of a project; however, these interests can be distinct. Landowner property rights issues are different in character from other environmental issues considered under the National Environmental Policy Act of 1969 (NEPA).

2. Indicators of Public Benefit

To demonstrate that its proposal is in the public convenience and necessity, an applicant must show public benefits that would be achieved by the project that are proportional to the project's adverse impacts. The objective is for the applicant to create a record that will enable the Commission to find that the benefits to be achieved by the project will outweigh the potential adverse effects, after efforts have been made by the applicant to mitigate these adverse effects. The types of public benefits that might be shown are quite diverse but could include meeting unserved demand, eliminating bottlenecks, access to new supplies, lower costs to consumers, providing new interconnects that improve the interstate grid, providing competitive alternatives, increasing electric reliability, or advancing clean air objectives. Any relevant evidence could be presented to support any public benefit the applicant may identify. This is a change from the current policy which relies primarily on one test to establish the need for the project.

The amount of evidence necessary to establish the need for a proposed project will depend on the potential adverse effects of the proposed project on the relevant interests. Thus, projects to serve new demand might be approved on a lesser showing of need and public benefits than those to serve markets already served by another pipeline. However, the evidence necessary to establish the need for the project will usually include a market study. There is no reason for an applicant to do a new market study of its own in every instance. An applicant could rely on generally available studies by EIA or GRI, for example, showing projections of market growth. If one of the benefits of a proposed project would be to lower gas or electric rates for consumers, then the applicant's market study would need to explain the basis for that projection. Vague assertions of public benefits will not be sufficient.

Although the Commission traditionally has required an applicant to present contracts to demonstrate need, that policy, as discussed above, no longer reflects the reality of the natural gas industry's structure, nor does it appear to minimize the adverse impacts on any of the relevant interests. Therefore, although contracts or precedent agreements always will be important evidence of demand for a project, the Commission will no longer require an applicant to present contracts for any specific percentage of the new capacity. Of course, if an applicant has entered into contracts or precedent agreements for the capacity, it will be expected to file the agreements in support of the project, and they would constitute significant evidence of demand for the project.

Eliminating a specific contract requirement reduces the significance of whether the contracts are with affiliated or unaffiliated shippers, which was the subject of a number of comments. A project that has precedent agreements with multiple new customers may present a greater indication of need than a project with only a precedent agreement with an affiliate. The new focus, however, will be on the impact of the project on the relevant interests balanced against the benefits to be gained from the project. As long as the project is built without subsidies from the existing ratepayers, the fact

that it would be used by affiliated shippers is unlikely to create a rate impact on existing ratepayers. With respect to the impact on the other relevant interests, a project built on speculation (whether or not it will be used by affiliated shippers) will usually require more justification than a project built for a specific new market when balanced against the impact on the affected interests.

3. Assessing Public Benefits and Adverse Effects

The more interests adversely affected or the more adverse impact a project would have on a particular interest, the greater the showing of public benefits from the project required to balance the adverse impact. The objective is for the applicant to develop whatever record is necessary, and for the Commission to impose whatever conditions are necessary, for the Commission to be able to find that the benefits to the public from the project outweigh the adverse impact on the relevant interests.

It is difficult to construct helpful bright line standards or tests for this area. Bright line tests are unlikely to be flexible enough to resolve specific cases and to allow the Commission to take into account the different interests that must be considered. Indeed, the current contract test has become problematic. However, the analytical framework described here should give applicants more certainty and sufficient guidance to anticipate how to structure their projects and develop the record to facilitate the Commission's decisional process.

Under this policy, if project sponsors, proposing a new pipeline company, are able to acquire all, or substantially all, of the necessary right-of-way by negotiation prior to filing the application, and the proposal is to serve a new, previously unserved market, it would not adversely affect any of the three interests. Such a project would not need any additional indicators of need and may be readily approved if there are no environmental considerations. Under these circumstances landowners would not be subject to eminent domain proceedings, and because the pipeline was new, there would be no existing customers who might be called upon to subsidize the project. A similar result might be achieved by an existing pipeline extending into a new unserved market by negotiating for a right-of-way for the proposed expansion and following the first requirement for showing need, financing the project without financial subsidies. It would avoid adverse impacts to existing customers by pricing its new capacity incrementally and it is unlikely that other relevant interests would be adversely affected if the pipeline obtained the right-of-way by negotiation.

It may not be possible to acquire all the necessary right-of-way by negotiation. However, the company might minimize the effect of the project on landowners by acquiring as much right-of-way as possible. In that case, the applicant may be called upon to present some evidence of market demand, but under this sliding scale approach the benefits needed to be shown would be less than in a case where no land rights had been previously acquired by negotiation. For example, if an applicant had precedent agreements with multiple parties for most of the new capacity, that would be strong evidence of market demand and potential public benefits that could outweigh the inability to negotiate right-of-way agreements with some landowners. Similarly, a project to attach major new gas supplies to the interstate grid would have benefits that may outweigh the lack of some right-of-way agreements. A showing of significant public benefit would outweigh the modest use of federal eminent domain authority in this example.

In most cases it will not be possible to acquire all the necessary right-of-way by negotiation. Under this policy, a few holdout landowners cannot veto a project, as feared by some commenters, if the applicant provides support for the benefits of its proposal that justifies the issuance of a certificate and the exercise of the corresponding eminent domain rights. The strength of the benefit showing will need to be proportional to the applicant's proposed exercise of eminent domain procedures.

Of course, the Commission will continue to do an independent environmental review of projects, even if the project does not rely on the use of eminent domain and the applicant structures the project to avoid or minimize adverse impacts on any of the identified interests. The Commission anticipates no change to this aspect of its certificate policies. However, to the extent applicants minimize the adverse impacts of projects in advance, this should also lessen the adverse environmental impacts as well, making the NEPA analysis easier. The balancing of interests and benefits that will precede the environmental analysis will largely focus on economic interests such as the property rights of landowners. The other interests of landowners and the surrounding community, such as noise reduction or esthetic concerns will continue to be taken into account in the environmental analysis. If the environmental analysis following a preliminary determination indicates a preferred route other than the one proposed by the applicant, the earlier balancing of the public benefits of the project against its adverse effects would be reopened to take into account the adverse effects on landowners who would be affected by the changed route.

In another example of the proportional approach, a proposal that may have adverse impacts on customers of another pipeline may require evidence of additional benefits to consumers, such as lower rates for the customers to be served. The Commission might also consider how the proposal would affect the cost recovery of the existing pipeline, particularly the amount of unsubscribed capacity that would be created and who would bear that risk, before approving the project. This evaluation would be needed to ensure consideration of the interests of the existing pipeline and particularly its captive customers. Such consideration does not mean that the Commission would always favor existing pipelines and their captive customers. For instance, a proposed project may be so efficient and offer substantial benefits, such as significant service flexibility, so that the benefits would outweigh the adverse impact on existing pipelines and their captive customers.

A number of commenters were concerned that the Commission might give too much weight to the impact on the existing pipeline and its captive customers and undervalue the benefits that can arise from competitive alternatives. The Commission's focus is not to protect incumbent pipelines from the risk of loss of market share to a new entrant, but rather to take the impact into account in balancing the interests. In such a case the evidence of benefits will need to be more specific and detailed than the generalized benefits that arise from the availability of competitive alternatives. The interests of the captive customers are slightly different from the interests of the incumbent pipeline. The captive customers are affected if the incumbent pipeline shifts to the captive customers the costs associated with its unsubscribed capacity. Under the Commission's current rate model captive customers can be asked to pay for unsubscribed capacity in their rates, but the Commission has indicated that it will not permit all costs resulting from the loss of market share to be shifted to captive customers.

Whether and to what extent costs can be shifted is an issue to be resolved in the incumbent pipeline's rate case, but the potential impact on these captive customers is a factor to be taken into account in the certificate proceeding of the new entrant.

In sum, the Commission will approve an application for a certificate only if the public benefits from the project outweigh any adverse effects. Under this policy, pipelines seeking a certificate of public convenience and necessity authorizing the construction of facilities are encouraged to submit applications designed to avoid or minimize adverse effects on relevant interests including effects on existing customers of the applicant, existing pipelines serving the market and their captive customers, and affected landowners and communities. The threshold requirement for approval, that project sponsors must be prepared to develop the project without relying on subsidization by the sponsor's existing customers, protects all of the relevant interests. Applicants also must submit evidence of the public benefits to be achieved by the proposed project such as contracts, precedent agreements, studies of projected demand in the market to be served, or other evidence of public benefit of the project.

V. Conclusion

At a time when the Commission is urged to authorize new pipeline capacity to meet an anticipated increase in the demand for natural gas, the Commission is also urged to act with caution to avoid unnecessary rights-of-way and the potential for overbuilding with the consequent effects on existing pipelines and their captive customers. This policy statement is intended to provide more certainty as to how the Commission will analyze certificate applications to balance these concerns. By encouraging applicants to devote more effort in advance of filing to minimize the adverse effects of a project, the policy gives them the ability to expedite the decisional process by working out contentious issues in advance. Thus, this policy will provide more guidance about the Commission's analytical process and provide participants in certificate proceedings with a framework for shaping the record that is needed by the Commission to expedite its decisional process.

Finally, this new policy will not be applied retroactively. A major purpose of the policy statement is to provide certainty about the decisionmaking process and the impacts that would result from approval of the project. This includes providing participants in a certificate proceeding certainty as to economic impacts that will result from the certificate. It is important for the participants to know the economic consequences that can result before construction begins. After the economic decisions have been made it is difficult to undo those choices. Therefore, the new policy will not be applied retroactively to cases where the certificate has already issued and the investment decisions have been made.

NEWS RELEASES

FERC Updates Policies to Guide Natural Gas Project Certifications

February 17, 2022

Docket Nos. PL18-1, PL21-3

Item C-1 | C-1 Staff Presentation | C-1 Fact Sheet

Item C-2 | C-2 Staff Presentation | C-2 Fact Sheet

FERC today issued two policy statements, providing guidance for future consideration of natural gas projects by the Commission. In addition to providing an analytical framework for many need, environmental and public interest issues that arise when companies seek to build new natural gas facilities, the certificate policy statement and interim greenhouse gas (GHG) policy statement are intended to improve the legal durability of the Commission's natural gas certificate and LNG decisions following a series of court decisions raising concerns about the Commission's prior approach.

The updates to the certificate policy statement include the first revision in more than 20 years to the Commission's policy for the certification of new interstate natural gas projects under section 7 of the Natural Gas Act (NGA). With the interim GHG Policy statement, the Commission is taking a critical step in clarifying how it will address GHG emissions under the NGA and National Environmental Policy Act (NEPA) for proposed pipeline and LNG projects. The Commission is seeking comment on the Interim GHG Policy Statement.

> "I believe today's long overdue policy statements are essential to ensuring the Commission's natural gas siting decisions are reflective of all stakeholder concerns and interests," Chairman Rich Glick said. "We have witnessed the impact on pipeline projects when federal agencies, including the Commission, fail to fulfill their statutory responsibilities assessing the potential effects of a project on the environment, landowners and communities. If we are going to ensure legal durability of our orders, it is essential that the Commission satisfy its statutory obligations the first time. I'm proud of these policy statements because they provide a forward-looking declaration on how the Commission intends to execute its authority to consider proposed infrastructure projects in a manner that is responsive both to all the interests at stake and to the direction of the courts."

Updated Certificate Policy Statement (PL18-1)

In 2018 and again, in 2021, the Commission issued notices of inquiry (NOI) seeking public comment on its 1999 policy statement on the certification of new interstate natural gas transportation facilities. In particular, the Commission requested information on the consideration of the effects of such projects on affected communities, the treatment of precedent agreements in determining the need for a project, and the scope of the Commission's environmental review, including an analysis of the impact of a project's greenhouse gas emissions.

The Updated Certificate Policy Statement reaffirms many of the goals and objectives of the Commission's 1999 policy statement, but further clarifies how the Commission will execute its public interest obligations under the Natural Gas Act. The Updated Policy Statement explains that, in making such determinations, the Commission intends to consider all impacts of a proposed project, including economic and environmental impacts, together. It also calls for a robust consideration of impacts to landowners and environmental justice communities in the Commission's decision-making process.

And where the Commission traditionally has relied on precedent agreements between project applicants and shippers to establish the need for a project, the Updated Certificate Policy Statement states that applicants should provide more than just precedent agreements, to help explain *why* a project is needed, such as the intended end use of the gas. It also states that the Commission may consider other evidence of need, including demand projections, estimated capacity utilization rates, potential cost savings to customers, regional assessments and statements from state regulators or local utilities.

Interim GHG Policy Statement (PL21-3)

The Commission is issuing the Interim GHG Policy Statement to explain how it will assess the impacts of natural gas infrastructure projects on climate change in its reviews under the National Environmental Policy Act and the Natural Gas Act. The Commission seeks comment on all aspects of the interim policy statement, including, in particular, the approach to assessing the significance of the proposed project's contribution to climate change. The guidance is subject to revision based on the record developed in this proceeding; however, the Commission will begin applying the framework established in this policy statement in the interim. This will allow the Commission to evaluate and act on pending applications under section 3 and section 7 of the Natural Gas Act without undue delay and with an eye toward greater certainty and predictability for all stakeholders.

The interim policy sets a threshold of 100,000 metric tons per year of GHG emissions. Projects under consideration with emissions above that level will require the preparation of Environmental Impact Statements (EIS). The Commission will consider proposals by project sponsors to mitigate all or part of their projects' climate change impacts. The Commission may condition its approval on further mitigation of those impacts.

In quantifying GHG emissions, FERC will consider emissions that are reasonably foreseeable and have a reasonably close causal relationship to the proposed action. This will include GHG emissions from construction and operation of the project, and *may* include GHG emissions resulting from the upstream production and downstream combustion of transported gas.

Applicability

As policy statements, neither document establishes binding rules. They are intended to explain how the Commission will consider applications for natural gas project construction. They will apply only to pending and new projects; those applicants with projects now pending before the Commission will have the opportunity to supplement their records.

R22-22

Contact Information

Mary O'Driscoll
Director, Media Relations

Telephone: 202-502-8680
Email: mediadl@ferc.gov

This page was last updated on February 24, 2022

NEWS RELEASES

FERC Seeks Comment on Draft Policy Statements on Pipeline Certification, GHG Emissions

March 24, 2022
Item C-1

FERC today voted to seek comments on two policy statements it issued last month that provide guidance regarding the certification of interstate natural gas pipelines and consideration of greenhouse gas (GHG) emissions in natural gas project reviews. In February, the Commission issued an update to its 1999 Certificate Policy Statement and also issued an interim policy statement focused on the Commission's assessment of the impact of a project's GHG emissions.

After further consideration, the Commission today designated both documents as draft policy statements on which the Commission is seeking further public comment. The two draft policy statements will not apply to pending project applications or filed applications before the Commission issues any final guidance in these dockets.

> "The U.S. Court of Appeals for the D.C. Circuit has on several occasions, including as recently as March 11th, cast significant doubt about the approach the Commission has been taking to site natural gas pipelines and LNG facilities. The policy statements were intended to provide a more legally durable framework for the Commission to consider proposed natural gas projects," Chairman Rich Glick said.
>
> "However, in light of concerns that the policy statements created further confusion about the Commission's approach to the siting of natural gas projects, the Commission decided it would be helpful to gather additional comments from all interested stakeholders, including suggestions for creating greater certainty, before implementing the new policy statements," Glick added.

Comments on the draft policy statements are due by April 25th, with reply comments due May 25th.

R22-27

Contact Information

News media
Telephone: 202-502-8680
Toll-free Telephone: 1-866-208-3372
Email: MediaDL@ferc.gov

This page was last updated on March 25, 2022

Otter Tail Power Co. v. United States

410 U.S. 366 (1973)

MR. JUSTICE DOUGLAS delivered the opinion of the Court: In this civil antitrust suit brought by appellee against Otter Tail Power Co. (Otter Tail), an electric utility company, the District Court found that Otter Tail had attempted to monopolize and had monopolized the retail distribution of electric power in its service area in violation of § 2 of the Sherman Act, 26 Stat. 209, as amended, 15 U.S.C. § 2. The District Court found that Otter Tail had attempted to prevent communities in which its retail distribution franchise had expired from replacing it with a municipal distribution system. The principal means employed were (1) refusals to sell power at wholesale to proposed municipal systems in the communities where it had been retailing power; (2) refusals to "wheel" power to such systems, that is to say, to transfer by direct transmission or displacement electric power from one utility to another over the facilities of an intermediate utility; (3) the institution and support of litigation designed to prevent or delay establishment of those systems; and (4) the invocation of provisions in its transmission contracts with several other power suppliers for the purpose of denying the municipal systems access to other suppliers by means of Otter Tail's transmission systems.

Otter Tail sells electric power at retail in 465 towns in Minnesota, North Dakota, and South Dakota. The District Court's decree enjoins it from refusing to sell electric power at wholesale to existing or proposed municipal electric power systems in the areas serviced by Otter Tail, from refusing to wheel electric power over the lines from the electric power suppliers to existing or proposed municipal system in the area, from entering into or enforcing any contract which prohibits use of Otter Tail's lines to wheel electric power to municipal electric power systems, or from entering into or enforcing any contract which limits the customers to whom and areas in which Otter Tail or any other electric power company may sell electric power.

The decree also enjoins Otter Tail from instituting, supporting, or engaging in litigation, directly or indirectly, against municipalities and their officials who have voted to establish municipal electric power systems for the purpose of delaying, preventing, or interfering with the establishment of a municipal electric power system. 331 F. Supp. 54. Otter Tail took a direct appeal to this Court under § 2 of the Expediting Act, as amended, 62 Stat. 989, 15 U.S.C. § 29; and we noted probable jurisdiction, 406 U.S. 944.

In towns where Otter Tail distributes at retail, it operates under municipally granted franchises which are limited from 10 to 20 years. Each town in Otter Tail's service area generally can accommodate only one distribution system, making each town a natural monopoly market for the distribution and sale of electric power at retail. The aggregate of towns in Otter Tail's service area is the geographic market in which Otter Tail competes for the right to serve the towns at retail.[1] That competition is generally for the right to serve the entire retail market within the composite limits of a town,

[1] Northern States Power Co. also supplies some towns in Otter Tail's area with electric power at retail. But the District Court excluded these towns from Otter Tail's area because the two companies do not compete in the towns served by each other. Of the 615 remaining towns in the area, 465 are served at retail by Otter Tail, 45 by municipal systems, and 105 by rural electric cooperatives. The cooperatives are barred by § 4 of the Rural Electrification Act of 1936, 49 Stat. 1365, as amended, 7 U.S.C. § 904, from borrowing federal funds to provide power to towns already receiving central station service. For this and related reasons, the District Court excluded the rural cooperatives from the relevant market.

and that competition is generally between Otter Tail and a prospective or existing municipal system. These towns number 510 and of those Otter Tail serves 91%, or 465.

Otter Tail's policy is to acquire, when it can, existing municipal systems within its service areas. It has acquired six since 1947. Between 1945 and 1970, there were contests in 12 towns served by Otter Tail over proposals to replace it with municipal systems. In only three—Elbow Lake, Minnesota, Colman, South Dakota, and Aurora, South Dakota—were municipal systems actually established. Proposed municipal systems have great obstacles; they must purchase the electric power at wholesale. To do so they must have access to existing transmission lines. The only ones available belong to Otter Tail. While the Bureau of Reclamation has high-voltage bulk-power supply lines in the area, it does not operate a subtransmission network, but relies on wheeling contracts with Otter Tail and other utilities to deliver power for its bulk supply lines to its wholesale customers.

The antitrust charge against Otter Tail does not involve the lawfulness of its retail outlets, but only its methods of preventing the towns it served from establishing their own municipal systems when Otter Tail's franchises expired. The critical events centered largely in four towns—Elbow Lake, Minnesota, Hankinson, North Dakota, Colman, South Dakota, and Aurora, South Dakota. When Otter Tail's franchise in each of these towns terminated, the citizens voted to establish a municipal distribution system. Otter Tail refused to sell the new systems energy at wholesale and refused to agree to wheel power from other suppliers of wholesale energy.

Colman and Aurora had access to other transmission. Against them, Otter Tail used the weapon of litigation.

As respects Elbow Lake and Hankinson, Otter Tail simply refused to deal, although according to the findings it had the ability to do so. Elbow Lake, cut off from all sources of wholesale power, constructed its own generating plant. Both Elbow Lake and Hankinson requested the Bureau of Reclamation and various cooperatives to furnish them with wholesale power; they were willing to supply it if Otter Tail would wheel it. But Otter Tail refused, relying on provisions in its contracts which barred the use of its lines for wheeling power to towns which it had served at retail. Elbow Lake after completing its plant asked the Federal Power Commission, under § 202 (b) of the Federal Power Act, 49 Stat. 848, 16 U.S.C. § 824a (b), to require Otter Tail to interconnect with the town and sell it power at wholesale. The Federal Power Commission ordered first a temporary and then a permanent connection. Hankinson tried unsuccessfully to get relief from the North Dakota Commission and then filed a complaint with the federal commission seeking an order to compel Otter Tail to wheel. While the application was pending, the town council voted to withdraw it and subsequently renewed Otter Tail's franchise.

It was found that Otter Tail instituted or sponsored litigation involving four towns in its service area which had the effect of halting or delaying efforts to establish municipal systems. Municipal power systems are financed by the sale of electric revenue bonds. Before such bonds can be sold, the town's attorney must submit an opinion which includes a statement that there is no pending or threatened litigation which might impair the value or legality of the bonds. The record amply bears out the District Court's holding that Otter Tail's use of litigation halted or appreciably slowed the ef-

forts for municipal ownership. "The delay thus occasioned and the large financial burden imposed on the towns' limited treasury dampened local enthusiasm for public ownership." 331 F. Supp. 54, 62.

I

Otter Tail contends that by reason of the Federal Power Act it is not subject to antitrust regulation with respect to its refusal to deal. We disagree with that position. *** The District Court determined that Otter Tail's consistent refusals to wholesale or wheel power to its municipal customers constituted illegal monopolization. Otter Tail maintains here that its refusals to deal should be immune from antitrust prosecution because the Federal Power Commission has the authority to compel involuntary interconnections of power pursuant to § 202 (b) of the Federal Power Act. The essential thrust of § 202, however, is to encourage voluntary interconnections of power. See S. Rep. No. 621, 74th Cong., 1st Sess., 19-20, 48-49; H.R. Rep. No. 1318, 74th Cong., 1st Sess., 8. Only if a power company refuses to interconnect voluntarily may the Federal Power Commission, subject to limitations unrelated to antitrust considerations, order the interconnection. The standard which governs its decision is whether such action is "necessary or appropriate in the public interest." Although antitrust considerations may be relevant, they are not determinative.

There is nothing in the legislative history which reveals a purpose to insulate electric power companies from the operation of the antitrust laws. To the contrary, the history of Part II of the Federal Power Act indicates an overriding policy of maintaining competition to the maximum extent possible consistent with the public interest. As originally conceived, Part II would have included a "common carrier" provision making it "the duty of every public utility to . . . transmit energy for any person upon reasonable request . . . ." In addition, it would have empowered the Federal Power Commission to order wheeling if it found such action to be "necessary or desirable in the public interest." H.R. 5423, 74th Cong., 1st Sess.; S. 1725, 74th Cong., 1st Sess. These provisions were eliminated to preserve "the voluntary action of the utilities." S. Rep. No. 621, 74th Cong., 1st Sess., 19.

It is clear, then, that Congress rejected a pervasive regulatory scheme for controlling the interstate distribution of power in favor of voluntary commercial relationships. When these relationships are governed in the first instance by business judgment and not regulatory coercion, courts must be hesitant to conclude that Congress intended to override the fundamental national policies embodied in the antitrust laws. This is particularly true in this instance because Congress, in passing the Public Utility Holding Company Act, which included Part II of the Federal Power Act, was concerned with "restraint of free and independent competition" among public utility holding companies. See 15 U.S.C. § 79a(b)(2).

Thus, there is no basis for concluding that the limited authority of the Federal Power Commission to order interconnections was intended to be a substitute for, or to immunize Otter Tail from, antitrust regulation for refusing to deal with municipal corporations.

II

The decree of the District Court enjoins Otter Tail from "[r]efusing to sell electric power at wholesale to existing or proposed municipal electric power systems in cities and towns located in [its service area]" and from refusing to wheel electric power over

its transmission lines from other electric power lines to such cities and towns. But the decree goes on to provide:

> "The defendant shall not be compelled by the Judgment in this case to furnish wholesale electric service or wheeling service to a municipality except at rates which are compensatory and under terms and conditions which are filed with and subject to approval by the Federal Power Commission."

So far as wheeling is concerned, there is no authority granted the Commission under Part II of the Federal Power Act to order it, for the bills originally introduced contained common carrier provisions which were deleted.[6] The Act as passed contained only the interconnection provision set forth in § 202(b).[7] The common carrier provision in the original bill and the power to direct wheeling were left to the "voluntary coordination of electric facilities."[8] Insofar as the District Court ordered wheeling to correct anticompetitive and monopolistic practices of Otter Tail, there is no conflict with the authority of the Federal Power Commission.

As respects the ordering of interconnections, there is no conflict on the present record. Elbow Lake applied to the Federal Power Commission for an interconnection with Otter Tail and, as we have said, obtained it. Hankinson renewed Otter Tail's franchise. So the decree of the District Court, as far as the present record is concerned, presents no actual conflict between the federal judicial decree and an order of the Federal Power Commission. The argument concerning the pre-emption of the area by the Federal Power Commission concerns only instances which may arise in the future, if Otter Tail continues its hostile attitude and conduct against "existing or proposed municipal electric power systems." The decree of the District Court has an open end by which that court retains jurisdiction "necessary or appropriate" to carry out the decree or "for the modification of any of the provisions." It also contemplates that future disputes over interconnections and the terms and conditions governing those interconnections will be subject to Federal Power Commission perusal. It will be time enough to consider whether the antitrust remedy may override the power of the Commission under § 202 (b) as, if, and when the Commission denies the interconnection and the District Court nevertheless undertakes to direct it. At present, there is only a potential conflict, not a present concrete case or controversy concerning it.

III

The record makes abundantly clear that Otter Tail used its monopoly power in the towns in its service area to foreclose competition or gain a competitive advantage, or to destroy a competitor, all in violation of the antitrust laws. *** When a community

---

[6] See S. Rep. No. 621, 74th Cong., 1st Sess.; H. R. Rep. No. 1318, 74th Cong., 1st Sess..

[7] Section 202 (b) provides: "Whenever the Commission, upon application of any State commission or of any person engaged in the transmission or sale of electric energy, and after notice to each State commission and public utility affected and after opportunity for hearing, finds such action necessary or appropriate in the public interest it may by order direct a public utility (if the Commission finds that no undue burden will be placed upon such public utility thereby) to establish physical connection of its transmission facilities with the facilities of one or more other persons engaged in the transmission or sale of electric energy, to sell energy to or exchange energy with such persons: *Provided,* That the Commission shall have no authority to compel the enlargement of generating facilities for such purposes, nor to compel such public utility to sell or exchange energy when to do so would impair its ability to render adequate service to its customers. The Commission may prescribe the terms and conditions of the arrangement to be made between the persons affected by any such order, including the apportionment of cost between them and the compensation or reimbursement reasonably due to any of them."

[8] S. Rep. No. 621, *supra,* n. 6, at 19.

serviced by Otter Tail decides not to renew Otter Tail's retail franchise when it expires, it may generate, transmit, and distribute its own electric power. We recently described the difficulties and problems of those isolated electric power systems. See *Gainesville Utilities v. Florida Power Corp.*, 402 U.S. 515, 517-520. Interconnection with other utilities is frequently the only solution. *Id.,* at 519 n. 3. That is what Elbow Lake in the present case did. There were no engineering factors that prevented Otter Tail from selling power at wholesale to those towns that wanted municipal plants or wheeling the power. The District Court found—and its findings are supported—that Otter Tail's refusals to sell at wholesale or to wheel were solely to prevent municipal power systems from eroding its monopolistic position. ***

IV

The District Court found that the litigation sponsored by Otter Tail had the purpose of delaying and preventing the establishment of municipal electric systems "with the expectation that this would preserve its predominant position in the sale and transmission of electric power in the area." 331 F. Supp., at 62. The District Court in discussing *Eastern Railroad Conference v. Noerr Motor Freight*, 365 U.S. 127, explained that it was applicable "only to efforts aimed at influencing the legislative and executive branches of the government." *Ibid.* That was written before we decided *California Motor Transport Co. v. Trucking Unlimited*, 404 U.S. 508, 513, where we held that the principle of *Noerr* may also apply to the use of administrative or judicial processes where the purpose to suppress competition is evidenced by repetitive lawsuits carrying the hallmark of insubstantial claims and thus is within the "mere sham" exception announced in *Noerr*. 365 U.S., at 144. On that phase of the order, we vacate and remand for consideration in light of our intervening decision in *California Motor Transport Co.*

V

Otter Tail argues that, without the weapons which it used, more and more municipalities will turn to public power and Otter Tail will go downhill. The argument is a familiar one. *** The same may properly be said of § 2 cases under the Sherman Act. That Act assumes that an enterprise will protect itself against loss by operating with superior service, lower costs, and improved efficiency. Otter Tail's theory collided with the Sherman Act as it sought to substitute for competition anticompetitive uses of its dominant economic power.

The fact that three municipalities which Otter Tail opposed finally got their municipal systems does not excuse Otter Tail's conduct. That fact does not condone the antitrust tactics which Otter Tail sought to impose. *** We do not suggest, however, that the District Court, concluding that Otter Tail violated the antitrust laws, should be impervious to Otter Tail's assertion that compulsory interconnection or wheeling will erode its integrated system and threaten its capacity to serve adequately the public. As the dissent properly notes, the Commission may not order interconnection if to do so "would impair [the utility's] ability to render adequate service to its customers." 16 U.S.C. § 824a (b). The District Court in this case found that the "pessimistic view" advanced in Otter Tail's "erosion study" "is not supported by the record." Furthermore, it concluded that "it does not appear that Bureau of Reclamation power is a serious threat to the defendant nor that it will be in the foreseeable future." Since the District Court has made future connections subject to Commission approval and in any event has retained jurisdiction to enable the parties to apply for "necessary or appropriate" relief and presumably will give effect to the policies embodied in the

Federal Power Act, we cannot say under these circumstances that it has abused its discretion.

Except for the provision of the order discussed in part IV of this opinion, the judgment is

Affirmed.

MR. JUSTICE BLACKMUN and MR. JUSTICE POWELL took no part in the consideration or decision of this case.

MR. JUSTICE STEWART, with whom THE CHIEF JUSTICE and MR. JUSTICE REHNQUIST join, concurring in part and dissenting in part: I join Part IV of the Court's opinion, which sets aside the judgment and remands the case to the District Court for consideration of the appellant's litigation activities in light of our decision in *California Motor Transport Co. v. Trucking Unlimited*, 404 U.S. 508. As to the rest of the Court's opinion, however, I respectfully dissent.

The Court in this case has followed the District Court into a misapplication of the Sherman Act to a highly regulated, natural-monopoly industry wholly different from those that have given rise to ordinary antitrust principles. In my view, Otter Tail's refusal to wholesale power through interconnection or to perform wheeling services was conduct entailing no antitrust violation.

It is undisputed that Otter Tail refused either to wheel power or to sell it at wholesale to the towns of Elbow Lake, Minnesota, and Hankinson, North Dakota, both of which had formerly been its customers and had elected to establish municipally owned electric utility systems. The District Court concluded that Otter Tail had substantial monopoly power at retail and "strategic dominance" in the subtransmission of power in most of its market area. 331 F. Supp. 54, 58-60. The District Court then mechanically applied the familiar Sherman Act formula: since Otter Tail possessed monopoly power and had acted to preserve that power, it was guilty of an antitrust violation. Nowhere did the District Court come to grips with the significance of the Federal Power Act, either in terms of the specific regulatory apparatus it established or the policy considerations that moved the Congress to enact it. Yet it seems to me that these concerns are central to the disposition of this case.

In considering the bill that became the Federal Power Act of 1935, the Congress had before it the report of the National Power Policy Committee on Public-Utility Holding Companies. That report chiefly concerned patterns of ownership in the power industry and the evils of concentrated ownership by holding companies. The problem that Congress addressed in fashioning a regulatory system reflected a purpose to prevent unnecessary financial concentration while recognizing the "natural monopoly" aspects, and concomitant efficiencies, of power generation and transmission. The report stated that

> "[w]hile the distribution of gas or electricity in any given community is tolerated as a 'natural monopoly' to avoid local duplication of plants, there is no justification for an extension of that idea of local monopoly to embrace the common control, by a few powerful interests, of utility plants *scattered over many States and totally unconnected in operation.*" S. Rep. No. 621, 74th Cong., 1st Sess., 55 (emphasis added).

The resulting statutory system left room for the development of economies of large scale, single company operations. One of the stated mandates to the Federal Power Commission was for it to assure "an abundant supply of electric energy throughout

the United States with the greatest possible economy and with regard to the proper utilization and conservation of natural resources," 16 U.S.C. § 824a. In the face of natural monopolies at retail and similar economies of scale in the subtransmission of power, Congress was forced to address the very problem raised by this case—use of the lines of one company by another. One obvious solution would have been to impose the obligations of a common carrier upon power companies owning lines capable of the wholesale transmission of electricity. Such a provision was originally included in the bill. One proposed section provided that:

> "It shall be the duty of every public utility to furnish energy to, exchange energy with, and transmit energy for any person upon reasonable request therefor . . . ." S. 1725, 74th Cong., 1st Sess., § 213.

Another proposed provision was that:

> "Whenever the Commission, after notice and opportunity for hearing, finds such action necessary or desirable in the public interest, it may by order direct a public utility to make additions, extensions, repairs, or improvements to or changes in its facilities, to establish physical connection with the facilities of one or more other persons, to permit the use of its facilities by one or more persons, or to utilize the facilities of, sell energy to, purchase energy from, transmit energy for, or exchange energy with, one or more other persons." *Ibid.*

Had these provisions been enacted, the Commission would clearly have had the power to order interconnections and wheeling for the purpose of making available to local power companies wholesale power obtained from or through companies with subtransmission systems. The latter companies would equally clearly have had an obligation to provide such services upon request. Yet, after substantial debate, the Congress declined to follow this path. As the Senate report indicates in discussing § 202 as enacted:

> "The committee is confident that enlightened self-interest will lead the utilities to cooperate with the commission and with each other in bringing about the economies which can alone be secured through the planned coordination which has long been advocated by the most able and progressive thinkers on this subject.
>
> "When interconnection cannot be secured by voluntary action, subsection (b) gives the Commission limited authority to compel inter-state utilities to connect their lines and sell or exchange energy. The power may only be invoked upon complaint by a State commission or a utility subject to the act." S. Rep. No. 621, 74th Cong., 1st Sess., 49.

This legislative history, especially when viewed in the light of repeated subsequent congressional refusals to impose common carrier obligations in this area, indicates a clear congressional purpose to allow electric utilities to decide for themselves whether to wheel or sell at wholesale as they see fit. This freedom is qualified by a grant of authority to the Commission to order interconnection (but not wheeling) in certain circumstances. But the exercise of even that power is limited by a consideration of the ability of the regulated utility to function. The Commission may not order interconnection where this would entail an "undue burden" on the regulated utility. In addition, the Commission has

> "no authority to compel the enlargement of generating facilities for such purposes, nor to compel such public utility to sell or exchange energy when to do so would impair its ability to render adequate service to its customers." 16 U.S.C. § 824a (b).

As the District Court found, Otter Tail is a vertically integrated power company. But the bulk of its business —some 90% of its income—derives from sales of power at retail. Left to its own judgment in dealing with its customers, it seems entirely predictable that Otter Tail would decline wholesale dealing with towns in which it had previously done business at retail. If the purpose of the congressional scheme is to leave such decisions to the power companies in the absence of a contrary requirement imposed by the Commission, it would appear that Otter Tail's course of conduct in refusing to deal with the municipal system at Elbow Lake and in refusing to promise to deal with the proposed system at Hankinson, was foreseeably within the zone of freedom specifically created by the statutory scheme. As a retailer of power, Otter Tail asserted a legitimate business interest in keeping its lines free for its own power sales and in refusing to lend a hand in its own demise by wheeling cheaper power from the Bureau of Reclamation to municipal consumers which might otherwise purchase power at retail from Otter Tail itself.

The opinion of the Court emphasizes that Otter Tail's actions were not simple refusals to deal—they resulted in Otter Tail's maintenance of monopoly control by hindering the emergence of municipal power companies. *** [A] monopoly is sure to result either way. If the consumers of Elbow Lake receive their electric power from a municipally owned company or from Otter Tail, there will be a monopoly at the retail level, for there will in any event be only one supplier. The very reason for the regulation of private utility rates—by state bodies and by the Commission—is the inevitability of a monopoly that requires price control to take the place of price competition. Antitrust principles applicable to other industries cannot be blindly applied to a unilateral refusal to deal on the part of a power company, operating in a regime of rate regulation and licensed monopolies.

The Court's opinion scoffs at Otter Tail's defense of business justification. *** This facet of the Court's reasoning also escapes me in the case before us, where the health of power companies and the abundance of our energy supply were considerations central to the congressional purpose in devising the regulatory scheme. As noted above, the Commission is specifically prohibited from imposing interconnection requirements that are unduly burdensome or that interfere with a public utility's ability to serve its customers efficiently. The District Court noted that Otter Tail had offered a "so-called `erosion study'" documenting the way in which its business would suffer if it were forced to wholesale and wheel power to municipally owned companies. The District Court gave little credence to the report's predictions. "But regardless," the court went on, "even the threat of losing business does not justify or excuse violating the law." 331 F. Supp., at 64-65. This question-begging disregard of the economic health of Otter Tail is wholly at odds with the congressional purpose in specifying the conditions under which interconnections can be required.

This is not to say that Otter Tail's financial health is paramount in all instances, or that the electric power industry as regulated by the Commission is *per se* exempt from the antitrust laws. In the absence of a specific statutory immunity, such exemptions are not lightly to be implied. Furthermore, no sweeping antitrust exemption is warranted, as it has been in cases involving certain pervasively regulated industries, under

the doctrine of "primary jurisdiction." Our duty in attempting to reconcile the Federal Power Act with the Sherman Act on the facts of the case before us requires a judgment regarding the "character and objectives" of the regulatory scheme and the extent to which they "are incompatible with the maintenance of an antitrust action." *Silver v. New York Stock Exchange*, 373 U.S. 341, 358. "Repeal [of the antitrust laws] is to be regarded as implied only if necessary to make the . . . [Act] work, and even then only to the minimum extent necessary." *Id.,* at 357.

With respect to decisions by regulated electric utilities as to whether or not to provide nonretail services, I think that in the absence of horizontal conspiracy, the teaching of the "primary jurisdiction" cases argues for leaving governmental regulation to the Commission instead of the invariably less sensitive and less specifically expert process of antitrust litigation. I believe this is what Congress intended by declining to impose common carrier obligations on companies like Otter Tail, and by entrusting the Commission with the burden of "assuring an abundant supply of electric energy throughout the United States" and with the power to order interconnections when necessary in the public interest. ***

But the basic conflict between the Commission's authority and the decree entered in the District Court cannot be so easily wished away. The decree enjoins Otter Tail from "[r]efusing to sell electric power at wholesale to existing or proposed municipal electric power systems in cities and towns located in any area serviced by Defendant." This injunction is qualified by a provision that such wholesaling be done at "compensatory" rates and under "terms and conditions which are filed with and subject to approval by the Federal Power Commission." The setting of rates, terms, and conditions, however, is but part of the Commission's authority under § 202(b), 16 U.S.C. § 824a(b). The Court's decree plainly ignores the Commission's authority to decide *whether* involuntary interconnection is warranted under the enunciated statutory criteria. Unless the decree is modified, its future implementation will starkly conflict with the explicit statutory mandate of the Federal Power Commission.

Both because I believe Otter Tail's refusal to wheel or wholesale power was conduct exempt from the antitrust laws and because I believe the District Court's decree improperly pre-empted the jurisdiction of the Federal Power Commission, I would reverse the judgment before us.

Midwest ISO Transmission Owners v. Federal Energy Regulatory Commission

373 F.3d 1361 (D.C. Cir. 2004)

ROBERTS, Circuit Judge:

I.

1. In the bad old days, utilities were vertically integrated monopolies; electricity generation, transmission, and distribution for a particular geographic area were generally provided by and under the control of a single regulated utility. Sales of those services were "bundled," meaning consumers paid a single price for generation, transmission,

and distribution. As the Supreme Court observed, with blithe understatement, "[c]ompetition among utilities was not prevalent." *New York v. FERC*, 535 U.S. 1, 5 (2002).

In its pathmarking Order No. 888, FERC required utilities that owned transmission facilities to guarantee all market participants non-discriminatory access to those facilities. See *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities,* FERC Stats. & Regs. ¶ 31,036, 31,635-36 (1996) (*Order No. 888*). That is, FERC required all transmission-owning utilities to provide transmission service for electricity generated by others on the same basis that they provided transmission service for the electricity they themselves generated. To effectuate this introduction of competition, FERC required public utilities to "functionally unbundle" their wholesale generation and transmission services by stating separate rates for each service in a single tariff and offering transmission service under that tariff on an open-access, non-discriminatory basis. See *New York*, 535 U.S. at 11, 122; see generally *California Indep. Sys. Operator Corp. v. FERC,* 372 F.3d 395, 397 (D.C. Cir. 2004).

As the next step toward the goal of a more competitive electricity marketplace, Order No. 888 encouraged—but did not require—the development of multi-utility regional transmission organizations (RTOs). The concern was that the segmentation of the transmission grid among different utilities, even if each had functionally unbundled transmission, contributed to inefficiencies that impeded free competition in the market for electric power. Combining the different segments and placing control of the grid in one entity—an RTO—was expected to overcome these inefficiencies and promote competition. *Order No. 888* at 31,730-32; see also *Public Util. Dist. No. 1 of Snohomish County v. FERC*, 272 F.3d 607, 610-11 (D.C. Cir. 2001). Better still if the RTO were run by an independent system operator—an ISO. As envisioned by FERC, an ISO would assume operational control—but not ownership—of the transmission facilities owned by its member utilities, thereby "separat[ing] operation of the transmission grid and access to it from economic interests in generation." *Order No. 888* at 31,654; see also *id.* at 31,730-32. The ISO would then provide open access to the regional transmission system to all electricity generators at rates established in "a single, unbundled, grid-wide tariff that applies to all eligible users in a non-discriminatory manner." *Id.* at 31,731; see also *California Indep. Sys. Operator Corp.,* at 397. FERC called this type of separation of generation and transmission "operational unbundling," a step beyond "functional unbundling." *Order No. 888* at 31,654. Although several parties to the 1996 rulemaking had requested that FERC require "operational unbundling" or even divestiture of transmission assets, it was FERC's considered judgment that "the less intrusive functional unbundling approach ... is all that we must require at this time." *Id.* at 31,655.

By 1999, FERC had come to a less sanguine view of the curative powers of functional unbundling. In FERC's view, inefficiencies in the transmission grid and lingering opportunities for transmission owners to discriminate in their own favor remained obstacles to robust competition in the wholesale electricity market. FERC concluded that these problems could be remedied through the establishment of RTOs, explaining that "better regional coordination in areas such as maintenance of transmission and generation systems and transmission planning and operation" was necessary to address regional reliability concerns and to foster regional competition. See *Regional Transmission Organizations,* Order No. 2000, FERC Stats. & Regs. ¶ 31,089, 30,999 (1999) (*Order No. 2000*) (codified at 18 C.F.R. § 35.34) (citing *Staff Report to FERC on the Causes of*

Wholesale Electric Pricing Abnormalities in the Midwest During June 1998, at 5-8 (Sept. 22, 1998)). FERC concluded that RTOs would: "(1) improve efficiencies in transmission grid management; (2) impose grid reliability; (3) remove remaining opportunities for discriminatory transmission practices; (4) improve market performance; and (5) facilitate lighter handed regulation." *Order No. 2000* at 30,993; *Public Util. Dist. No. 1*, 272 F.3d at 611. To further encourage RTO development, FERC directed transmission-owning utilities either to participate in an RTO or to explain their refusal to do so. *Public Util. Dist. No. 1*, 272 F.3d at 612. Importantly, though, Order No. 2000 still did not *require* utilities to join RTOs; participation remained voluntary. See *id.* at 616.

For those utilities opting to join an RTO, Order No. 2000 retained a flexible approach, allowing the RTOs to employ a variety of ownership and operational structures, so long as the RTO established that it had certain required characteristics and functional capabilities. *Id.* at 611. FERC required, *inter alia,* that an RTO be regional in scope, 18 C.F.R. § 35.34(j)(2); "have operational authority for all transmission facilities under its control," *id.* § 35.34(j)(3); "be the only provider of transmission service over the facilities under its control," *id.* § 35.34(k)(1)(i); and "have the sole authority to receive, evaluate, and approve or deny all requests for transmission service," *id.* Thus, whatever its structure, once a utility made the decision to surrender operational control of its transmission facilities to an RTO, any transmissions across those facilities were subject to the control of that RTO.

2. In January 1998 (more than a year before Order No. 2000), several transmission-owning utilities in the Midwest sought FERC's approval for the transfer of operational control of their transmission facilities to an ISO known as Midwest ISO (MISO), which would be organized as a non-profit, non-stock corporation. *See Midwest Indep. Transmission Sys. Operator, Inc.,* 84 FERC ¶ 61,231, 62,138-39 (1998) (*MISO Initial Approval*). MISO would link up the transmission lines of the member transmission-owning utilities (MISO Owners) into a single interconnected grid stretching across the northern border of the U.S. from Michigan to eastern Montana, and reaching as far south as Kansas City, Missouri and Louisville, Kentucky. Under the MISO proposal, the MISO Owners would retain ownership of and physically operate and maintain their transmission facilities, subject to MISO's instructions. MISO would have functional control of the transmission system, with responsibility for calculating available transmission capability; receiving, approving, and scheduling transmission service requests; and providing or arranging for ancillary services under the tariff. MISO would also serve as the system security coordinator for the MISO Owners.

The MISO Owners concurrently applied for approval of MISO's open access transmission tariff. See *id.* at 62,166. Under the tariff, all customers would pay a single rate to use the entire MISO transmission system, based on the volume of power the customer carried on the system. The MISO Owners did not, however, propose to bring all of their own transmission loads immediately under that new open access tariff. Several of the MISO Owners were required to provide bundled retail service (generation and transmission) to consumers at rates frozen by state legislation, state regulatory agencies, or legal settlements. The MISO Owners proposed that such bundled retail loads be brought under the MISO tariff at the end of a six-year transition period, unless the state regulatory authorities unbundled those loads sooner. See *id.* at 62,167. Also, some MISO Owners had pre-existing bilateral agreements with other utilities to provide wholesale transmission service at fixed rates. The MISO Owners proposed that

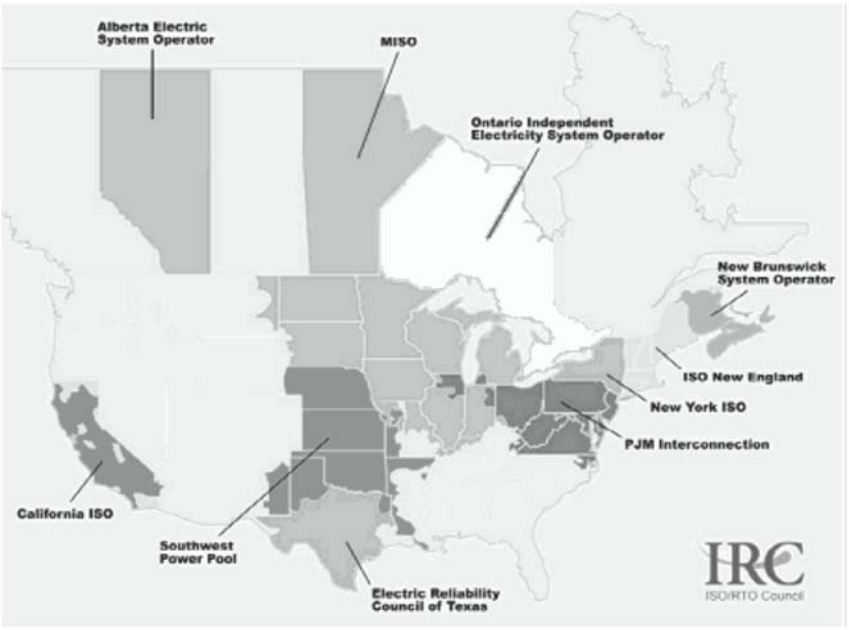
loads under such grandfathered agreements also remain outside of the tariff until the end of the transition period. Thus, only new wholesale and unbundled retail transmission loads would be immediately subject to the MISO tariff. ***

Illinois Commerce Commission v. Federal Energy Regulatory Commission

721 F.3d 764 (7th Cir. 2013)

POSNER, Circuit Judge: Control of more than half the nation's electrical grid is divided among seven Regional Transmission Organizations, as shown in Figure 1. These are voluntary associations of utilities that own electrical transmission lines interconnected to form a regional grid and that agree to delegate operational control of the grid to the association. See 18 C.F.R. § 35.34(j), (k)(1)(i); *Midwest ISO Transmission Owners v. FERC*, 373 F.3d 1361, 1363-65 (D.C. Cir. 2004). Power plants that do not own any part of the grid but generate electricity transmitted by it are also members of these associations, as are other electrical companies involved in one way or another with the regional grid.

FIGURE 1
REGIONAL TRANSMISSION ORGANIZATIONS



The RTOs play a key role in the effort by the Federal Energy Regulatory Commission "to promote competition in those areas of the industry amenable to competition, such as the segment that generates electric power, while ensuring that the segment of the industry characterized by natural monopoly—namely, the transmission grid that conveys the generated electricity—cannot exert monopolistic influence over other areas.... To further pry open the wholesale-electricity market and to reduce technical

inefficiencies caused when different utilities operate different portions of the grid independently, the Commission has encouraged transmission providers to establish 'Regional Transmission Organizations'—entities to which transmission providers would transfer operational control of their facilities for the purpose of efficient coordination ... [and] has encouraged the management of those entities by 'Independent System Operators,' not-for-profit entities that operate transmission facilities in a nondiscriminatory manner." *Morgan Stanley Capital Group, Inc. v. Public Utility District No. 1*, 554 U.S. 527, 536-37 (2008).

Two Regional Transmission Organizations are involved in this case—Midwest Independent Transmission System Operator, Inc. (MISO) and PJM Interconnection, LLC (PJM). As shown in Figure 1, MISO operates in the midwest and in the Great Plains states while PJM operates in the mid-Atlantic region but has midwestern enclaves in and surrounding Chicago and in southwestern Michigan.

Each RTO is responsible for planning and directing expansions and upgrades of its grid. It finances these activities by adding a fee to the price of wholesale electricity transmitted on the grid. 18 C.F.R. § 35.34(k)(1), (7). The Federal Power Act requires that the fee be "just and reasonable," 16 U.S.C. § 824d(a), and therefore at least roughly proportionate to the anticipated benefits to a utility of being able to use the grid. *Illinois Commerce Commission v. FERC*, 576 F.3d 470, 476 (7th Cir. 2009); *Pacific Gas & Electric Co. v. FERC*, 373 F.3d 1315, 1320-21 (D.C. Cir. 2004). Thus "all approved rates [must] reflect to some degree the costs actually caused by the customer who must pay them." *KN Energy, Inc. v. FERC*, 968 F.2d 1295, 1300 (D.C. Cir. 1992). Courts "evaluate compliance [with this principle, which is called 'cost causation'] by comparing the costs assessed against a party to the burdens imposed or benefits drawn by that party." *Midwest ISO Transmission Owners v. FERC*, *supra*, 373 F.3d at 1368.

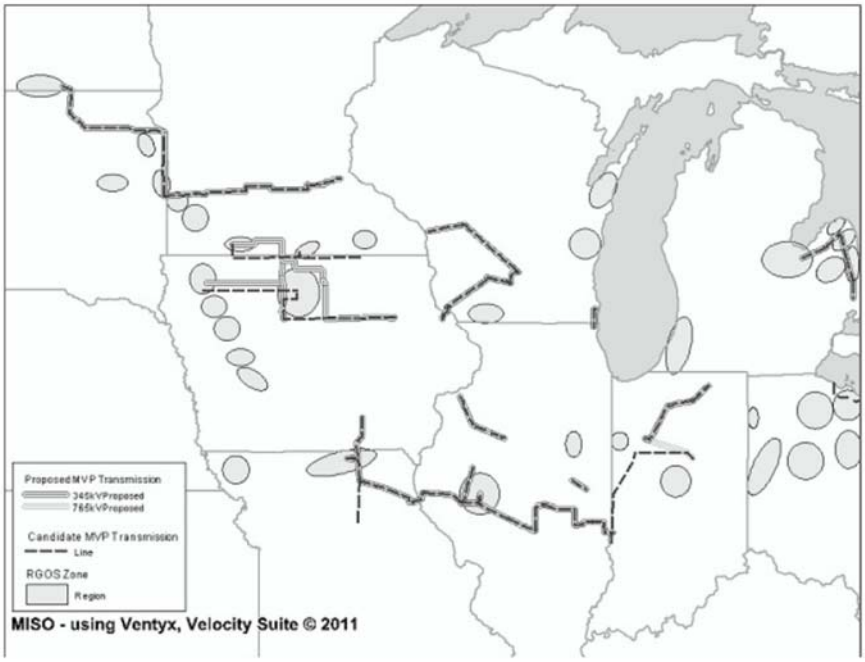
MISO began operating in 2002 and soon grew to have 130 members. (Unfortunately, the voluminous briefs say little about the association's governance structure.) In 2010 it sought FERC's approval to impose a tariff on its members to fund the construction of new high-voltage power lines that it calls "multi-value projects" (MVPs), beginning with 16 pilot projects. The tariff is mainly intended to finance the construction of transmission lines for electricity generated by remote wind farms. Every state in MISO's region except Kentucky (which is barely in the region, see Figure 1) encourages or even requires utilities to obtain a specified percentage of their electricity supply from renewable sources, mainly wind farms. Indiana, North Dakota, and South Dakota have aspirational goals; the rest have mandates. The details vary but most of the states expect or require utilities to obtain between 10 and 25 percent of their electricity needs from renewable sources by 2025—and by then there may be federal renewable energy requirements as well.

"The dirty secret of clean energy is that while generating it is getting easier, moving it to market is not.... Achieving [a 20% renewable energy quota] would require moving large amounts of power over long distances, from the windy, lightly populated plains in the middle of the country to the coasts where many people live... The grid's limitations are putting a damper on such projects already." Matthew L. Wald, "Wind Energy Bumps into Power Grid's Limits," *New York Times,* Aug. 27, 2008, p. A1. MISO aims to overcome these limitations.

To begin with, it has identified what it believes to be the best sites in its region for wind farms that will meet the region's demand for wind power. They are the shaded

ovals in Figure 2. Most are in the Great Plains, because electricity produced by wind farms there is cheaper despite the longer transmission distance; the wind flow is stronger and steadier and land is cheaper because population density is low (wind farms require significant amounts of land).

FIGURE 2
WIND DEVELOPMENT ZONES AND MVP PROJECTS (dashed lines are initial proposals, solid lines approved projects)



MISO has estimated that the cost of the transmission lines necessary both to bring electricity to its urban centers from the Great Plains and to integrate the existing wind farms elsewhere in its region with transmission lines from the Great Plains—transmission lines that the multi-value projects will create—will be more than offset by the lower cost of electricity produced by western wind farms. The new transmission lines will also increase the reliability of the electricity supply in the MISO region and thus reduce brownouts and outages, and also increase the efficiency with which electricity is distributed throughout the region.

The cost of the multi-value projects is to be allocated among utilities drawing power from MISO's grid in proportion to each utility's share of the region's total wholesale consumption of electricity. Before 2010, MISO allocated the cost of expanding or upgrading the transmission grid to the utilities nearest a proposed transmission line, on the theory that they would benefit the most from the new line. But wind farms in the Great Plains can generate far more power than that sparsely populated region needs. So MISO decided to allocate MVP costs among all utilities drawing power from the grid according to the amount of electrical energy used, thus placing most of those costs on urban centers, where demand for energy is greatest.

FERC approved (with a few exceptions, one discussed later in this opinion) MISO's rate design and pilot projects in two orders (for simplicity we'll pretend they're just one), precipitating the petitions for review that we have consolidated.

Six issues are presented: the proportionality of benefits to costs; the procedural adequacy of the Commission's treatment of proportionality; the propriety of apportioning the cost of the multi-value projects among utilities on the basis of their total power consumption while allocating no MVP costs to the plants that generate the power; whether MISO should be permitted to add the MVP fee to electricity transmitted to utilities that belong to the PJM Regional Transmission Organization rather than to MISO; whether MISO should be permitted to assess some of the multi-value projects' costs on departing members of MISO; and whether the Commission's approval of the MVP tariff—which if implemented will influence decisions by state utility commissions regarding the siting of transmission lines—violates the Tenth Amendment to the Constitution by invading state prerogatives.

The Tenth Amendment. The last issue is frivolous, so we dispatch it first. FERC approved the MVP tariff pursuant to its statutory authority to regulate interstate electrical rates, 16 U.S.C. § 824(a), but (unlike the regulation of natural gas, a field in which FERC has jurisdiction both over pricing and over the siting of interstate lines, see 15 U.S.C. § 717f(c)) the states retain authority over the location and construction of electrical transmission lines. 16 U.S.C. § 824(b)(1); *New York v. FERC*, 535 U.S. 1, 24 (2002). Some of the petitioners complain that FERC's approval of the MVP tariff coerces each state to approve all MVPs proposed within its territory. They argue that since the costs of each project are distributed among all MISO utilities while any local benefits will be retained in the state in which the project is located, a state will deprive itself of the local benefits of a project subsidized by other utilities if it refuses to approve an MVP project.

But this is just to say that the tariff provides a carrot that states won't be able to resist eating; to obtain the benefits of the MVP program each state's MISO members may have to shoulder costs of some specific projects that they'd prefer not to support. But that's a far cry from the federal government's conscripting a state government into federal service. That it may not do. *National Federation of Independent Business v. Sebelius*, ___ U.S. ___ (2012); *New York v. United States*, 505 U.S. 144, 149 (1992); *Printz v. United States*, 521 U.S. 898, 935 (1997). This it may do. Cf. *National Ass'n of Regulatory Utility Commissioners v. FERC*, 475 F.3d 1277, 1282-83 (D.C. Cir. 2007). It's not as if FERC were ordering states to build transmission lines that the federal government wants to use for its own purposes. And to glance ahead a bit, there is nothing to prevent a member of MISO from withdrawing from the association and joining another Regional Transmission Organization.

Five issues remain; we discuss them in the order in which we listed them, beginning with—

Proportionality and Procedure (best discussed together). MISO used to allocate the cost of an upgrade to its grid to the local area ("pricing zone") in which the upgrade was located. (There are 24 pricing zones in MISO.) But those were upgrades to low-voltage lines, which transmit power short distances and thus benefit only the local area served by the lines. MISO contends (and FERC agrees) that the multi-value projects, which involve high-voltage lines that transmit electricity over long distances, will benefit all members of MISO and so the projects' costs should be shared among all members.

The petitioners' objections fall into two groups. One consists of objections lodged by the Michigan utilities and their regulator (we'll call this set of objectors "Michigan"), the other of objections by other petitioners led by the Illinois Commerce Commission. We'll call these objectors "Illinois," though they include other state utilities and regulators; and we'll begin with their objections.

Illinois contends that the criteria for determining what projects are eligible to be treated as MVPs are too loose and as a result all MISO members will be forced to contribute to the cost of projects that benefit only a few. To qualify as an MVP a project must have an expected cost of at least $20 million, must consist of high-voltage transmission lines (at least 100kV), and must help MISO members meet state renewable energy requirements, fix reliability problems, or provide economic benefits in multiple pricing zones. None of these eligibility criteria ensures that every utility in MISO's vast region will benefit from every MVP project, let alone in exact proportion to its share of the MVP tariff. For example, Illinois power cooperatives are exempt from the state's renewable energy requirements, 83 Ill. Adm.Code 455.100; 20 ILCS 3855/1-75(c), and so would not benefit from MVPs that help utilities meet state renewable energy requirements. But FERC expects them to benefit by virtue of the criteria for MVP projects relating to reliability and to the provision of benefits across pricing zones.

Bear in mind that every multi-value project is to be large, is to consist of high-voltage transmission (enabling power to be transmitted efficiently across pricing zones), and is to help utilities satisfy renewable energy requirements, improve reliability (which benefits the entire regional grid by reducing the likelihood of brownouts or outages, which could occur anywhere on it, *Illinois Commerce Commission v. FERC*, *supra*, 576 F.3d at 477), facilitate power flow to currently underserved areas in the MISO region, or attain several of these goals at once. The 16 projects that have been authorized are just the beginning. And FERC has required MISO to provide annual updates on the status of those projects. Should the reports show that the benefits anticipated by MISO and FERC are not being realized, the Commission can modify or rescind its approval of the MVP tariff.

Illinois also complains that MISO has failed to show that the multi-value projects as a whole will confer benefits greater than their costs, and it complains too about FERC's failure to determine the costs and benefits of the projects subregion by subregion and utility by utility. But Illinois's briefs offer no estimates of costs and benefits either, whether for the MISO region as a whole or for particular subregions or particular utilities. And in complaining that MISO and the Commission failed to calculate the full financial incidence of the MVP tariff, Illinois ignores the limitations on calculability that the uncertainty of the future imposes. MISO did estimate that there would be cost savings of some $297 million to $423 million annually because western wind power is cheaper than power from existing sources, and that these savings would be "spread almost evenly across all Midwest ISO Planning Regions." *Midwest Independent Transmission System Operator, Inc.,* 133 FERC 61221, ¶ 34 (2010). It also estimated that the projected high-voltage lines would reduce losses of electricity in transmission by $68 to $104 million, and save another $217 to $271 million by reducing "reserve margin losses." *Id.* That term refers to electricity generated in excess of demand and therefore (because it can't be stored) wasted. Fewer plants will have to be kept running in reserve to meet unexpected spikes in demand if by virtue of longer transmission lines

electricity can be sent from elsewhere to meet those unexpected spikes. It's impossible to allocate these cost savings with any precision across MISO members.

The promotion of wind power by the MVP program deserves emphasis. Already wind power accounts for 3.5 percent of the nation's electricity, U.S. Energy Information Administration, "What is U.S. Electricity Generation by Source?" May 9, 2013, www.eia.gov/tools/faqs/faq.cfm? id=427 & t=3 (visited May 29, 2013), and it is expected to continue growing despite the downsides of wind power that we summarized in *Muscarello v. Winnebago County Board*, 702 F.3d 909, 910-11 (7th Cir. 2012). The use of wind power in lieu of power generated by burning fossil fuels reduces both the nation's dependence on foreign oil and emissions of carbon dioxide. And its cost is falling as technology improves. No one can know how fast wind power will grow. But the best guess is that it will grow fast and confer substantial benefits on the region served by MISO by replacing more expensive local wind power, and power plants that burn oil or coal, with western wind power. There is no reason to think these benefits will be denied to particular subregions of MISO. Other benefits of MVPs, such as increasing the reliability of the grid, also can't be calculated in advance, especially on a subregional basis, yet are real and will benefit utilities and consumers in all of MISO's subregions.

It's not enough for Illinois to point out that MISO's and FERC's attempt to match the costs and the benefits of the MVP program is crude; if crude is all that is possible, it will have to suffice. As we explained in *Illinois Commerce Commission v. FERC*, *supra*, 576 F.3d at 477, if FERC "cannot quantify the benefits [to particular utilities or a particular utility]... but it has an articulable and plausible reason to believe that the benefits are at least roughly commensurate with those utilities' share of total electricity sales in [the] region, then fine; the Commission can approve [the pricing scheme proposed by the Regional Transmission Organization for that region] ... on that basis. For that matter it can presume [as it did in this case] that new transmission lines benefit the entire network by reducing the likelihood or severity of outages."

Illinois can't counter FERC without presenting evidence of imbalance of costs and benefits, which it hasn't done. When we pointed this out at oral argument, Illinois's lawyer responded that he could not obtain the necessary evidence without pretrial discovery and that FERC had refused to grant his request for an evidentiary hearing even though the Commission's rules make the grant of such a hearing a precondition to discovery. 18 C.F.R. § 385.504(b)(5). FERC refused because it already had voluminous evidentiary materials, including MISO's elaborate quantifications of costs and benefits—and these were materials to which the petitioners had access as well; they are, after all, members of MISO. The only information MISO held back was the production costs of particular power plants, which it deemed trade secrets and anyway are only tenuously related to the issue of proportionality. The need for discovery has not been shown; and for us to order it without a compelling reason two and a half years after the Commission rendered its exhaustive decision (almost 400 pages long) would create unconscionable regulatory delay.

Michigan (which is to say Michigan utilities plus the state's electric power regulatory agency) argues that unique features of the state's power system will cause Michigan utilities to pay a share of the MVP tariff greatly disproportionate to the benefits they will derive from the multi-value projects. A Michigan statute, Mich. Comp. L. 460.1029(1), forbids Michigan utilities to count renewable energy generated outside

the state toward satisfying the requirement in the state's "Clean, Renewable, and Efficient Energy Act" of 2008 that they obtain at least 10 percent of their electrical power needs from renewable sources by 2015. Michigan further argues that it won't benefit from any multi-value projects constructed in other states because its utilities draw very little power from the rest of the MISO grid, as a consequence of the limited capacity to transmit electricity from Indiana to Michigan. It argues that for these reasons it should be required to contribute only to the costs of multi-value projects built in Michigan.

The second argument founders on the fact that the construction of high-voltage lines from Indiana to Michigan is one of the multi-value projects and will enable more electricity to be transmitted to Michigan at lower cost. Michigan's first argument—that its law forbids it to credit wind power from out of state against the state's required use of renewable energy by its utilities—trips over an insurmountable constitutional objection. Michigan cannot, without violating the commerce clause of Article I of the Constitution, discriminate against out-of-state renewable energy. See *Oregon Waste Systems, Inc. v. Department of Environmental Quality*, 511 U.S. 93, 100-01 (1994); *Wyoming v. Oklahoma*, 502 U.S. 437, 454-55 (1992); *Alliance for Clean Coal v. Miller*, 44 F.3d 591, 595-96 (7th Cir.1995).

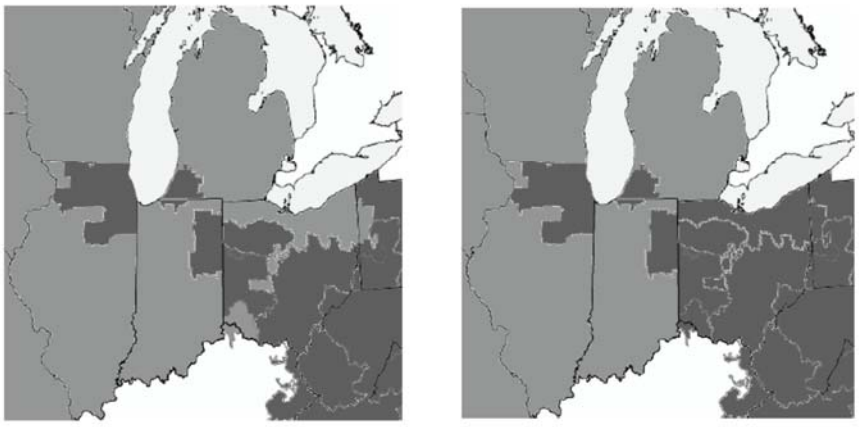
Like Illinois, Michigan objects to the Commission's refusal to conduct an evidentiary hearing. It wants an opportunity to present evidence in a trial-type proceeding involving cross-examination of expert witnesses. (All direct testimony at FERC's evidentiary hearings is presented in writing; only cross-examination is oral.) It also wants pretrial discovery, like Illinois. But unlike Illinois it didn't raise the issue until its reply brief, which is too late.

FERC need not conduct an oral hearing if it can adequately resolve factual disputes on the basis of written submissions. Considering the highly technical character of the data and analysis required to match costs and benefits of transmission projects, the technical knowledge and experience of FERC's members and staff, and the petitioners' access to MISO's studies, we would be creating gratuitous delay to insist at this late date on the Commission's resorting to litigation procedures designed long ago for run-of-the-mine legal disputes. Michigan has failed to indicate what evidence that it might present in an evidentiary hearing would contribute to the data and analysis in the record already before the Commission.

A further answer to both the substantive and procedural questions about proportionality is that MISO members who think they're being mistreated by the MVP tariff can vote with their feet. Membership in an RTO is voluntary and though there's a "departure fee" (discussed later in this opinion), it is an unexceptionable feature of membership in a voluntary association, designed to prevent a departing member from reaping a windfall by leaving costs for which it is properly liable to be borne by the remaining members. A departure fee, which if properly calculated just deters windfalls, will not prevent a discontented MISO member from decamping to an adjacent RTO. As shown in the right-hand panel of Figure 3, Michigan abuts the border between MISO (light gray) and PJM (dark gray) and has claimed that 96.5 percent of its external grid connections are with PJM. It should therefore be able without great difficulty to quit MISO and join PJM. It doesn't want to do that; so far as appears, it is objecting to the MVP program only in the hope of getting better terms.

FIGURE 3: MISO-PJM BORDER REGION (MISO to left, PJM to right)

2004 2013



Allocation of cost on the basis of peak load versus total electricity consumption. Because a power grid must be built to handle peak loads (the amount of electricity transmitted when demand is greatest, as on hot summer days), some of the petitioners argue that the MVP surcharge should be allocated according to each utility's contribution to peak demand. The peak demanders would be paying for facilities built to accommodate that demand and thus minimize brownouts and outages. Instead MISO allocates the surcharge by the total amount of electricity that each utility receives over the MISO grid. A higher share of MVP costs is thus allocated to utilities receiving electricity to meet continuous demands, such as the demand by a factory for electricity much of which it uses in off-peak periods.

The objection to MISO's allocating costs by total rather than peak demand is refuted by the fact that a primary goal of the MVPs is to increase the supply of wind-powered energy. The electricity generated by wind farms varies with the amount of wind rather than with demand and therefore is not a reliable source of energy to meet peak demand. That is why the states' renewable energy standards are couched in terms of total energy rather than peak load. See, e.g., 20 ILCS 3855/1-75(c)(2); Wis. Stat. § 196.378(1)(fm); Minn.Stat. § 216B.1691 subd. 2a(a). Furthermore, long-distance power transmission will enable fewer power plants to serve the grid's off-peak demand. True, the projects are also intended to increase the grid's reliability, which is challenged mainly by peak load (which is why outages are more frequent on hot summer days, when everyone is running his air conditioner at the same time). But MISO and FERC were entitled to conclude that the benefits of more and cheaper wind power predominate over the benefits of greater reliability brought about by improvement in meeting peak demand.

Allocation of cost between power plants and the wholesale buyers of the power. Petitioners complain about MISO's decision to allocate all MVP costs to the utilities that buy electricity from its grid and none to the power plants that generate that electricity. Because the power plants are required to pay for connecting to the grid and the multivalue projects will shorten the interconnection distance and thus reduce the cost to the power plants

of connecting, the petitioners argue that the power plants should pay part of the MVP tariff. But the utilities benefit from cheaper power generated by efficiently sited wind farms whose development the multi-value projects will stimulate. The MVP tariff allocates to the wholesale buyers some of the costs of conferring these benefits on those buyers, though competition might do the same thing without the tariff because the power plants would pass some of their higher costs on to their customers, the wholesale buyers.

An important consideration is that when wind farms are built in remote areas (which are the best places to site them), the costs of connecting them to the grid are very high, and by reducing those costs the multi-value projects, financed by the MVP tariff, facilitate siting wind farms at the best locations in MISO's region rather than at inefficient ones that are however closer to the existing grid and so would be preferred by the wind-farm developers if they had to pay for the connection. See *California Independent System Operator Corp.,* 119 F.E.R.C. 61061, ¶¶ 64-67 (2007); *Southwest Power Pool, Inc.,* 127 FERC 61283, ¶¶ 5, 11, 28 (2009).

Export charges to PJM. An issue that unlike the previous ones finds MISO and FERC at loggerheads is whether the Commission is unreasonable in prohibiting MISO from adding the MVP surcharge to electricity transmitted from its grid to the grid of PJM, an adjoining Regional Transmission Organization. The Commission permits MISO to charge for transmission to other RTOs.

The prohibition arises from a concern with what in FERC-speak is called "rate pancaking" but is more transparently described as exploiting a locational monopoly by charging a toll. It is illustrated by Henrich von Kleist's classic German novella *Michael Kohlhaas*. When the book was published in 1810, what is now Germany was divided into hundreds of independent states. A road from Munich to Berlin, say, would cross many boundaries, and each state that the road entered could charge a toll as a condition for allowing entry. The toll would be limited not by the cost imposed on the state by the traveler, in wear and tear on the road or traffic congestion, but by the cost to the traveler of using a less direct alternative route. Like early nineteenth-century Germany, the American electric grid used to be divided among hundreds of independent utilities, each charging a separate toll for the right to send electricity over its portion of the grid. The multiple charges imposed on long-distance transmission discouraged such transmission. FERC promoted the creation of the Regional Transmission Organizations as a way of eliminating these locational monopolies. *Wabash Valley Power Ass'n v. FERC*, 268 F.3d 1105, 1116 (D.C. Cir. 2001). For it required that the RTOs embrace coherent geographic regions and that each RTO charge a single fee for use of its entire grid. 18 C.F.R. § 35.34(j)(2), (k)(1)(ii).

In the early 2000s Commonwealth Edison and American Electric Power had requested FERC's permission to join PJM despite being inside MISO's region (around Chicago and in southwestern Michigan, respectively). The Commission approved their requests yet was concerned that the irregular border (seen in the left-hand panel of Figure 3) between the two regions, by creating PJM enclaves in MISO's region, violated the requirement that RTOs embrace coherent regions. The Commission was concerned for example with Michigan utilities' having to pay PJM charges on power sent from elsewhere in MISO (such as Wisconsin), because those transmissions, though beginning and ending in MISO territory, traversed a PJM enclave—the area served by Commonwealth Edison.

The Commission had another concern with the irregular border, what we'll call the "power routing" concern. Notice in the left-hand panel of Figure 3 the MISO utilities that lie (or rather lay, as of 2004) on a south to north diagonal in Kentucky and Ohio. Imagine a wholesale buyer of electricity located on the diagonal. It would be more efficient for it to draw electricity from the PJM transmission lines to its immediate west or east than from the MISO lines that snake to the northeast and thus bring electricity from a great distance. But the buyer might be deflected from the most efficient routing option because buying from PJM would cross both MISO and PJM territory and thus require paying a double toll.

So in 2003 FERC forbade export charges between MISO and PJM and ordered the two RTOs to negotiate a joint rate that would divide the costs of the cross-border transmissions between them, much as with "divisions" of railroad rates for shipments in which more than one railroad participates. The Commission didn't require a similar negotiation between MISO and the other RTOs that MISO abuts because no enclave or power-routing problem was created by transmission to those RTOs; there were no enclaves or highly irregular borders.

The two RTOs negotiated a joint rate designed to share the costs of some transmission upgrades with crossborder benefits—but have not negotiated a joint rate for multi-value projects. MISO argues that the Commission should have reconsidered its 2003 prohibition of export charges to PJM and permitted such charges for multi-value projects that benefit electricity customers in PJM, in light of the changes (seen in the right-hand panel of Figure 3) in the MISO-PJM border between 2003-2004 and 2013. Those changes have straightened out the border and by doing so should have lessened the Commission's concern that "the elongated and highly irregular seam between MISO and PJM....would subject a large number of transactions in the region to continued rate pancaking." *Midwest Independent Transmission System Operator, Inc.,* 137 FERC 61074, ¶ 264 (2011). No longer are any parts of Ohio in MISO. True, there still are PJM enclaves. For example, a transmission from a PJM enclave in northern Illinois or southwestern Michigan to Ohio or Pennsylvania runs through MISO lines in Indiana. But with the disappearance of the MISO diagonal that we mentioned, the power-routing problem, at least, appears to have been solved, though FERC wants more data from MISO to demonstrate this.

A further concern about the continued validity of the 2003 order prohibiting tolls on transmissions between MISO and PJM is that the order was issued at a time when all of MISO's transmission projects were local and therefore provided only local benefits, so that an export charge would have shifted costs to PJM utilities that derived few or even no benefits from the projects. A related consideration behind the 2003 order was that export charges would not finance projects, but would merely operate as a toll exploiting a locational advantage. Cf. *Illinois Commerce Commission v. FERC*, *supra*, 576 F.3d at 473-74. The multi-value projects are new projects, not yet paid for, and since they will benefit electricity users in PJM, those users should contribute to the costs.

The MVPs also are not local. They will "support all uses of the system, including transmission on the system that is ultimately used to deliver to an external load," and "benefit all users of the integrated transmission system, regardless of whether the ultimate point of delivery is to an internal or external load." *Midwest Independent Transmission System Operator, Inc.,* 133 FERC 61221, ¶ 439 (2010). (By "external" read PJM or any

other recipient of electricity that is outside MISO.) That is an argument for shifting some of the costs of the system to PJM utilities. The requirement of proportionality between costs and benefits requires that all beneficiaries—which the Commission has determined include all users of the MISO grid, including users in PJM—shoulder a reasonable portion of MVP costs.

MISO and PJM may eventually negotiate an allocation agreement, as they did in the pre-MVP era, but the rest of the grid is left to pay for PJM's share unless and until they do so. So far as we can tell, the Commission is being arbitrary in continuing to prohibit MISO from charging anything for exports of energy to PJM enabled by the multi-value projects while permitting it to charge for exports of energy to all the other RTOs. The Commission must determine in light of current conditions what if any limitation on export pricing to PJM by MISO is justified. This part of the Commission's decision must therefore be vacated.

The departers. Two former members of MISO, FirstEnergy and Duke Energy, which lie on the diagonal that had created the power-routing problem, announced their intention to quit MISO before the MVP tariff was announced. MISO wants nevertheless to allocate some MVP costs to them. FERC has ruled that allocation to departing utilities is proper in principle. But it has not yet determined which if any costs may be allocated to the two utilities in particular. That determination FERC has ruled to be outside the scope of the present proceeding, the proceeding before us. *Midwest Independent Transmission System Operator, Inc.,* 133 FERC 61221, ¶ 472 (2010). FirstEnergy and Duke respond that they can't be made liable for any such costs because their membership contract with MISO does not provide for the imposition of such costs.

When a firm withdraws from an association owing money to it, its withdrawal does not terminate its liability; an example is an employer who withdraws from a multiemployer ERISA plan. The same may be true of withdrawal from a Regional Transmission Organization. If MISO began to incur costs relating to the MVPs (including the pilot projects) before the departing members announced their departure, those utilities may be liable for some of those costs. MISO contends that they *are* liable, but the Commission has reserved the question for a separate proceeding, see *FirstEnergy Service Co. v. Midwest Independent Transmission System Operator, Inc.,* 138 FERC 61140, ¶ 74 (2012), as it is authorized to do. *Mobil Oil Exploration & Producing Southeast Inc. v. United Distribution Cos.*, 498 U.S. 211, 230 (1991). That proceeding is pending.

The departing members' attack on an order that amounts to a truism—that amounts to saying that if they're liable they're liable—is premature, and must therefore be dismissed for want of a final administrative decision on the matter.

In summary, the challenged orders are affirmed, except that the challenge by the departing MISO members is dismissed as premature and the determination regarding export pricing to PJM is remanded for further analysis by the Commission in light of the discussion of the issue in this opinion.

Ameren Services Co. v. Federal Energy Regulatory Commission

893 F.3d 786 (D.C. Cir. 2018)

Opinion for the Court filed by Circuit Judge Srinivasan. In 2011, the Federal Energy Regulatory Commission issued Order 1000, which aims, among other things, to encourage the development of "interregional" electricity transmission projects—projects spanning more than one geographic region. The interregional component of Order 1000 rested on the belief that certain interregional projects might meet the needs of transmission providers and customers more efficiently and effectively than regional projects, but that prevailing incentives and coordination mechanisms did not adequately encourage regional transmission providers to pursue interregional projects.

To that end, Order 1000 calls for regional providers to jointly evaluate interregional projects. As part of that process, providers must adopt cost-allocation methodologies for dividing up the costs of a joint project. The primary goal of Order 1000's cost-allocation provisions is to assure that the relative costs borne by a particular transmission provider be commensurate with the relative benefits gained by the provider from the project.

This case concerns one transmission provider's proposed interregional cost-allocation methodology. Midcontinent Independent System Operator (MISO), an organization that operates transmission facilities on behalf of providers across fifteen states in the Midwest, proposed to conduct cost allocation for interregional projects using what's called a cost-avoidance method. The share of costs allocated to MISO under that method corresponds to the benefits to MISO of its regional projects that would be displaced by the interregional project. In identifying which regional projects should be regarded as displaced by an interregional project, MISO proposed to exclude any project that had already been approved by the MISO board.

The Commission rejected MISO's cost-allocation approach. In the Commission's view, excluding approved regional projects from the analysis would result in a failure to account for the full potential benefits of an interregional project. The transmission providers that make up MISO filed a petition for review in this court. We deny the petition.

I.

A.

Electric transmission in the United States is largely managed by regional transmission organizations (RTOs) and independent system operators (ISOs). Those entities operate the electric transmission systems for a geographic region on behalf of the local utilities (known as transmission providers) in a region. MISO operates transmission facilities in the midwestern United States on behalf of more than two dozen transmission providers, petitioners here.

For the past several decades, the Federal Energy Regulatory Commission, acting under its authority to fix just and reasonable rates under section 206 of the Federal Power Act has issued orders requiring RTOs and ISOs to adopt practices meant to encourage competition in the market for electricity. *E.g., Transmission Planning and Cost Allocation by Transmission Owning and Operating Public Utilities,* Order No. 1000, 136 FERC ¶ 61,051 at PP 1-5 (2011). Order 1000, among the most recent of those orders, requires ISOs and RTOs to consider and evaluate interregional projects—projects embracing more than one region—and set certain parameters for allocating the costs of those

interregional projects among providers. *Id.* The Commission's aim is to induce the construction of interregional projects "if such facilities address the needs of the transmission planning regions more efficiently or cost-effectively" than regional projects. *Id.* at 111.

Order 1000's cost-allocation provisions seek to further that goal. Establishing both a mechanism and set of principles for cost allocation, Order 1000 calls for neighboring ISOs and RTOs to reach agreements on cost allocation for interregional projects that avoid free rider problems, that improve transparency with respect to the costs of interregional projects, and that otherwise align regional and interregional planning processes. The guiding principle behind Order 1000's cost-allocation provisions is that the costs of interregional projects should be "allocated in a way that is roughly commensurate with benefits." *Id.* at 178.

This court considered a petition for review raising a variety of challenges to Order 1000. *S.C. Pub. Serv. Authority v. FERC*, 762 F.3d 41 (D.C. Cir. 2014) (per curiam). The court sustained Order 1000 in all respects.

B.

MISO submitted filings to the Commission that purported to comply with Order 1000's interregional project coordination and cost-allocation provisions. The particular filing at issue in this case concerns the cost-allocation methodology MISO proposed to use with respect to one of its neighboring transmission planning regions, the Southeastern Regional Transmission Planning organization (SERTP).

MISO proposed to conduct cost allocation using a "cost-avoidance" method. Under that method, the costs allocated to MISO for a given interregional project would correspond to the costs of the regional projects MISO expects to avoid as a result of the interregional project—that is, the costs of the regional projects rendered unnecessary by the interregional project. Of central relevance here, MISO proposed to include in its cost calculation only those displaced projects that had been identified in the regional transmission plan but had yet to be approved. The costs of displaced projects already approved in the regional transmission plan would be excluded from the calculation.

The Commission accepted MISO's compliance filing in part. The Commission concluded that the cost-avoidance method largely complied with Order 1000's cost-allocation provisions calling for the costs of an interregional project to be allocated in a manner roughly commensurate with the project's benefits. As a general matter, the Commission said, the costs of regional projects that would be avoided by undertaking an interregional project should approximate the expected benefits of the interregional project.

The Commission ultimately rejected MISO's proposed cost-allocation method, however, because it excluded from its calculation the costs of any displaced projects that had already been approved in MISO's transmission plan. By excluding approved projects, the Commission determined, MISO's methodology would undervalue the benefits of an interregional project. That undervaluation, the Commission found, would result in an improper allocation of costs: relative to its neighboring region (SERTP), MISO would bear a lesser share of costs than would be warranted based on the share of an interregional project's benefits it would receive.

In addition, the Commission concluded, inclusion of approved regional projects in the cost-allocation analysis would make it more likely that MISO would pursue a beneficial interregional project—*i.e.,* one that would displace less efficient and less cost-effective regional projects. That is because, if MISO counts an approved regional project for cost-allocation purposes, it also includes that project when assessing the benefits of an interregional project for purposes of deciding whether to undertake the project. The inclusion of an approved regional project for cost-allocation purposes thus ultimately makes it more likely that an interregional project will be pursued.

MISO filed a request for clarification and, in the alternative, rehearing. MISO argued that the Commission's requirement to include approved regional projects in MISO's cost-avoidance calculation could lead to the displacement of those approved projects: if, as just explained, the inclusion of approved regional projects increases the likelihood that an interregional project will be pursued, the selection of that project could occasion the displacement of approved regional projects that are rendered unnecessary. The possibility that already-approved regional projects could be displaced, MISO contended, creates uncertainty among transmission providers and harms investors and consumers.

The Commission denied MISO's petition, reiterating its position that MISO's cost-avoidance methodology failed to account for the full range of projects displaced by interregional projects, thus undervaluing the benefits of an interregional project. The Commission also noted that MISO's cost-avoidance methodology lacked adequate transparency to comply with Order 1000 because MISO failed to explain what it meant for a project to be "identified," but not approved, in its current regional transmission plan. *Midcontinent Indep. Sys. Operator, Inc.,* 153 FERC ¶ 61,247 at P 10 (Nov. 25, 2015).

The transmission providers forming MISO filed a petition for review in this court, and MISO intervened in their support. The transmission providers making up SERTP intervened on the Commission's side. Petitioners advance two principal arguments: first, that the Commission did not adequately respond to their contention that the mandated change in cost-allocation methodology would displace approved projects, causing harm to the providers and their customers; and second, that the Commission's denial of MISO's compliance filing did not comport with the Commission's affirmative obligation under section 206 of the Federal Power Act, 16 U.S.C. § 824e, to justify its rates as just and reasonable. ***

III.

On the merits, petitioners argue that the Commission failed to give adequate consideration to their concerns about the effects of displacing approved regional projects. We disagree.

We set aside the Commission's actions if they are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A). "An agency's failure to respond meaningfully to objections raised by a party renders its decision arbitrary and capricious." *PPL Wallingford Energy LLC v. FERC*, 419 F.3d 1194, 1198 (D.C. Cir. 2005) (internal quotation marks omitted). But if "FERC `has considered the relevant factors and articulated a rational connection between the facts found and the choice made,' we will uphold its decision." *Aera Energy LLC v. FERC*, 789 F.3d 184, 190 (D.C. Cir. 2015) (quoting *Transcon. Gas Pipe Line Corp. v. FERC*, 518 F.3d 916, 919 (D.C. Cir. 2008)). That is the case here.

Petitioners contend that the Commission failed to give adequate consideration to four concerns they had raised in their request for rehearing. We conclude that the Commission adequately addressed each of petitioners' concerns.

First, petitioners argued generally that the Commission's orders could require them to replace an already-approved regional project with a new interregional project. In response, the Commission acknowledged that possibility, noting that "displacing a selected regional transmission project with a more efficient or cost-effective interregional transmission solution" would not be "inconsistent with MISO's regional transmission planning process." *Midcontinent Indep. Sys. Operator, Inc.,*153 FERC ¶ 61,247 at P 12.

Second, petitioners contended that the displacement of approved regional projects would harm certain stakeholders in various ways. For instance, developers might have already expended significant sums of money on approved projects that would be subject to displacement by a new interregional project. And on a prospective basis, developers might find it more difficult to gain access to financing for an approved project if it might be displaced. That could in turn have the effect of raising rates for consumers.

The Commission offered several responses. The Commission's central response was that failing to account for approved regional projects that would be displaced by an interregional project would undervalue the benefits of the interregional project. The cost-avoidance method could approximate the benefits of an interregional project, the Commission explained, if it captured *all* the regional benefits gained by the ISO or RTO, including the efficiency and public-policy benefits of the interregional project. But it could capture all the regional benefits only if it included all regional projects that stood to be displaced by an interregional project. Indeed, the Commission noted, approved projects tend to be the most efficient and cost-effective projects. So by excluding them from the calculation of benefits of an interregional project, MISO would disregard the most beneficial projects. The result would be a significant undervaluation of the benefits of the interregional project.

Undervaluing the benefits, the Commission explained, would violate Order 1000's core cost-allocation principle: that an interregional project's costs be allocated in a manner "roughly commensurate" with the project's benefits. *Midcontinent Indep. Sys. Operator, Inc.,* 153 FERC ¶ 61,247 at P 10. As a result, MISO would be allocated a smaller proportion of an interregional project's costs, relative to its neighbor SERTP, than would be appropriate had the benefits been properly calculated. In addition, MISO would be less likely to pursue "more efficient or cost-effective" interregional projects. *Id.* As explained, undervaluation of an interregional project's benefits for cost-allocation purposes would result in an under-appreciation of the project's benefits for purposes of deciding whether to undertake the project.

In short, the Commission, while not disputing the possibility that the harms raised by petitioners could come to pass, determined that the interest in an appropriate allocation of the costs of an interregional project (and the resulting implications for undertaking interregional projects) required MISO to account for already-approved regional projects in its cost-allocation methodology. We see no basis for setting aside that determination by the Commission.

Third, petitioners argued in their request for rehearing that, "in the interests of certainty and fairness to potential [project] bidders," there "must be some point at which

the comparisons of different regional and interregional projects concludes." J.A. 277. In petitioners' view, the logical point to make that comparison is after the identification of projects but before their approval. The Commission permissibly disagreed, concluding that petitioners could properly account for the benefits of an interregional project only if they considered the benefits of approved projects, not merely of identified ones. That might lead to the displacement of approved regional projects only when it is appropriate to do so—*i.e.,* when an interregional project is selected in a region's own transmission planning process as the more efficient or cost-effective solution to a transmission need. The Commission further noted that other regions had adopted the same approach without protest.

Fourth, petitioners contended that their existing tariff did "not contemplate removing projects from [their] bid solicitation process." J.A. 276. In response, the Commission pointed out that MISO's tariff already contained provisions allowing for the removal of bids under certain circumstances, including cost increases or changes in developer qualifications. In light of those provisions, the Commission explained, it would not be inconsistent with MISO's transmission planning process to allow the displacement of approved regional projects when those projects are rendered unnecessary by a more optimal interregional project.

In the end, we conclude that the Commission adequately responded to petitioners' concerns about the possible effects of including approved regional projects in the cost-allocation calculation. Petitioners ultimately disagree with the Commission's policy judgment about whether the importance of properly calculating an interregional project's benefits outweighs the effects of potentially displacing approved regional projects. Petitioners' disagreement with the Commission's resolution of that issue does not render the Commission's explanation any less thorough or reasoned.

* * * * *

For the foregoing reasons, we deny the petition for review.

It is so ordered.

Executive Order on Improving the Nation's Cybersecurity

May 12, 2021

By the authority vested in me as President by the Constitution and the laws of the United States of America, it is hereby ordered as follows:

Section 1. Policy. The United States faces persistent and increasingly sophisticated malicious cyber campaigns that threaten the public sector, the private sector, and ultimately the American people's security and privacy. The Federal Government must improve its efforts to identify, deter, protect against, detect, and respond to these actions and actors. The Federal Government must also carefully examine what occurred during any major cyber incident and apply lessons learned. But cybersecurity requires more than government action. Protecting our Nation from malicious cyber actors requires the Federal Government to partner with the private sector. The private sector must adapt to the continuously changing threat environment, ensure its products are built and operate securely, and partner with the Federal Government to foster a more secure cyberspace. In the end, the trust we place in our digital infrastructure should be proportional to how trustworthy and transparent that infrastructure is, and to the consequences we will incur if that trust is misplaced.

Incremental improvements will not give us the security we need; instead, the Federal Government needs to make bold changes and significant investments in order to defend the vital institutions that underpin the American way of life. The Federal Government must bring to bear the full scope of its authorities and resources to protect and secure its computer systems, whether they are cloud-based, on-premises, or hybrid. The scope of protection and security must include systems that process data (information technology (IT)) and those that run the vital machinery that ensures our safety (operational technology (OT)).

It is the policy of my Administration that the prevention, detection, assessment, and remediation of cyber incidents is a top priority and essential to national and economic security. The Federal Government must lead by example. All Federal Information Systems should meet or exceed the standards and requirements for cybersecurity set forth in and issued pursuant to this order.

Sec. 2. Removing Barriers to Sharing Threat Information.

(a) The Federal Government contracts with IT and OT service providers to conduct an array of day-to-day functions on Federal Information Systems. These service providers, including cloud service providers, have unique access to and insight into cyber threat and incident information on Federal Information Systems. At the same time, current contract terms or restrictions may limit the sharing of such threat or incident information with executive departments and agencies (agencies) that are responsible for investigating or remediating cyber incidents, such as the Cybersecurity and Infrastructure Security Agency (CISA), the Federal Bureau of Investigation (FBI), and other elements of the Intelligence Community (IC). Removing these contractual barriers and increasing the sharing of information about such threats, incidents, and risks are necessary steps to accelerating incident deterrence, prevention, and response efforts and to enabling more effective defense of agencies' systems and of information collected, processed, and maintained by or for the Federal Government.

(b) Within 60 days of the date of this order, the Director of the Office of Management and Budget (OMB), in consultation with the Secretary of Defense, the Attorney

General, the Secretary of Homeland Security, and the Director of National Intelligence, shall review the Federal Acquisition Regulation (FAR) and the Defense Federal Acquisition Regulation Supplement contract requirements and language for contracting with IT and OT service providers and recommend updates to such requirements and language to the FAR Council and other appropriate agencies. The recommendations shall include descriptions of contractors to be covered by the proposed contract language.

(c) The recommended contract language and requirements described in subsection (b) of this section shall be designed to ensure that:

(i) service providers collect and preserve data, information, and reporting relevant to cybersecurity event prevention, detection, response, and investigation on all information systems over which they have control, including systems operated on behalf of agencies, consistent with agencies' requirements;

(ii) service providers share such data, information, and reporting, as they relate to cyber incidents or potential incidents relevant to any agency with which they have contracted, directly with such agency and any other agency that the Director of OMB, in consultation with the Secretary of Defense, the Attorney General, the Secretary of Homeland Security, and the Director of National Intelligence, deems appropriate, consistent with applicable privacy laws, regulations, and policies;

(iii) service providers collaborate with Federal cybersecurity or investigative agencies in their investigations of and responses to incidents or potential incidents on Federal Information Systems, including by implementing technical capabilities, such as monitoring networks for threats in collaboration with agencies they support, as needed; and

(iv) service providers share cyber threat and incident information with agencies, doing so, where possible, in industry-recognized formats for incident response and remediation.

(d) Within 90 days of receipt of the recommendations described in subsection (b) of this section, the FAR Council shall review the proposed contract language and conditions and, as appropriate, shall publish for public comment proposed updates to the FAR.

(e) Within 120 days of the date of this order, the Secretary of Homeland Security and the Director of OMB shall take appropriate steps to ensure to the greatest extent possible that service providers share data with agencies, CISA, and the FBI as may be necessary for the Federal Government to respond to cyber threats, incidents, and risks.

(f) It is the policy of the Federal Government that:

(i) information and communications technology (ICT) service providers entering into contracts with agencies must promptly report to such agencies when they discover a cyber incident involving a software product or service provided to such agencies or involving a support system for a software product or service provided to such agencies;

(ii) ICT service providers must also directly report to CISA whenever they report under subsection (f)(i) of this section to Federal Civilian Executive Branch (FCEB) Agencies, and CISA must centrally collect and manage such information; and

(iii) reports pertaining to National Security Systems, as defined in section 10(h) of this order, must be received and managed by the appropriate agency as to be determined under subsection (g)(i)(E) of this section.

(g) To implement the policy set forth in subsection (f) of this section:

(i) Within 45 days of the date of this order, the Secretary of Homeland Security, in consultation with the Secretary of Defense acting through the Director of the National Security Agency (NSA), the Attorney General, and the Director of OMB, shall recommend to the FAR Council contract language that identifies:

(A) the nature of cyber incidents that require reporting;

(B) the types of information regarding cyber incidents that require reporting to facilitate effective cyber incident response and remediation;

(C) appropriate and effective protections for privacy and civil liberties;

(D) the time periods within which contractors must report cyber incidents based on a graduated scale of severity, with reporting on the most severe cyber incidents not to exceed 3 days after initial detection;

(E) National Security Systems reporting requirements; and

(F) the type of contractors and associated service providers to be covered by the proposed contract language.

(ii) Within 90 days of receipt of the recommendations described in subsection (g)(i) of this section, the FAR Council shall review the recommendations and publish for public comment proposed updates to the FAR.

(iii) Within 90 days of the date of this order, the Secretary of Defense acting through the Director of the NSA, the Attorney General, the Secretary of Homeland Security, and the Director of National Intelligence shall jointly develop procedures for ensuring that cyber incident reports are promptly and appropriately shared among agencies.

(h) Current cybersecurity requirements for unclassified system contracts are largely implemented through agency-specific policies and regulations, including cloud-service cybersecurity requirements. Standardizing common cybersecurity contractual requirements across agencies will streamline and improve compliance for vendors and the Federal Government.

(i) Within 60 days of the date of this order, the Secretary of Homeland Security acting through the Director of CISA, in consultation with the Secretary of Defense acting through the Director of the NSA, the Director of OMB, and the Administrator of General Services, shall review agency-specific cybersecurity requirements that currently exist as a matter of law, policy, or contract and recommend to the FAR Council standardized contract language for appropriate cybersecurity requirements. Such recommendations shall include consideration of the scope of contractors and associated service providers to be covered by the proposed contract language.

(j) Within 60 days of receiving the recommended contract language developed pursuant to subsection (i) of this section, the FAR Council shall review the recommended contract language and publish for public comment proposed updates to the FAR.

(k) Following any updates to the FAR made by the FAR Council after the public comment period described in subsection (j) of this section, agencies shall update their

agency-specific cybersecurity requirements to remove any requirements that are duplicative of such FAR updates.

(l) The Director of OMB shall incorporate into the annual budget process a cost analysis of all recommendations developed under this section.

Sec. 3. Modernizing Federal Government Cybersecurity.

(a) To keep pace with today's dynamic and increasingly sophisticated cyber threat environment, the Federal Government must take decisive steps to modernize its approach to cybersecurity, including by increasing the Federal Government's visibility into threats, while protecting privacy and civil liberties. The Federal Government must adopt security best practices; advance toward Zero Trust Architecture; accelerate movement to secure cloud services, including Software as a Service (SaaS), Infrastructure as a Service (IaaS), and Platform as a Service (PaaS); centralize and streamline access to cybersecurity data to drive analytics for identifying and managing cybersecurity risks; and invest in both technology and personnel to match these modernization goals.

(b) Within 60 days of the date of this order, the head of each agency shall:

(i) update existing agency plans to prioritize resources for the adoption and use of cloud technology as outlined in relevant OMB guidance;

(ii) develop a plan to implement Zero Trust Architecture, which shall incorporate, as appropriate, the migration steps that the National Institute of Standards and Technology (NIST) within the Department of Commerce has outlined in standards and guidance, describe any such steps that have already been completed, identify activities that will have the most immediate security impact, and include a schedule to implement them; and

(iii) provide a report to the Director of OMB and the Assistant to the President and National Security Advisor (APNSA) discussing the plans required pursuant to subsection (b)(i) and (ii) of this section.

(c) As agencies continue to use cloud technology, they shall do so in a coordinated, deliberate way that allows the Federal Government to prevent, detect, assess, and remediate cyber incidents. To facilitate this approach, the migration to cloud technology shall adopt Zero Trust Architecture, as practicable. The CISA shall modernize its current cybersecurity programs, services, and capabilities to be fully functional with cloud-computing environments with Zero Trust Architecture. The Secretary of Homeland Security acting through the Director of CISA, in consultation with the Administrator of General Services acting through the Federal Risk and Authorization Management Program (FedRAMP) within the General Services Administration, shall develop security principles governing Cloud Service Providers (CSPs) for incorporation into agency modernization efforts. To facilitate this work:

(i) Within 90 days of the date of this order, the Director of OMB, in consultation with the Secretary of Homeland Security acting through the Director of CISA, and the Administrator of General Services acting through FedRAMP, shall develop a Federal cloud-security strategy and provide guidance to agencies accordingly. Such guidance shall seek to ensure that risks to the FCEB from using cloud-based services are broadly understood and effectively addressed, and that FCEB Agencies move closer to Zero Trust Architecture.

(ii) Within 90 days of the date of this order, the Secretary of Homeland Security acting through the Director of CISA, in consultation with the Director of OMB and the Administrator of General Services acting through FedRAMP, shall develop and issue, for the FCEB, cloud-security technical reference architecture documentation that illustrates recommended approaches to cloud migration and data protection for agency data collection and reporting.

(iii) Within 60 days of the date of this order, the Secretary of Homeland Security acting through the Director of CISA shall develop and issue, for FCEB Agencies, a cloud-service governance framework. That framework shall identify a range of services and protections available to agencies based on incident severity. That framework shall also identify data and processing activities associated with those services and protections.

(iv) Within 90 days of the date of this order, the heads of FCEB Agencies, in consultation with the Secretary of Homeland Security acting through the Director of CISA, shall evaluate the types and sensitivity of their respective agency's unclassified data, and shall provide to the Secretary of Homeland Security through the Director of CISA and to the Director of OMB a report based on such evaluation. The evaluation shall prioritize identification of the unclassified data considered by the agency to be the most sensitive and under the greatest threat, and appropriate processing and storage solutions for those data.

(d) Within 180 days of the date of this order, agencies shall adopt multi-factor authentication and encryption for data at rest and in transit, to the maximum extent consistent with Federal records laws and other applicable laws. To that end:

(i) Heads of FCEB Agencies shall provide reports to the Secretary of Homeland Security through the Director of CISA, the Director of OMB, and the APNSA on their respective agency's progress in adopting multifactor authentication and encryption of data at rest and in transit. Such agencies shall provide such reports every 60 days after the date of this order until the agency has fully adopted, agency-wide, multi-factor authentication and data encryption.

(ii) Based on identified gaps in agency implementation, CISA shall take all appropriate steps to maximize adoption by FCEB Agencies of technologies and processes to implement multifactor authentication and encryption for data at rest and in transit.

(iii) Heads of FCEB Agencies that are unable to fully adopt multi-factor authentication and data encryption within 180 days of the date of this order shall, at the end of the 180-day period, provide a written rationale to the Secretary of Homeland Security through the Director of CISA, the Director of OMB, and the APNSA.

(e) Within 90 days of the date of this order, the Secretary of Homeland Security acting through the Director of CISA, in consultation with the Attorney General, the Director of the FBI, and the Administrator of General Services acting through the Director of FedRAMP, shall establish a framework to collaborate on cybersecurity and incident response activities related to FCEB cloud technology, in order to ensure effective information sharing among agencies and between agencies and CSPs.

(f) Within 60 days of the date of this order, the Administrator of General Services, in consultation with the Director of OMB and the heads of other agencies as the Administrator of General Services deems appropriate, shall begin modernizing FedRAMP by:

(i) establishing a training program to ensure agencies are effectively trained and equipped to manage FedRAMP requests, and providing access to training materials, including videos-on-demand;

(ii) improving communication with CSPs through automation and standardization of messages at each stage of authorization. These communications may include status updates, requirements to complete a vendor's current stage, next steps, and points of contact for questions;

(iii) incorporating automation throughout the lifecycle of FedRAMP, including assessment, authorization, continuous monitoring, and compliance;

(iv) digitizing and streamlining documentation that vendors are required to complete, including through online accessibility and pre-populated forms; and

(v) identifying relevant compliance frameworks, mapping those frameworks onto requirements in the FedRAMP authorization process, and allowing those frameworks to be used as a substitute for the relevant portion of the authorization process, as appropriate.

Sec. 4. Enhancing Software Supply Chain Security.

(a) The security of software used by the Federal Government is vital to the Federal Government's ability to perform its critical functions. The development of commercial software often lacks transparency, sufficient focus on the ability of the software to resist attack, and adequate controls to prevent tampering by malicious actors. There is a pressing need to implement more rigorous and predictable mechanisms for ensuring that products function securely, and as intended. The security and integrity of "critical software" — software that performs functions critical to trust (such as affording or requiring elevated system privileges or direct access to networking and computing resources) — is a particular concern. Accordingly, the Federal Government must take action to rapidly improve the security and integrity of the software supply chain, with a priority on addressing critical software.

(b) Within 30 days of the date of this order, the Secretary of Commerce acting through the Director of NIST shall solicit input from the Federal Government, private sector, academia, and other appropriate actors to identify existing or develop new standards, tools, and best practices for complying with the standards, procedures, or criteria in subsection (e) of this section. The guidelines shall include criteria that can be used to evaluate software security, include criteria to evaluate the security practices of the developers and suppliers themselves, and identify innovative tools or methods to demonstrate conformance with secure practices.

(c) Within 180 days of the date of this order, the Director of NIST shall publish preliminary guidelines, based on the consultations described in subsection (b) of this section and drawing on existing documents as practicable, for enhancing software supply chain security and meeting the requirements of this section.

(d) Within 360 days of the date of this order, the Director of NIST shall publish additional guidelines that include procedures for periodic review and updating of the guidelines described in subsection (c) of this section.

(e) Within 90 days of publication of the preliminary guidelines pursuant to subsection (c) of this section, the Secretary of Commerce acting through the Director of NIST, in consultation with the heads of such agencies as the Director of NIST deems appropriate, shall issue guidance identifying practices that enhance the security of the software supply chain. Such guidance may incorporate the guidelines published pursuant to subsections (c) and (i) of this section. Such guidance shall include standards, procedures, or criteria regarding:

(i) secure software development environments, including such actions as:

(A) using administratively separate build environments;

(B) auditing trust relationships;

(C) establishing multi-factor, risk-based authentication and conditional access across the enterprise;

(D) documenting and minimizing dependencies on enterprise products that are part of the environments used to develop, build, and edit software;

(E) employing encryption for data; and

(F) monitoring operations and alerts and responding to attempted and actual cyber incidents;

(ii) generating and, when requested by a purchaser, providing artifacts that demonstrate conformance to the processes set forth in subsection (e)(i) of this section;

(iii) employing automated tools, or comparable processes, to maintain trusted source code supply chains, thereby ensuring the integrity of the code;

(iv) employing automated tools, or comparable processes, that check for known and potential vulnerabilities and remediate them, which shall operate regularly, or at a minimum prior to product, version, or update release;

(v) providing, when requested by a purchaser, artifacts of the execution of the tools and processes described in subsection (e)(iii) and (iv) of this section, and making publicly available summary information on completion of these actions, to include a summary description of the risks assessed and mitigated;

(vi) maintaining accurate and up-to-date data, provenance (i.e., origin) of software code or components, and controls on internal and third-party software components, tools, and services present in software development processes, and performing audits and enforcement of these controls on a recurring basis;

(vii) providing a purchaser a Software Bill of Materials (SBOM) for each product directly or by publishing it on a public website;

(viii) participating in a vulnerability disclosure program that includes a reporting and disclosure process;

(ix) attesting to conformity with secure software development practices; and

(x) ensuring and attesting, to the extent practicable, to the integrity and provenance of open source software used within any portion of a product.

(f) Within 60 days of the date of this order, the Secretary of Commerce, in coordination with the Assistant Secretary for Communications and Information and the Administrator of the National Telecommunications and Information Administration, shall publish minimum elements for an SBOM.

(g) Within 45 days of the date of this order, the Secretary of Commerce, acting through the Director of NIST, in consultation with the Secretary of Defense acting

through the Director of the NSA, the Secretary of Homeland Security acting through the Director of CISA, the Director of OMB, and the Director of National Intelligence, shall publish a definition of the term "critical software" for inclusion in the guidance issued pursuant to subsection (e) of this section. That definition shall reflect the level of privilege or access required to function, integration and dependencies with other software, direct access to networking and computing resources, performance of a function critical to trust, and potential for harm if compromised.

(h) Within 30 days of the publication of the definition required by subsection (g) of this section, the Secretary of Homeland Security acting through the Director of CISA, in consultation with the Secretary of Commerce acting through the Director of NIST, shall identify and make available to agencies a list of categories of software and software products in use or in the acquisition process meeting the definition of critical software issued pursuant to subsection (g) of this section.

(i) Within 60 days of the date of this order, the Secretary of Commerce acting through the Director of NIST, in consultation with the Secretary of Homeland Security acting through the Director of CISA and with the Director of OMB, shall publish guidance outlining security measures for critical software as defined in subsection (g) of this section, including applying practices of least privilege, network segmentation, and proper configuration.

(j) Within 30 days of the issuance of the guidance described in subsection (i) of this section, the Director of OMB acting through the Administrator of the Office of Electronic Government within OMB shall take appropriate steps to require that agencies comply with such guidance.

(k) Within 30 days of issuance of the guidance described in subsection (e) of this section, the Director of OMB acting through the Administrator of the Office of Electronic Government within OMB shall take appropriate steps to require that agencies comply with such guidelines with respect to software procured after the date of this order.

(l) Agencies may request an extension for complying with any requirements issued pursuant to subsection (k) of this section. Any such request shall be considered by the Director of OMB on a case-by-case basis, and only if accompanied by a plan for meeting the underlying requirements. The Director of OMB shall on a quarterly basis provide a report to the APNSA identifying and explaining all extensions granted.

(m) Agencies may request a waiver as to any requirements issued pursuant to subsection (k) of this section. Waivers shall be considered by the Director of OMB, in consultation with the APNSA, on a case-by-case basis, and shall be granted only in exceptional circumstances and for limited duration, and only if there is an accompanying plan for mitigating any potential risks.

(n) Within 1 year of the date of this order, the Secretary of Homeland Security, in consultation with the Secretary of Defense, the Attorney General, the Director of OMB, and the Administrator of the Office of Electronic Government within OMB, shall recommend to the FAR Council contract language requiring suppliers of software available for purchase by agencies to comply with, and attest to complying with, any requirements issued pursuant to subsections (g) through (k) of this section.

(o) After receiving the recommendations described in subsection (n) of this section, the FAR Council shall review the recommendations and, as appropriate and consistent with applicable law, amend the FAR.

(p) Following the issuance of any final rule amending the FAR as described in subsection (o) of this section, agencies shall, as appropriate and consistent with applicable law, remove software products that do not meet the requirements of the amended FAR from all indefinite delivery indefinite quantity contracts; Federal Supply Schedules; Federal Government-wide Acquisition Contracts; Blanket Purchase Agreements; and Multiple Award Contracts.

(q) The Director of OMB, acting through the Administrator of the Office of Electronic Government within OMB, shall require agencies employing software developed and procured prior to the date of this order (legacy software) either to comply with any requirements issued pursuant to subsection (k) of this section or to provide a plan outlining actions to remediate or meet those requirements, and shall further require agencies seeking renewals of software contracts, including legacy software, to comply with any requirements issued pursuant to subsection (k) of this section, unless an extension or waiver is granted in accordance with subsection (l) or (m) of this section.

(r) Within 60 days of the date of this order, the Secretary of Commerce acting through the Director of NIST, in consultation with the Secretary of Defense acting through the Director of the NSA, shall publish guidelines recommending minimum standards for vendors' testing of their software source code, including identifying recommended types of manual or automated testing (such as code review tools, static and dynamic analysis, software composition tools, and penetration testing).

(s) The Secretary of Commerce acting through the Director of NIST, in coordination with representatives of other agencies as the Director of NIST deems appropriate, shall initiate pilot programs informed by existing consumer product labeling programs to educate the public on the security capabilities of Internet-of-Things (IoT) devices and software development practices, and shall consider ways to incentivize manufacturers and developers to participate in these programs.

(t) Within 270 days of the date of this order, the Secretary of Commerce acting through the Director of NIST, in coordination with the Chair of the Federal Trade Commission (FTC) and representatives of other agencies as the Director of NIST deems appropriate, shall identify IoT cybersecurity criteria for a consumer labeling program, and shall consider whether such a consumer labeling program may be operated in conjunction with or modeled after any similar existing government programs consistent with applicable law. The criteria shall reflect increasingly comprehensive levels of testing and assessment that a product may have undergone, and shall use or be compatible with existing labeling schemes that manufacturers use to inform consumers about the security of their products. The Director of NIST shall examine all relevant information, labeling, and incentive programs and employ best practices. This review shall focus on ease of use for consumers and a determination of what measures can be taken to maximize manufacturer participation.

(u) Within 270 days of the date of this order, the Secretary of Commerce acting through the Director of NIST, in coordination with the Chair of the FTC and representatives from other agencies as the Director of NIST deems appropriate, shall identify secure software development practices or criteria for a consumer software labeling program, and shall consider whether such a consumer software labeling program may

be operated in conjunction with or modeled after any similar existing government programs, consistent with applicable law. The criteria shall reflect a baseline level of secure practices, and if practicable, shall reflect increasingly comprehensive levels of testing and assessment that a product may have undergone. The Director of NIST shall examine all relevant information, labeling, and incentive programs, employ best practices, and identify, modify, or develop a recommended label or, if practicable, a tiered software security rating system. This review shall focus on ease of use for consumers and a determination of what measures can be taken to maximize participation.

(v) These pilot programs shall be conducted in a manner consistent with OMB Circular A-119 and NIST Special Publication 2000-02 (Conformity Assessment Considerations for Federal Agencies).

(w) Within 1 year of the date of this order, the Director of NIST shall conduct a review of the pilot programs, consult with the private sector and relevant agencies to assess the effectiveness of the programs, determine what improvements can be made going forward, and submit a summary report to the APNSA.

(x) Within 1 year of the date of this order, the Secretary of Commerce, in consultation with the heads of other agencies as the Secretary of Commerce deems appropriate, shall provide to the President, through the APNSA, a report that reviews the progress made under this section and outlines additional steps needed to secure the software supply chain.

Sec. 5. Establishing a Cyber Safety Review Board.

(a) The Secretary of Homeland Security, in consultation with the Attorney General, shall establish the Cyber Safety Review Board (Board), pursuant to section 871 of the Homeland Security Act of 2002 (6 U.S.C. 451).

(b) The Board shall review and assess, with respect to significant cyber incidents (as defined under Presidential Policy Directive 41 of July 26, 2016 (United States Cyber Incident Coordination) (PPD 41)) affecting FCEB Information Systems or non-Federal systems, threat activity, vulnerabilities, mitigation activities, and agency responses.

(c) The Secretary of Homeland Security shall convene the Board following a significant cyber incident triggering the establishment of a Cyber Unified Coordination Group (UCG) as provided by section V(B)(2) of PPD-41; at any time as directed by the President acting through the APNSA; or at any time the Secretary of Homeland Security deems necessary.

(d) The Board's initial review shall relate to the cyber activities that prompted the establishment of a UCG in December 2020, and the Board shall, within 90 days of the Board's establishment, provide recommendations to the Secretary of Homeland Security for improving cybersecurity and incident response practices, as outlined in subsection (i) of this section.

(e) The Board's membership shall include Federal officials and representatives from private-sector entities. The Board shall comprise representatives of the Department of Defense, the Department of Justice, CISA, the NSA, and the FBI, as well as representatives from appropriate private-sector cybersecurity or software suppliers as determined by the Secretary of Homeland Security. A representative from OMB shall participate in Board activities when an incident under review involves FCEB Information Systems, as determined by the Secretary of Homeland Security. The Secretary

of Homeland Security may invite the participation of others on a case-by-case basis depending on the nature of the incident under review.

(f) The Secretary of Homeland Security shall biennially designate a Chair and Deputy Chair of the Board from among the members of the Board, to include one Federal and one private-sector member.

(g) The Board shall protect sensitive law enforcement, operational, business, and other confidential information that has been shared with it, consistent with applicable law.

(h) The Secretary of Homeland Security shall provide to the President through the APNSA any advice, information, or recommendations of the Board for improving cybersecurity and incident response practices and policy upon completion of its review of an applicable incident.

(i) Within 30 days of completion of the initial review described in subsection (d) of this section, the Secretary of Homeland Security shall provide to the President through the APNSA the recommendations of the Board based on the initial review. These recommendations shall describe:

(i) identified gaps in, and options for, the Board's composition or authorities;

(ii) the Board's proposed mission, scope, and responsibilities;

(iii) membership eligibility criteria for private sector representatives;

(iv) Board governance structure including interaction with the executive branch and the Executive Office of the President;

(v) thresholds and criteria for the types of cyber incidents to be evaluated;

(vi) sources of information that should be made available to the Board, consistent with applicable law and policy;

(vii) an approach for protecting the information provided to the Board and securing the cooperation of affected United States individuals and entities for the purpose of the Board's review of incidents; and

(viii) administrative and budgetary considerations required for operation of the Board.

(j) The Secretary of Homeland Security, in consultation with the Attorney General and the APNSA, shall review the recommendations provided to the President through the APNSA pursuant to subsection (i) of this section and take steps to implement them as appropriate.

(k) Unless otherwise directed by the President, the Secretary of Homeland Security shall extend the life of the Board every 2 years as the Secretary of Homeland Security deems appropriate, pursuant to section 871 of the Homeland Security Act of 2002.

Sec. 6. Standardizing the Federal Government's Playbook for Responding to Cybersecurity Vulnerabilities and Incidents.

(a) The cybersecurity vulnerability and incident response procedures currently used to identify, remediate, and recover from vulnerabilities and incidents affecting their systems vary across agencies, hindering the ability of lead agencies to analyze vulnerabilities and incidents more comprehensively across agencies. Standardized response processes ensure a more coordinated and centralized cataloging of incidents and tracking of agencies' progress toward successful responses.

(b) Within 120 days of the date of this order, the Secretary of Homeland Security acting through the Director of CISA, in consultation with the Director of OMB, the Federal Chief Information Officers Council, and the Federal Chief Information Security Council, and in coordination with the Secretary of Defense acting through the Director of the NSA, the Attorney General, and the Director of National Intelligence, shall develop a standard set of operational procedures (playbook) to be used in planning and conducting a cybersecurity vulnerability and incident response activity respecting FCEB Information Systems. The playbook shall:

(i) incorporate all appropriate NIST standards;

(ii) be used by FCEB Agencies; and

(iii) articulate progress and completion through all phases of an incident response, while allowing flexibility so it may be used in support of various response activities.

(c) The Director of OMB shall issue guidance on agency use of the playbook.

(d) Agencies with cybersecurity vulnerability or incident response procedures that deviate from the playbook may use such procedures only after consulting with the Director of OMB and the APNSA and demonstrating that these procedures meet or exceed the standards proposed in the playbook.

(e) The Director of CISA, in consultation with the Director of the NSA, shall review and update the playbook annually, and provide information to the Director of OMB for incorporation in guidance updates.

(f) To ensure comprehensiveness of incident response activities and build confidence that unauthorized cyber actors no longer have access to FCEB Information Systems, the playbook shall establish, consistent with applicable law, a requirement that the Director of CISA review and validate FCEB Agencies' incident response and remediation results upon an agency's completion of its incident response. The Director of CISA may recommend use of another agency or a third-party incident response team as appropriate.

(g) To ensure a common understanding of cyber incidents and the cybersecurity status of an agency, the playbook shall define key terms and use such terms consistently with any statutory definitions of those terms, to the extent practicable, thereby providing a shared lexicon among agencies using the playbook.

Sec. 7. Improving Detection of Cybersecurity Vulnerabilities and Incidents on Federal Government Networks.

(a) The Federal Government shall employ all appropriate resources and authorities to maximize the early detection of cybersecurity vulnerabilities and incidents on its networks. This approach shall include increasing the Federal Government's visibility into and detection of cybersecurity vulnerabilities and threats to agency networks in order to bolster the Federal Government's cybersecurity efforts.

(b) FCEB Agencies shall deploy an Endpoint Detection and Response (EDR) initiative to support proactive detection of cybersecurity incidents within Federal Government infrastructure, active cyber hunting, containment and remediation, and incident response.

(c) Within 30 days of the date of this order, the Secretary of Homeland Security acting through the Director of CISA shall provide to the Director of OMB recom-

mendations on options for implementing an EDR initiative, centrally located to support host-level visibility, attribution, and response regarding FCEB Information Systems.

(d) Within 90 days of receiving the recommendations described in subsection (c) of this section, the Director of OMB, in consultation with Secretary of Homeland Security, shall issue requirements for FCEB Agencies to adopt Federal Government-wide EDR approaches. Those requirements shall support a capability of the Secretary of Homeland Secretary, acting through the Director of CISA, to engage in cyber hunt, detection, and response activities.

(e) The Director of OMB shall work with the Secretary of Homeland Security and agency heads to ensure that agencies have adequate resources to comply with the requirements issued pursuant to subsection (d) of this section.

(f) Defending FCEB Information Systems requires that the Secretary of Homeland Security acting through the Director of CISA have access to agency data that are relevant to a threat and vulnerability analysis, as well as for assessment and threat-hunting purposes. Within 75 days of the date of this order, agencies shall establish or update Memoranda of Agreement (MOA) with CISA for the Continuous Diagnostics and Mitigation Program to ensure object level data, as defined in the MOA, are available and accessible to CISA, consistent with applicable law.

(g) Within 45 days of the date of this order, the Director of the NSA as the National Manager for National Security Systems (National Manager) shall recommend to the Secretary of Defense, the Director of National Intelligence, and the Committee on National Security Systems (CNSS) appropriate actions for improving detection of cyber incidents affecting National Security Systems, to the extent permitted by applicable law, including recommendations concerning EDR approaches and whether such measures should be operated by agencies or through a centralized service of common concern provided by the National Manager.

(h) Within 90 days of the date of this order, the Secretary of Defense, the Director of National Intelligence, and the CNSS shall review the recommendations submitted under subsection (g) of this section and, as appropriate, establish policies that effectuate those recommendations, consistent with applicable law.

(i) Within 90 days of the date of this order, the Director of CISA shall provide to the Director of OMB and the APNSA a report describing how authorities granted under section 1705 of Public Law 116-283, to conduct threat-hunting activities on FCEB networks without prior authorization from agencies, are being implemented. This report shall also recommend procedures to ensure that mission-critical systems are not disrupted, procedures for notifying system owners of vulnerable government systems, and the range of techniques that can be used during testing of FCEB Information Systems. The Director of CISA shall provide quarterly reports to the APNSA and the Director of OMB regarding actions taken under section 1705 of Public Law 116-283.

(j) To ensure alignment between Department of Defense Information Network (DODIN) directives and FCEB Information Systems directives, the Secretary of Defense and the Secretary of Homeland Security, in consultation with the Director of OMB, shall:

(i) within 60 days of the date of this order, establish procedures for the Department of Defense and the Department of Homeland Security to immediately share with each other Department of Defense Incident Response Orders or Department of Homeland Security Emergency Directives and Binding Operational Directives applying to their respective information networks;

(ii) evaluate whether to adopt any guidance contained in an Order or Directive issued by the other Department, consistent with regulations concerning sharing of classified information; and

(iii) within 7 days of receiving notice of an Order or Directive issued pursuant to the procedures established under subsection (j)(i) of this section, notify the APNSA and Administrator of the Office of Electronic Government within OMB of the evaluation described in subsection (j)(ii) of this section, including a determination whether to adopt guidance issued by the other Department, the rationale for that determination, and a timeline for application of the directive, if applicable.

Sec. 8. Improving the Federal Government's Investigative and Remediation Capabilities.

(a) Information from network and system logs on Federal Information Systems (for both on-premises systems and connections hosted by third parties, such as CSPs) is invaluable for both investigation and remediation purposes. It is essential that agencies and their IT service providers collect and maintain such data and, when necessary to address a cyber incident on FCEB Information Systems, provide them upon request to the Secretary of Homeland Security through the Director of CISA and to the FBI, consistent with applicable law.

(b) Within 14 days of the date of this order, the Secretary of Homeland Security, in consultation with the Attorney General and the Administrator of the Office of Electronic Government within OMB, shall provide to the Director of OMB recommendations on requirements for logging events and retaining other relevant data within an agency's systems and networks. Such recommendations shall include the types of logs to be maintained, the time periods to retain the logs and other relevant data, the time periods for agencies to enable recommended logging and security requirements, and how to protect logs. Logs shall be protected by cryptographic methods to ensure integrity once collected and periodically verified against the hashes throughout their retention. Data shall be retained in a manner consistent with all applicable privacy laws and regulations. Such recommendations shall also be considered by the FAR Council when promulgating rules pursuant to section 2 of this order.

(c) Within 90 days of receiving the recommendations described in subsection (b) of this section, the Director of OMB, in consultation with the Secretary of Commerce and the Secretary of Homeland Security, shall formulate policies for agencies to establish requirements for logging, log retention, and log management, which shall ensure centralized access and visibility for the highest level security operations center of each agency.

(d) The Director of OMB shall work with agency heads to ensure that agencies have adequate resources to comply with the requirements identified in subsection (c) of this section.

(e) To address cyber risks or incidents, including potential cyber risks or incidents, the proposed recommendations issued pursuant to subsection (b) of this section shall

include requirements to ensure that, upon request, agencies provide logs to the Secretary of Homeland Security through the Director of CISA and to the FBI, consistent with applicable law. These requirements should be designed to permit agencies to share log information, as needed and appropriate, with other Federal agencies for cyber risks or incidents.

Sec. 9. National Security Systems.

(a) Within 60 days of the date of this order, the Secretary of Defense acting through the National Manager, in coordination with the Director of National Intelligence and the CNSS, and in consultation with the APNSA, shall adopt National Security Systems requirements that are equivalent to or exceed the cybersecurity requirements set forth in this order that are otherwise not applicable to National Security Systems. Such requirements may provide for exceptions in circumstances necessitated by unique mission needs. Such requirements shall be codified in a National Security Memorandum (NSM). Until such time as that NSM is issued, programs, standards, or requirements established pursuant to this order shall not apply with respect to National Security Systems.

(b) Nothing in this order shall alter the authority of the National Manager with respect to National Security Systems as defined in National Security Directive 42 of July 5, 1990 (National Policy for the Security of National Security Telecommunications and Information Systems) (NSD-42). The FCEB network shall continue to be within the authority of the Secretary of Homeland Security acting through the Director of CISA.

Sec. 10. Definitions. For purposes of this order:

(a) the term "agency" has the meaning ascribed to it under 44 U.S.C. 3502.

(b) the term "auditing trust relationship" means an agreed-upon relationship between two or more system elements that is governed by criteria for secure interaction, behavior, and outcomes relative to the protection of assets.

(c) the term "cyber incident" has the meaning ascribed to an "incident" under 44 U.S.C. 3552(b)(2).

(d) the term "Federal Civilian Executive Branch Agencies" or "FCEB Agencies" includes all agencies except for the Department of Defense and agencies in the Intelligence Community.

(e) the term "Federal Civilian Executive Branch Information Systems" or "FCEB Information Systems" means those information systems operated by Federal Civilian Executive Branch Agencies, but excludes National Security Systems.

(f) the term "Federal Information Systems" means an information system used or operated by an agency or by a contractor of an agency or by another organization on behalf of an agency, including FCEB Information Systems and National Security Systems.

(g) the term "Intelligence Community" or "IC" has the meaning ascribed to it under 50 U.S.C. 3003(4).

(h) the term "National Security Systems" means information systems as defined in 44 U.S.C. 3552(b)(6), 3553(e)(2), and 3553(e)(3).

(i) the term "logs" means records of the events occurring within an organization's systems and networks. Logs are composed of log entries, and each entry contains information related to a specific event that has occurred within a system or network.

(j) the term "Software Bill of Materials" or "SBOM" means a formal record containing the details and supply chain relationships of various components used in building software. Software developers and vendors often create products by assembling existing open source and commercial software components. The SBOM enumerates these components in a product. It is analogous to a list of ingredients on food packaging. An SBOM is useful to those who develop or manufacture software, those who select or purchase software, and those who operate software. Developers often use available open source and third-party software components to create a product; an SBOM allows the builder to make sure those components are up to date and to respond quickly to new vulnerabilities. Buyers can use an SBOM to perform vulnerability or license analysis, both of which can be used to evaluate risk in a product. Those who operate software can use SBOMs to quickly and easily determine whether they are at potential risk of a newly discovered vulnerability. A widely used, machine-readable SBOM format allows for greater benefits through automation and tool integration. The SBOMs gain greater value when collectively stored in a repository that can be easily queried by other applications and systems. Understanding the supply chain of software, obtaining an SBOM, and using it to analyze known vulnerabilities are crucial in managing risk.

(k) the term "Zero Trust Architecture" means a security model, a set of system design principles, and a coordinated cybersecurity and system management strategy based on an acknowledgement that threats exist both inside and outside traditional network boundaries. The Zero Trust security model eliminates implicit trust in any one element, node, or service and instead requires continuous verification of the operational picture via real-time information from multiple sources to determine access and other system responses. In essence, a Zero Trust Architecture allows users full access but only to the bare minimum they need to perform their jobs. If a device is compromised, zero trust can ensure that the damage is contained. The Zero Trust Architecture security model assumes that a breach is inevitable or has likely already occurred, so it constantly limits access to only what is needed and looks for anomalous or malicious activity. Zero Trust Architecture embeds comprehensive security monitoring; granular risk-based access controls; and system security automation in a coordinated manner throughout all aspects of the infrastructure in order to focus on protecting data in real-time within a dynamic threat environment. This data-centric security model allows the concept of least-privileged access to be applied for every access decision, where the answers to the questions of who, what, when, where, and how are critical for appropriately allowing or denying access to resources based on the combination of sever.

Sec. 11. General Provisions.

(a) Upon the appointment of the National Cyber Director (NCD) and the establishment of the related Office within the Executive Office of the President, pursuant to section 1752 of Public Law 116-283, portions of this order may be modified to enable the NCD to fully execute its duties and responsibilities.

(b) Nothing in this order shall be construed to impair or otherwise affect:

(i) the authority granted by law to an executive department or agency, or the head thereof; or

(ii) the functions of the Director of the Office of Management and Budget relating to budgetary, administrative, or legislative proposals.

(c) This order shall be implemented in a manner consistent with applicable law and subject to the availability of appropriations.

(d) This order is not intended to, and does not, create any right or benefit, substantive or procedural, enforceable at law or in equity by any party against the United States, its departments, agencies, or entities, its officers, employees, or agents, or any other person.

(e) Nothing in this order confers authority to interfere with or to direct a criminal or national security investigation, arrest, search, seizure, or disruption operation or to alter a legal restriction that requires an agency to protect information learned in the course of a criminal or national security investigation.

JOSEPH R. BIDEN JR.

THE WHITE HOUSE,
May 12, 2021.

Biden Administration Announces Further Actions to Protect U.S. Critical Infrastructure

July 28, 2021

The Biden Administration continues to take steps to safeguard U.S. critical infrastructure from growing, persistent, and sophisticated cyber threats. Recent high-profile attacks on critical infrastructure around the world, including the ransomware attacks on the Colonial Pipeline and JBS Foods in the United States, demonstrate that significant cyber vulnerabilities exist across U.S. critical infrastructure, which is largely owned and operated by the private sector. As we have seen, the degradation, destruction, or malfunction of systems that control this infrastructure can have cascading physical consequences that could have a debilitating effect on national security, economic security, and the public health and safety of the American people.

Currently, federal cybersecurity regulation in the United States is sectoral. We have a patchwork of sector-specific statutes that have been adopted piecemeal, as data security threats in particular sectors have gained public attention. Given the evolving threat we face today, we must consider new approaches, both voluntary and mandatory. We look to responsible critical infrastructure owners and operators to follow voluntary guidance as well as mandatory requirements in order to ensure that the critical services the American people rely on are protected from cyber threats.

Today, President Biden is signing a National Security Memorandum (NSM) on "Improving Cybersecurity for Critical Infrastructure Control Systems," which addresses cybersecurity for critical infrastructure and implements long overdue efforts to meet the threats we face. The NSM:

Directs the Department of Homeland Security's Cybersecurity & Infrastructure Security Agency (CISA) and the Department of Commerce's National Institute of Standards and Technology (NIST), in collaboration with other agencies, to develop cybersecurity performance goals for critical infrastructure. We expect those standards will assist companies responsible for providing essential services like power, water, and transportation to strengthen their cybersecurity.

Formally establishes the President's Industrial Control System Cybersecurity (ICS) Initiative. The ICS initiative is a voluntary, collaborative effort between the federal government and the critical infrastructure community to facilitate the deployment of technology and systems that provide threat visibility, indicators, detections, and warnings. The Initiative began in mid-April with an Electricity Subsector pilot, and already over 150 electricity utilities representing almost 90 million residential customers are either deploying or have agreed to deploy control system cybersecurity technologies. The action plan for natural gas pipelines is underway, and additional initiatives for other sectors will follow later this year.

Last week, the Department of Homeland Security's Transportation Security Administration (TSA) announced a second Security Directive for critical pipeline owners and operators. Following the ransomware attack on a major petroleum pipeline in May 2021, TSA issued an initial Security Directive requiring critical pipeline owners and operators to report cybersecurity incidents, designate a Cybersecurity Coordinator, and conduct a review of their current cybersecurity practices. This second Security Directive will require owners and operators of pipelines that transport hazardous liquids and natural gas to implement a number of urgently needed protections, including:

- Implementing specific mitigation measures to protect against ransomware attacks and other known threats to information technology and operational technology systems within prescribed timeframes.
- Developing and implementing a cybersecurity contingency and recovery plan.
- Conducting an annual cybersecurity architecture design review.

The Federal Government cannot do this alone and securing our critical infrastructure requires a whole-of-nation effort. This NSM, the ICS Cybersecurity Initiative, TSA's Security Directives and the President's Executive Order on Improving the Nation's Cybersecurity are parts of a focused and aggressive continuing effort to address these significant threats to our nation.

Statement by President Biden on our Nation's Cybersecurity

March 21, 2022

This is a critical moment to accelerate our work to improve domestic cybersecurity and bolster our national resilience. I have previously warned about the potential that Russia could conduct malicious cyber activity against the United States, including as a response to the unprecedented economic costs we've imposed on Russia alongside our allies and partners. It's part of Russia's playbook. Today, my Administration is reiterating those warnings based on evolving intelligence that the Russian Government is exploring options for potential cyberattacks.

From day one, my Administration has worked to strengthen our national cyber defenses, mandating extensive cybersecurity measures for the Federal Government and those critical infrastructure sectors where we have authority to do so, and creating innovative public-private partnerships and initiatives to enhance cybersecurity across all our critical infrastructure. Congress has partnered with us on these efforts — we appreciate that Members of Congress worked across the aisle to require companies to report cyber incidents to the United States Government.

My Administration will continue to use every tool to deter, disrupt, and if necessary, respond to cyberattacks against critical infrastructure. But the Federal Government can't defend against this threat alone. Most of America's critical infrastructure is owned and operated by the private sector and critical infrastructure owners and operators must accelerate efforts to lock their digital doors. The Department of Homeland Security's Cybersecurity and Infrastructure Security Agency (CISA) has been actively working with organizations across critical infrastructure to rapidly share information and mitigation guidance to help protect their systems and networks

If you have not already done so, I urge our private sector partners to harden your cyber defenses immediately by implementing the best practices we have developed together over the last year. You have the power, the capacity, and the responsibility to strengthen the cybersecurity and resilience of the critical services and technologies on which Americans rely. We need everyone to do their part to meet one of the defining threats of our time — your vigilance and urgency today can prevent or mitigate attacks tomorrow.

United States v. American Telephone and Telegraph Co.

552 F.Supp. 131 (D.C.D.C. 1982), aff'd, 460 U.S. 1001 (1983)

HAROLD H. GREENE, District Judge.: These actions are before the Court for a determination whether a consent decree proposed by the parties is in the "public interest" and should therefore be entered as the Court's judgment. ***

I

Preliminary Considerations

A. *History of the Litigation*

On January 14, 1949, the government filed an action in the District Court for the District of New Jersey against the Western Electric Company, Inc.[3] and the American Telephone and Telegraph Company, Inc. (Civil Action No. 17-49). The complaint alleged that the defendants had monopolized and conspired to restrain trade in the manufacture, distribution, sale, and installation of telephones, telephone apparatus, equipment, materials, and supplies, in violation of sections 1, 2, and 3 of the Sherman Act, 15 U.S.C. §§ 1, 2, and 3. The relief sought included the divestiture by AT&T of its stock ownership in Western Electric; termination of exclusive relationships between AT&T and Western Electric; divestiture by Western Electric of its fifty percent interest in Bell Telephone Laboratories;[6] separation of telephone manufacturing from the provision of telephone service; and the compulsory licensing of patents owned by AT&T on a non-discriminatory basis.

The court record reveals little activity in the case between the date of the filing of the complaint in 1949 and the entry of a consent decree in 1956. Except for the notation that an answer was filed in April, 1949, there are no record entries until the Fall of 1951 when the government filed and the court ordered compliance with several discovery requests. Following the discovery order, there is another two-year gap, and it is not until April 27, 1953, that another record entry is found. This entry indicates that defendants were given two additional months to complete their compliance with the government's 1951 discovery requests. The next reference is to the transcript of a hearing held on January 24, 1956, during which the consent decree was approved as being in the public interest.

The gaps in the court record are partly filled by a report of a committee of the United States House of Representatives which conducted an intensive investigation of the circumstances surrounding the entry of the consent decree. Report of the Antitrust Subcommittee of the House Committee on the Judiciary on the Consent Decree Program of the Department of Justice, 86th Cong., 1st Sess., January 30, 1959 (Committee Print) [hereinafter Subcommittee Report]. That report reveals that the parties were quite active between the time of the filing of the government's discovery requests in 1951 and the signing of the consent decree in 1956.

As early as February 28, 1952, the president of Bell Laboratories, Dr. M.J. Kelly, met with Secretary of Defense Robert A. Lovett and other members of the Department of

---

[3] Western Electric is the wholly owned subsidiary of AT&T that manufactures telecommunications equipment for AT&T's Long Lines Department and the Operating Companies. In addition, Western Electric provides telecommunications equipment and services to government agencies and, to a limited extent, the independent telephone companies.

[6] Bell Telephone Laboratories, AT&T's telecommunications research and development facility, is a jointly owned subsidiary in which AT&T and Western Electric each owns 50 percent of the stock.

Defense to enlist their help in persuading the Justice Department to suspend prosecution of the action until the end of the Korean War, a suspension the Attorney General refused to grant.

AT&T continued its attempts to end the litigation as soon as the Eisenhower Administration took office. Its executives and lawyers met with officials of the Departments of Defense and Justice throughout the first six months of 1953. These efforts culminated in a meeting on June 27, 1953, during a judicial conference held at White Sulphur Springs, West Virginia, between T.B. Price, AT&T's general counsel, and Attorney General Herbert Brownell. According to a memorandum prepared by Price following this meeting, Attorney General Brownell said that he believed that "a way ought to be found to get rid of the case," and that AT&T "could readily find practices that [they] might agree to have enjoined with no real injury to [their] business." Memorandum of T.B. Price (March 3, 1954) *reprinted in* Subcommittee Report at 53-54.

Shortly after this meeting, AT&T again urged the Defense Department "to intercede with the Justice Department to have the case settled on a basis that would not require divorcement of Western." Subcommittee Report at 55. To that end, Secretary of Defense Charles E. Wilson had a letter hand-carried to Attorney General Brownell urging him to end the litigation without divesting Western Electric. The rationale stated for this position was that the severance of Western Electric would "effectively disintegrate the coordinated organization which is fundamental to the successful carrying forward of these critical defense projects," and would "be contrary to the vital interests of the Nation." Subcommittee Report at 56. The Wilson letter was actually prepared by AT&T.

Periodic negotiations between AT&T and the government continued through 1954 and 1955, and by early December, 1955, the government and AT&T had reached an agreement.

The consent decree which was the product of this process included neither the divestiture of Western Electric nor any of the other structural relief originally requested by the government. Instead, an injunction was issued which precluded AT&T from engaging in any business other than the provision of common carrier communications services; precluded Western Electric from manufacturing equipment other than that used by the Bell System; and required the defendants to license their patents to all applicants upon the payment of appropriate royalties.

Despite the substantial differences between the structural relief requested in the government's 1949 complaint and the relief actually provided by the proposed decree, the District Court for the District of New Jersey accepted the proposal on January 24, 1956, after a brief hearing, stating:

> I feel that I can unhesitatingly accept the recommendation of the Attorney General, that this judgment is in the public interest, and that it is a satisfactory adjustment of this very, very vexatious problem; and I am therefore happy to go along with the recommendation made by the Attorney General and shall forthwith sign this judgment.

After the decree was approved, no major developments occurred in the case for the next several years. Until 1981, the entries in the court record concern primarily the patent licensing provisions.

This was the status of the *Western Electric* suit when the government filed a separate antitrust action on November 20, 1974, in this Court against AT&T, Western Electric, and Bell Telephone Laboratories, Inc. (Civil Action No. 74-1698). The complaint in the new action alleged monopolization by the defendants with respect to a broad variety of telecommunications services and equipment in violation of section 2 of the Sherman Act. In this lawsuit, the government initially sought the divestiture from AT&T of the Bell Operating Companies (hereinafter generally referred to as Operating Companies or BOCs) as well as the divestiture and dissolution of Western Electric. While the action was pending, the government changed its relief requests several times asking, at various times or in various alternatives, for the divestiture from AT&T of Western Electric and portions of the Bell Laboratories.

Pretrial discovery began shortly after the defendants filed their answer in February 1975 *** . The trial itself began on January 15, 1981. At the request of the parties, the trial was recessed immediately after the opening statements for a period of six weeks in order to afford an opportunity for a negotiated settlement. When the settlement discussions proved fruitless, the trial resumed on March 4, 1981. The government presented close to one hundred witnesses, many thousands of documents, and additional thousands of stipulations. After the conclusion of the government's case, defendants moved to dismiss the action on a variety of grounds. That motion was denied on September 11, 1981. *United States v. AT&T*, supra, 524 F.Supp. 1336. Defendants commenced their case-in-chief on August 3, 1981, and during the next five months they presented approximately 250 witnesses and tens of thousands of pages of documents.

Defendants were scheduled to complete the presentation of their evidence on about January 20, 1982, and it was expected that the government's rebuttal evidence would be presented between that date and February 10, 1982, when the trial would have ended. However, early in January, 1982, the Court was advised of the proposed decree described below.

B. The Proposed Decree

On January 8, 1982, the parties to these two actions filed with the District Court for the District of New Jersey a stipulation consenting to the entry by the Court of the "Modification of Final Judgment" filed therewith. On the same day, they attempted to file in this Court a dismissal of the *AT&T* action pursuant to Rule 41(a)(1)(ii), Federal Rules of Civil Procedure. This Court ordered that the dismissal be lodged, not filed, and, in accordance with that order and the provisions of the Tunney Act, the dismissal has not yet been effected.

In their settlement proposal, the parties proposed that the Court enter the following judgment with respect to both lawsuits.

Section I of the proposed decree would provide for significant structural changes in AT&T. In essence, it would remove from the Bell System the function of supplying local telephone service by requiring AT&T to divest itself of the portions of its twenty-two Operating Companies which perform that function.

The geographic area for which these Operating Companies would provide local telephone service is defined in the proposed decree by a new unit, the "exchange area." According to the Justice Department, an exchange area "will be large enough to comprehend contiguous areas having common social and economic characteristics but not so large as to defeat the intent of the decree to separate the provision of intercity

services from the provision of local exchange service." Court approval would be required for the inclusion in an exchange area of more than one standard metropolitan area or the territory of more than one State.

The Operating Companies would provide telephone service from one point in an exchange area to other points in the same exchange area—"exchange telecommunications"—and they would originate and terminate calls from one exchange area to another exchange area—"exchange access." The interexchange portion of calls from one exchange area to another exchange area would, however, be carried by AT&T and the other interexchange carriers, such as MCI and Southern Pacific Co.

The proposed decree sets forth general principles governing the configuration of the Operating Companies which AT&T would be required to divest. Under the proposal, AT&T would be required to endow the companies with sufficient personnel, facilities, systems, and rights to technical information to enable them to provide exchange telecommunications and exchange access services. These personnel, systems, facilities, and rights would be drawn from the Operating Companies and from AT&T and its other affiliates. AT&T would be permitted to choose to transfer some of these elements directly to the new Operating Companies and to place others in a central entity jointly owned by them.

AT&T would be required by the proposed decree to formulate a plan of reorganization which complied with these principles, and to submit the plan to the Department of Justice within six months after the Court approved the decree. The plan would not be effective without the Department's approval.

After divestiture, the new Operating Companies would be required to provide, through a centralized body, a single point of contact for national security and emergency preparedness. They would be permitted to use this or a similar central body to provide those services, such as administration and engineering, which "can most efficiently be provided on a centralized basis." In addition, until September 1987, AT&T, Western Electric, and Bell Laboratories would have to provide on a priority basis, all research, development, manufacturing, and other support services necessary to enable the Operating Companies to fulfill the requirements of the proposed decree.

Section II of the proposed decree would complement these structural changes by various restrictions which are said to be designed (1) to prevent the divested Operating Companies from discriminating against AT&T's competitors, and (2) to avoid a recurrence of the type of discrimination and cross-subsidization that were the basis of the *AT&T* lawsuit.

The first group of these provisions would require the divested Operating Companies to provide services to interexchange carriers equal in type, quality, and price to the services provided to AT&T and its affiliates In addition, they would be prohibited from discriminating between AT&T and other companies in their procurement activities, the establishment of technical standards, the dissemination of technical information, their use of Operating Company facilities and charges for such use, and their network planning. The Justice Department has indicated that it intends these provisions to be "construed broadly to encompass all potential areas of favoritism, subtle as well as overt, that may arise in relationship between the divested BOCs and AT&T and its competitors." Competitive Impact Statement at 26-27.

The second type of restriction imposed upon the Operating Companies is said to be intended to prevent them from engaging in any non-monopoly business so as to eliminate the possibility that they might use their control over exchange services to gain an improper advantage over competitors in such businesses. Thus, the Operating Companies would not be permitted (1) to manufacture or market telecommunications products and customer premises equipment; (2) to provide interexchange services, (3) to provide directory advertising such as the Yellow Pages; (4) to provide information services; and (5) to provide any other product or service is not a "natural monopoly service actually regulated by tariff." The Operating Companies would have the authority, however, to engage in what are called the "inherent" functions of procurement, engineering, marketing, and management. ***

Finally, the proposed decree would vacate the final judgment entered on January 24, 1956 in the *Western Electric* case, eliminating the restrictions imposed upon AT&T by that decree.

On January 11, 1982, Judge Vincent Biunno of the District Court for the District of New Jersey, following a brief hearing, approved the proposed decree, interpreting it solely as a modification of the 1956 consent judgment, but he did not, initially, agree to the parties' request for a transfer of the *Western Electric* action to this Court.

The following day, this Court held a hearing and continued in effect its order that the stipulation of dismissal which the parties had attempted to file in the *AT&T* action here be simply lodged pending completion of the appropriate public interest proceedings. Judge Biunno thereafter granted the parties' motion for a transfer of the *Western Electric* action, that action was docketed here under Civil Action No. 82-0192 and, by order of this Court, it was consolidated with the *AT&T* action. At the same time, this Court vacated the order of January 11, 1982, which had approved the proposed decree, and it ordered that procedures equivalent to those required by the Tunney Act be applied to the consolidated actions. ***

IV

The Divestiture

A key feature of the proposed decree is the divestiture of the Operating Companies from the remainder of AT&T. ***

A. Conditions Necessitating Antitrust Relief

1. Evidence of Anticompetitive Actions by AT&T

In its complaint and in documents filed thereafter (*i.e.,* the several Statements of Contentions and Proof), the government asserted that AT&T monopolized the intercity telecommunications market and the telecommunications product market in a variety of ways in violation of the Sherman Act.

The evidence that was produced during the *AT&T* trial indicates that, at least with respect to several of the government's claims, this charge may be well taken. It would be inappropriate for the Court at this juncture to draw definitive conclusions with regard either to the sufficiency of the evidence to sustain a finding of liability or to the validity of AT&T's various legal and factual defenses. ***

In its intercity case, the government alleged that AT&T used its control over its local monopoly to preclude competition in the intercity market. The government proved *inter alia* that after 1968 AT&T included a "customer premises" provision in its interconnection tariff which deterred potential competitors from entering that market ***

and that it attempted to prevent competitors from offering metered long distance service that would compete with AT&T's own regular long distance service.

AT&T's basic rationale for these policies was that it was attempting to prevent competitors from "creamskimming." As viewed by AT&T, it would have been able successfully to combat creamskimming if it had priced each of its routes on the basis of the costs for operating that route. However, it concluded that the FCC had rejected this approach when it endorsed national rate averaging in the interest of promoting the goal of universal service. Accordingly, AT&T argued that, since rate averaging is inconsistent with competition, and since the basic rate averaging policy had been required by the FCC as being in the public interest, it was acting reasonably under the Communications Act in preventing competition as best and as long as it could.

What this line of reasoning fails to consider is that, at least by the mid-1970s, the FCC had clearly begun to promote competition in telecommunications. The government contended during the trial—correctly, in the Court's view—that AT&T had an obligation to follow the more recent FCC policy rather than the Commission's previous policies which may have suited it better, particularly since there was never a direct FCC rule against de-averaging. Moreover, even if, because of the lack of definite guidance from the FCC, AT&T's actions were to be regarded as reasonable under the Communications Act standards, it does not at all follow that these same actions were immunized under the standards of the Sherman Act.

What is significant about these events is that AT&T was able to adopt the policies described above in large part because of its control over the local exchange facilities. *** The government proved that AT&T prohibited the attachment of competitors' equipment to the network except through a protective connecting arrangement (PCA). There was evidence that some experts (including a panel of the National Academy of Sciences) believed that such a PCA was necessary if the nationwide telephone network was to be protected from a variety of harms. On the other hand, the government's evidence indicated that AT&T required PCAs for equipment that in all probability could not harm the network; that there were delays in providing PCAs; that the PCAs were over-designed and over-engineered, and, thus, over-priced; that PCAs were required for competitive equipment while identical equipment sold by AT&T did not require their use; and that PCAs could not guard against all four potential harms to the network.

Additionally, the alternative option of certification[135] was available but never seriously pursued by Bell. Moreover, when ultimately certification was directly mandated by the FCC as a substitute for the protective connecting arrangement, the telephone network—AT&T's predictions to the contrary notwithstanding—did not cease to function in its customary fashion. Indeed, AT&T was unable during the trial to prove *any* actual harm to the network from the elimination of the PCAs.

In its procurement part of the case, the government alleged, and there was proof, that AT&T used its control over the local Operating Companies to force them to buy products from Western Electric even though other equipment manufacturers produced better products or products of identical quality at lower prices. Here, too,

[135] Under a certification program, non-Bell equipment may be connected directly to the AT & T network—without the use of a PCA—provided that the equipment has been certified as meeting certain technical standards.

AT&T's control of the Operating Companies was central to the allegedly anticompetitive behavior.

Without making definitive findings on any or all of the issues, it is certainly clear that—to the extent that the proposed decree is offered by the government on the premise that it will destroy the basis of past anticompetitive behavior—the Court would not be justified in rejecting it as constituting a remedy for non-existent anticompetitive acts.

2. Concentration of Power in the Telecommunications Industry

There is an additional reason, largely independent of the factors discussed above, which supports some type of antitrust relief in this case: AT&T's substantial domination of the telecommunications industry in general.

The antitrust laws are most often viewed as only a means for ensuring free competition in order to achieve the most efficient allocation of society's resources. However, Congress and the courts have repeatedly declared that these laws also embody "a desire to put an end to great aggregations of capital because of the helplessness of the individual before them." *United States v. Aluminum Company of America*, 148 F.2d 416, 428 (2d Cir.1945) (footnote omitted). ***

The significance of these concepts is accentuated by the context in which the Court must consider the public interest in these cases. The telecommunications industry plays a key role in modern economic, social, and political life. Indeed, many commentators have asserted that we are entering an age in which information will be the keystone of the economy *** .

The only pervasive two-way communications system is the telephone network. It is crucial in business affairs, in providing information to the citizenry, and in the simple conduct of daily life. In its present form, AT&T has a commanding position in that industry. The men and women who have guided the Bell System appear by and large to have been careful not to take advantage of its central position in America's economic life. There is no guarantee, however, that future managers will be equally careful. In any event, it is antithetical to our political and economic system for this key industry to be within the control of one company.

For these reasons, the Court concludes that the loosening of AT&T's control over telecommunications through the divestiture of the Operating Companies will entail benefits which transcend those which flow from the narrowest reading of the purpose of the antitrust laws.

B. Effect of the Divestiture

The remedy in an antitrust action—whether imposed by a court or agreed upon between the parties—is measured both by how well it halts the objectionable practices and by its prospects for minimizing the likelihood that such practices will occur in the future. Where, as here, the Court has heard substantially all of the evidence, it is appropriate that it weigh the proposed remedy against the evidence in that context.

*** [T]he ability of AT&T to engage in anticompetitive conduct stems largely from its control of the local Operating Companies. Absent such control, AT&T will not have the ability to disadvantage competitors in the interexchange and equipment markets. For example, with the divestiture of the Operating Companies AT&T will not be able to discriminate against intercity competitors, either by subsidizing its own intercity services with revenues from the monopoly local exchange services, or by obstructing

its competitors' access to the local exchange network. The local Operating Companies will not be providing interexchange services, and they will therefore have no incentive to discriminate. Moreover, AT&T's competitors will be guaranteed access that is equal to that provided to AT&T, and intercity carriers therefore will no longer be presented with the problems that confronted them in that area. ***

To the extent, then, that the proposed decree proceeds on the assumption that the structural reorganization will make it impossible, or at least unprofitable, for AT&T to engage in anticompetitive practices, it is fully consistent with the public interest in the enforcement of the antitrust laws. The soundness of this remedy becomes even more apparent when it is compared with other relief alternatives. ***

C. Alternative Remedies

*** There has long been a debate over the relative merits of regulation and competition. The evidence adduced during the *AT&T* trial indicates that the Bell System has been neither effectively regulated nor fully subjected to true competition. The FCC officials themselves acknowledge that their regulation has been woefully inadequate to cope with a company of AT&T's scope, wealth, and power. The efforts of various arms of government to introduce true competition into the telecommunications industry have been similarly feeble. The antitrust suit brought by the Department of Justice in 1949 ended in 1956 with a consent decree which imposed injunctive relief that was patently inadequate. It took from 1968 when the *Carterfone* decision[164] was handed down by the FCC to 1978 when the United States Court of Appeals decided *Execunet II*[165] to establish even the very principle of competition so that it was beyond dispute by AT&T. Future regulatory and injunctive remedies are unlikely to be more successful than were similar efforts in the past. In short, the choice is between a Bell System restrained by neither regulation nor true competition and a Bell System reorganized in such a way as to diminish greatly the possibility of future anticompetitive behavior.

The history of the American economic system teaches that fair competition is more likely to benefit all, especially consumers, than an industry dominated by a single-company monopolist. There is no reason to believe that the experience of the telecommunications industry will be contrary to that rule.

For all of these reasons, the Court concludes that the divestiture from AT&T of companies providing local telephone service is in the public interest.

V

Absence of Restrictions on AT&T

Under the terms of the proposed decree, the line of business restrictions and the licensing requirements imposed by the 1956 consent decree in the *Western Electric* case would be removed and AT&T would be free to compete in all facets of the marketplace. Some of the opponents of the proposed decree argue that several of the restrictions contained in the 1956 decree should not be eliminated, and others contend that the Court should also impose additional restrictions, not present in the 1956 decree. For the reasons explained in this part of the opinion and Part VI below, the Court

---

[164] 13 F.C.C.2d 420 (1968).

[165] *MCI Telecommunications Corp. v. FCC*, 580 F.2d 590 (D.C. Cir.1978).

finds that, with one exception (see Part VI(B) *infra*), the imposition of restrictions on AT&T would not be in the public interest.

The antitrust laws do not require that a company be prohibited from competing in a market unless it can be demonstrated that its participation in that market will have anticompetitive effects. Past restrictions on AT&T were justified primarily because of its control over the local Operating Companies. With the divestiture of these local exchange monopolies, continued restrictions are not required unless justified by some other rationale.

A. AT&T Power in the Interexchange Market

Virtually all those who suggest that restrictions beyond those in the proposed decree be imposed on AT&T make the same general arguments. Their basic claim is that AT&T still possesses monopoly power in the interexchange market and that it will leverage this power by cross subsidizing its competitive services with monopoly revenues. These interexchange monopoly revenues, it is said, will subsidize a variety of business activities, ranging from competitive interexchange routes to equipment manufacturing to alternative local distribution facilities.

The validity of these arguments depends, of course, upon the soundness of the claim that after the divestiture AT&T will still possess monopoly power in the interexchange market. If AT&T lacks such power, it would be unable to reap supra-competitive profits with which to support its other activities; it would only recover a profit commensurate with its interexchange operations.

There can be no doubt that AT&T's market share in the interexchange market is high. Although it is not possible to focus on a precise figure inasmuch as the number of market share estimates is almost as varied as the number of persons submitting comments, even AT&T concedes that as late as 1981 its share of interexchange revenue was around 77 percent. But the inquiry of whether AT&T possesses monopoly power in the interexchange areas does not end with a description of AT&T's size or its market share. ***

Both the Department of Justice and AT&T contend that competition in the interexchange market is growing and that this increase in competition demonstrates an absence of monopoly power. There is some validity to this claim. The interexchange market is now being served not only by relatively young businesses but also by subsidiaries of such well established firms as ITT, Southern Pacific, and IBM.

That is not to say, however, that competition has flourished without impediment or that it would soar if the Bell System were not broken up. There is substantial merit to the suggestion that, absent divestiture, AT&T would still possess significant monopoly power, and that whatever competition developed in the past did so despite anticompetitive conditions. But the overriding fact is that the principal means by which AT&T has maintained monopoly power in telecommunications has been its control of the Operating Companies with their strategic bottleneck position. The divestiture required by the proposed decree will thus remove the two main barriers that previously deterred firms from entering or competing effectively in the interexchange market.

First. AT&T will no longer have the opportunity to provide discriminatory interconnection to competitors. The Operating Companies will own the local exchange facilities. Since these companies will not be providing interexchange services, they will lack AT&T's incentive to discriminate. Moreover, they will be required to provide all

interexchange carriers with exchange access that is "equal in type, quality, and price to that provided to AT&T and its affiliates." Proposed Decree, Section II. See Part VIII *infra.*

Second. Once AT&T is divested of the local Operating Companies, it will be unable either to subsidize the prices of its interexchange service with revenues from local exchange services or to shift costs from competitive interexchange services. ***

B. Interexchange Restrictions

Some of those who have commented on the proposed decree urge that the Court require a modification which would add a clause guaranteeing access to AT&T's interexchange network for its competitors, and another which would require AT&T's Long Lines Department to be placed in a fully separated subsidiary. The imposition of such modifications is not warranted. Those who argue for these restrictions essentially cite no reason other than AT&T's share in the interexchange market to support their demands and, as discussed *supra,* that alone is insufficient.

Additionally, the proposed restrictions are substantively deficient. As the proponents of a clause which would guarantee access to AT&T's interexchange competitors concede, such access is already required by existing FCC decisions and regulations. These regulations make it possible for competing carriers to interconnect freely and to expand their facilities by "piecing out" AT&T's network, that is, by using AT&T's facilities to complete portions of routes that must traverse low density, sparsely populated, and hence presumably not very profitable territory. There is no basis for simply repeating in the decree precisely that which is already contained in the FCC regulations.

The second proposed restriction—that Long Lines be placed in a separate subsidiary—is likewise unsupported either by necessity or by adequate reasoning. This restriction is required, it is said, to prevent AT&T from using its interexchange revenues to subsidize its competitive services. But as the Court has stated elsewhere (see Part VII *infra*), if cross subsidization is a problem, a separate subsidiary will not resolve it. Moreover, AT&T's opportunity for any cross subsidization will become increasingly curtailed as interexchange competition increases; excessive profits from that service with which to subsidize other activities would quickly attract lower-priced competitors into the interexchange field or stimulate existing competitors into expanding their networks to displace AT&T.

For these reasons, the proposed interexchange restrictions must be rejected.

C. Equipment Restrictions

The restrictions that are suggested in the area of equipment manufacturing are of three basic types: that AT&T's equipment manufacturing and marketing operations be placed in a separate subsidiary or even, in the view of some of those who submitted comments, divested; that AT&T be required to disseminate its network standards and technical information; and that procurement quotas be imposed on the Operating Companies and on AT&T's Long Lines Department.

In addition to justifying these restrictions on the basis discussed above—that is, on AT&T's interexchange market share—their proponents support their position on two other grounds: that AT&T possesses monopoly power in the equipment market, and that the association with Bell Laboratories and Long Lines provides Western Electric with anticompetitive advantages in the manufacturing of equipment. The Court will examine each of the arguments in turn.

There is no merit to the claim that after divestiture AT&T will possess monopoly power in the area of equipment manufacturing. In reviewing the proof on anticompetitive behavior in the equipment market—even before divestiture—the Court found that the government's evidence on that aspect of the case was less convincing than, for example, on that involving intercity services. As explained in Part IV *supra,* where the government was able to show that AT&T's market share was high, it was generally unable to demonstrate significant anticompetitive behavior; where evidence of behavior was more damning, it had difficulty establishing market power. Thus, at a minimum the factual predicate for drastic restrictions in the equipment area is not as apparent as it might be with respect to other subjects. ***

D. Bypass

A considerable number of persons have suggested that the Court prohibit AT&T from using new local distribution technologies that would allow it to "bypass" the networks of the Operating Companies to reach its local subscribers directly. The fear is that, early on, use of this technology will tend to exert pressure on Operating Companies rates and their ability to levy access charges on interexchange carriers, and that, in time, the new technology will render the Operating Companies and their plant obsolete.

The suggestions for a modification to prohibit bypass would be worthy of implementation only if two premises were accepted: (1) that if AT&T does not develop the technology required for bypass, it will not be developed by anyone, and (2) that it is desirable as a matter of public policy to curtail this technological development. Neither premise is well taken.

AT&T is not the only carrier to possess the technical know-how necessary for bypassing the Operating Companies' local networks. Imposition of this restriction on AT&T is thus unlikely to be effective. Furthermore, because other interexchange carriers possess this technology, to prohibit only AT&T from developing and using it would artificially and unfairly restrict competition—an action antithetical to the purposes of the antitrust laws.

Even if the Court, by a simple modification of the decree, could stop bypass technology from developing, it would not be justified in doing so. This technology is a threat to the Operating Companies presumably because, when it is developed, it will be more advanced and less expensive than the present method of transmission which depends upon a cumbersome system of poles and wires. Bypass would provide telecommunications service directly to the subscriber by means of satellites, microwave towers, or other advanced technological innovations at a lower cost than such service is available now. If indeed this should prove to be the case—there is general agreement that truly large-scale use of bypass technology is still some time into the future—the answer is not to call a halt to these developments but to make certain that the benefits will not be distributed in such a way as to undermine the goal of universal service.

Neither the Court nor those who object to the decree can halt the electronic revolution any more than the Luddites could stop the industrial revolution at the beginning of the last century. If and when bypass technology becomes technically and economically feasible for widespread use, it should have the effect of reducing telephone costs and charges across the board, to the benefit of consumers, the economy, and the nation. Should it turn out instead that, as some fear, this technology will be used to reduce charges unevenly so as to threaten the goal of universal service, then those with legislative authority may at that time wish to take steps, through a program of subsidies,

special charges, or other regulatory means, to make the benefits of the new technology available to all, including those who are relatively low-volume users of telephone service. But there is no warrant for preventing the development of this technology through a ban on its use by AT&T or otherwise.

E. Patent Licensing Requirements

Under the terms of the 1956 consent decree, AT&T is required to grant to all applicants non-exclusive licenses for all existing and future Bell System patents. 1956 Consent Decree, Section X. In addition, the decree requires that, upon the payment of reasonable charges, AT&T must furnish to those with licenses for AT&T patents the technical information necessary to manufacture the equipment for which the applicant obtained the patent license. Section XIV. These licensing requirements would be eliminated by the proposed decree, and the Court must determine whether such elimination is in the public interest.

A prime reason for the imposition of the mandatory licensing requirement in 1956 was AT&T's anticompetitive hold on telecommunications and electronics technology. But this technology has advanced rapidly since then, and has become much more widely dispersed, so that AT&T now faces significant challenges in research and development both from established domestic firms and from powerful foreign competitors. The need for continued compulsory licensing of patents, therefore, is diminished on this basis alone.

Divestiture of the Operating Companies may be expected vastly to accelerate this trend. Until now, AT&T's research and development have been financed primarily through the licensing contracts with the local Operating Companies. As long as ratepayer-financed local exchange revenues were supporting this research and development, it made sense to require AT&T to share the fruits of its monopoly financing with others. But under the proposed decree, the licensing contracts will be terminated, and this rationale for exclusive licensing thus falls.

Moreover, AT&T would be forced after divestiture to fund its research and development just like other competitive enterprises—without an artificial subsidy from captive ratepayers. That being so, unless compulsory licensing is eliminated, AT&T would be placed at a significant disadvantage vis-a-vis its competitors: of all those who would be active in the development of new technology, it alone would be compelled to furnish its patents to those who might be interested, including all of its domestic and foreign competitors.

Some of AT&T's competitors contend next that compulsory licensing is necessary to ensure that equipment manufacturers and interexchange carriers receive the interface information necessary to interconnect with the local exchange network. There is no basis for such claims. *** [A]fter the divestiture, the local Operating Companies, not AT&T, will possess and generate the information necessary for interconnection. The proposed decree requires AT&T to provide these Operating Companies with, *inter alia,* sufficient technical information to permit them to perform their exchange telecommunications and exchange access functions. Proposed Decree, Section I(A)(1). The Operating Companies, in turn, are prohibited from discriminating in the "establishment and dissemination of technical information and procurement and interconnection standards." Section II(B)(2). And since the Operating Companies will neither

manufacture equipment nor provide interexchange services, they will have no incentive to favor Western Electric or Long Lines to the detriment of other intercity service providers and equipment manufacturers.

For these reasons, the Court concludes that the provisions in the proposed decree which would eliminate the patent licensing provisions imposed in 1956 are not inconsistent with the public interest. ***

VI

The 1956 Decree and Line of Business Restrictions

The basic agreement embodied in the 1956 consent decree in the *Western Electric* case was that AT&T would not be required to divest itself of Western Electric, provided that AT&T would restrict its operations to the provision of common carrier communications services and that Western Electric would manufacture only the types of equipment used by the Bell System.

The decree which has now been submitted by the parties would eliminate all of the restrictions of the 1956 consent judgment. If that decree is entered by the Court, AT&T would be free to enter the computer market as well as to provide the full range of so-called information services.

There has been no serious opposition to the entry of AT&T into manufacturing and marketing of computers and other electronic equipment, and there is no question that this development would be in the public interest.[199] It will accordingly be approved. By contrast, others who have submitted comments object to AT&T's entry into the information services market.

"Information services" are defined in the proposed decree at Section IV(J) as:

> the offering of a capability for generating, acquiring, storing, transforming, processing, retrieving, utilizing or making available information which may be conveyed via telecommunications ....

Two distinctly different types of information services fall within this general category: services which would involve no control by AT&T over the content of the information other than for transmission purposes (such as the traditional data processing services), and services in which AT&T would control both the transmission of the information and its content (such as news or entertainment). Because these two types of services raise different concerns, they will be addressed separately.

A. Data Processing and Other Computer-Related Services

As technology has advanced, the line between communications and data processing has become blurred. Advances in communications technology, for example, now allow otherwise incompatible computers to converse with each other. New sophisticated telephone equipment located on a customer's premises not only performs switching and call routing functions but it also retrieves information much as does a traditional

---

[199] Without control of the local exchange monopolies, AT&T will have no improper advantage over other competitors. It will not be able to subsidize its offerings with monopoly profits in the interexchange or telecommunications equipment markets and there is little likelihood of customer discrimination because these products and services, unlike information services, are not closely dependent upon access to the telecommunications network. If a potential competitor poses no threat to the development of a healthy competitive market it should obviously not be barred from entering that market. The greater the number of competitors, the more likely it is that consumers will reap the benefits of lower prices and product improvements. AT&T is likely to be an especially potent competitor given its manufacturing expertise and the resources of Bell Laboratories.

computer. Even ordinary telephones may be capable of performing functions that formerly required the support of a separate computer.

Providers of data processing services—like others who have commented on the decree in other contexts—contend that AT&T should be prohibited from entering these fields because of its market power in the area of interexchange services. Shaping the argument to support their particular interests, these persons contend that AT&T will use the monopoly profits from its interexchange services to subsidize its computer-related services, and that it will use its control over the interexchange network to discriminate against other data processing competitors in providing access to that network.

As explained in Part V *supra,* there is little possibility that AT&T will be able to use its revenues from the interexchange market to subsidize its prices for computer services. That being true, AT&T would not possess any anticompetitive advantages over competitors on this basis, and the possibility of cross subsidization as a basis for rejecting this portion of the proposed decree may therefore be completely discounted.

The discrimination argument is slightly more serious. Since AT&T will be offering its own computer-related services, it may well have an incentive to discriminate in transmitting competitors' services. But what defeats the objections is that AT&T's actual ability to discriminate is quite remote. This segment of the information services industry is already well established, comprised of some of the nation's leading corporate giants, as well as of many smaller concerns. The FCC has found that "[t]here are literally thousands of unregulated computer service vendors offering competing services connected to the interstate telecommunications network." *Computer II, supra,* 77 F.C.C.2d at 426. These strongly competitive conditions will limit AT&T's ability to practice discrimination in two ways. First, AT&T's competitors will have the economic resources necessary to combat any attempt at discrimination. Second, the growing demand for information services will necessarily increase the demand for transmission facilities for these services. Such an increase in demand is likely to stimulate AT&T's interexchange competitors to offer satisfactory alternatives to the AT&T network, and any attempt by AT&T to discriminate would only further enhance this eventuality.

This fairly limited possibility of discrimination clearly does not outweigh the substantial advantages to the public that would be gained by allowing AT&T to develop this new technology. AT&T's entry into these technologically sophisticated fields will stimulate competition, and it is therefore likely to produce further technological advances, new products, and better services—all of which are likely to benefit the American consumer, American foreign trade, and national defense.

Since AT&T's participation in these areas will foster the traditional objectives of the Sherman Act and is not likely to lead to anticompetitive practices, the Court will not sustain the objections to this aspect of the proposed decree.

B. Electronic Publishing Services

The second type of information service which AT&T would be permitted to provide under the proposed decree are those services in which it would control, or have a financial interest in, the content of the information being transmitted. Those services are generally referred to as electronic publishing or information publishing services.

A number of organizations have objected to entry of the proposed decree unless it is modified to include a ban on electronic publishing. However, the decree itself does

not specifically refer to the concept of electronic publishing, let alone provide a suitable definition. In order to conduct a meaningful discussion of the relevant issues, therefore, electronic publishing must first be defined. After drawing on various sources, the Court has concluded that, for purposes of this opinion, electronic publishing will be regarded as:

> the provision of any information which a provider or publisher has, or has caused to be originated, authored, compiled, collected, or edited, or in which he has a direct or indirect financial or proprietary interest, and which is disseminated to an unaffiliated person through some electronic means.

A number of persons have argued that because of potential dangers to competition and to First Amendment values, AT&T should be prohibited from engaging in such activities. For the reasons stated below, the Court agrees.

The threat to competition that is claimed to be posed by AT&T in this industry is that, through the use of cross-subsidization and customer discrimination, it will use its power in the interexchange market to disadvantage competing electronic publishers. While the possibility of cross-subsidization is as remote here as it is with respect to other subjects considered herein, there is a real danger that AT&T will use its control of the interexchange network to undermine competing publishing ventures.

AT&T could discriminate against competing electronic publishers in a variety of ways. It could, for example, use its control over the network to give priority to traffic from its own publishing operations over that of competitors. A second concern is that, inasmuch as AT&T has access to signalling and traffic data, it might gain proprietary information about its competitors' publishing services. Furthermore, it appears that AT&T would have both the incentive and the opportunity to develop technology, facilities, and services that favor its own publishing operations and the areas served by these operations rather than the operations of the publishing industry at large. Similarly, AT&T could discriminate in interconnecting competitors to the network and in providing needed maintenance on competitors' lines. Finally, AT&T might submit tariffs that would have the effect of favoring AT&T's publishing operations to the disadvantage of competing concerns.

AT&T and the Department of Justice provide the same response to these arguments that they make in other contexts: that market forces will curtail AT&T's ability effectively to engage in these practices. In the absence of special problems and concerns relating only to the electronic publishing industry, the Court probably would, as it has in other instances, accept that response. However, in the view of the Court a different conclusion is appropriate here, for the peculiar characteristics of the electronic publishing market would both render anticompetitive acts more damaging to AT&T's competitors in that market and insulate such acts from correction by market forces.

The electronic publishing industry is still in its infancy. Although this business may some day be a very significant part of the American communications system, at present, and most likely for the next several years, a small number of relatively small firms will be experimenting with new technology to provide services to an American public that is, for the most part, still almost totally unfamiliar with them. There can be no doubt that, if AT&T entered this market, the combination of its financial, technological, manufacturing, and marketing resources would dwarf any efforts of its competitors. In fact, AT&T's mere presence in the electronic publishing area would be likely to deter other potential competitors from even entering the market.

It is also readily apparent that competitors in the electronic publishing industry—far more so than competitors in any other industry—could easily be crushed were AT&T to engage in the types of anticompetitive behavior described above. Unlike most products and services, information in general and news in particular are by definition especially sensitive to even small impediments or delays. Information is only valuable if it is timely; by and large it is virtually worthless if its dissemination is delayed. This quality is especially important in electronic publishing because up-to-date information and constant availability are the features likely to be sought by subscribers.

The trial record in the *AT&T* case reveals many instances when AT&T was slow to respond to the needs of competitors, both in providing essential products or parts and in servicing these products and parts. Any delays of that kind, were they to occur in the context of the transmission of electronic publishing information, would quickly cause subscribers to desert their unreliable publishers and thus cripple AT&T's competitors in that business.

Finally, electronic publishers remain more dependent upon the AT&T network than others in the telecommunications business. In some areas, AT&T is the sole provider of intercity services. Elsewhere, where competition does exist, the other common carriers—although capable of handling voice transmissions—frequently lack the sophisticated facilities necessary to meet the needs of the electronic publishers. Systems that are specifically designed to transmit data do not provide a satisfactory solution; most of these systems lease part, if not all, their facilities from AT&T. Nor are satellites the answer, for at least for the present they do not appear to present a realistic alternative, given their restricted availability, potential transmission problems, and high costs.

Thus, even if AT&T should engage in anticompetitive activity, publishers would have no realistic alternative transmission system by which to reach their subscribers. The low level of demand for these services that exists at present makes it unlikely that competing interexchange carriers would construct transmission systems to be used solely for the delivery of electronic publishing services, and publishers would therefore be forced to accept the inferior services provided by AT&T.

Based on competitive considerations alone, therefore, the Court might well be justified in barring AT&T from electronic publishing industry. Beyond that, AT&T's entry into the electronic publishing market poses a substantial danger to First Amendment values. *** In determining whether the proposed decree is in the public interest, the Court must take into account the decree's effects on other public policies, such as the First Amendment principle of diversity in dissemination of information to the American public. Consideration of this policy is especially appropriate because, as the Supreme Court has recognized, in promoting diversity in sources of information, the values underlying the First Amendment coincide with the policy of the antitrust laws. *FCC v. National Citizens Committee for Broadcasting*, supra, 436 U.S. at 800, n. 18.

Applying this diversity principle to the issue here under discussion, it is clear that permitting AT&T to become an electronic publisher will not further the public interest.

During the last thirty years, there has been an unremitting trend toward concentration in the ownership and control of the media. Diversity has disappeared in many areas; newspapers have gone out of business; others have merged; and much of the flow of news and editorial opinion appears more and more to be controlled and shaped

by the three television networks and a handful of news magazines and metropolitan newspapers.

This concentration presents obvious dangers even today. Unless care is taken, both the concentration and the attendant dangers will be significantly increased by the new technologies. Indeed, it is not at all inconceivable that electronic publishing, with its speed and convenience will eventually overshadow the more traditional news media, and that a single electronic publisher would acquire substantial control over the provision of news in large parts of the United States.

The concentration that now exists in the media has presumably been brought about by impersonal economic and technological forces, and it is obviously beyond the concern of this or any other court. But the particular concentration that may emerge from the proposed decree is subject to the Court's jurisdiction in this antitrust case as part of the instant proceeding. Not only is AT&T a regulated company, and not only does the proceeding stem directly from serious charges of anticompetitive conduct, but the Court has been mandated not to approve the proposed decree unless it finds it to be in the public interest. AT&T's ability, described above, to use its control of the interexchange network to reduce or eliminate competition in the electronic publishing industry is the source of this threat to the First Amendment principle of diversity.

In sum, for a variety of reasons, the entry of AT&T into electronic publishing involves risks to the public interest that are greater than those which would be involved by that company's entry into other markets. Since under the Sherman Act, it is appropriate to bar a company from a market if the restriction is necessary to permit the development of competition in that market), and since First Amendment values, too, support a ban on electronic publishing by AT&T, the Court will require that the company be prohibited from entering that market.

At the same time, a prohibition on electronic publishing does not impose an undue burden on AT&T. The company is free to enter all the other computer, computer-related, and information services markets; and it will simply be barred from the creation or control of the information to be transmitted. AT&T may thus fulfill its traditional function of providing a delivery system for information which others wish to transmit, and it may also manufacture and market equipment for the electronic publishing industry and provide transmission services for other electronic publishers.

The restriction on electronic publishing—like any limitation on competition—should only remain in effect for the period necessary to establish conditions conducive to free and fair competition. Since it is not likely that the factors enumerated above which militate against AT&T's immediate entry into the electronic publishing market will continue to exist indefinitely, the Court will place a time limit on its prohibition. *** Section VII of the proposed decree allows modifications to be made in its provisions upon the application of a party or an Operating Company. It is the intention of the Court to remove the prohibition on electronic publishing at the end of seven years from the entry of the decree should application for such removal be made pursuant to Section VII. That seven-year period should be sufficient for the development of electronic publishing as a viable industry, for the acquisition of sufficient strength by individual publishers adequate to permit them to compete, and for the development of means other than the AT&T network for the transmission of the messages of electronic publishers. During that same period, the new AT&T will also have acquired a

track record with respect to behavior toward its competitors in other areas of the telecommunications business.

VII

Restrictions on the Divested Operating Companies

The proposed decree limits the Operating Companies, upon their divestiture, to the business of supplying local telephone service. In addition to a general prohibition against the provision of "any product or service that is not a natural monopoly service actually regulated by tariff," there are more specific restrictions in Section II(D) which deny the Operating Companies the opportunity to engage in the following activities: (1) the provision of interexchange services; (2) the provision of information services; (3) the manufacture of telecommunications products and customer premises equipment; (4) the marketing of such equipment and (5) directory advertising, including the production of the "Yellow Pages" directories.

*** These restrictions are justified, according to the Department, because the Operating Companies will have "both the ability and the incentive" to thwart competition in these markets by leveraging their monopoly power in the intraexchange telecommunications market. In the absence of the restrictions, it is reasoned, the Operating Companies will be able (1) to subsidize their prices in competitive markets with supracompetitive profits earned in the monopoly market, and (2) to hinder competitors by restricting their access to the intraexchange network. In short, it is the Department's view that the divested Operating Companies may appropriately be equated with the present Bell System complex in that, if permitted to enter competitive markets, they may be expected to engage in the same type of anticompetitive behavior that was the crux of the *AT&T* lawsuit.

The government's approach, while not without conceptual neatness, fails to take account of circumstances far more complex than these undifferentiated rules acknowledge. The Bell System is a vast, vertically integrated company which dominates local telecommunications, intercity telecommunications, telecommunications research, and the production and marketing of equipment. Each of the divested Operating Companies will have a monopoly in only one geographic portion of one of these markets—local telecommunications. In addition, the Bell System as presently constituted has few powerful competitors in any of the activities in which it is engaged. The Operating Companies, by contrast, will, if permitted to enter competitive markets, be faced with the most potent conceivable competitor: AT&T itself. Thus, the only similarity between the divested Operating Companies and the present Bell System is that both possess a monopoly in local telecommunications.

That single circumstance—important though it may be—is not a sufficient basis upon which to restrict competition generally in the name of the antitrust laws. If this were the case, all monopolies might have to be barred from competitive industries, and even the Department of Justice acknowledges that this drastic remedy is not required. The Tunney Act's public interest standard permits the Operating Companies to be barred from a competitive market only if there is a substantial possibility that they will use monopoly power to impede competition in that market. Two basic factors are relevant to this determination.

The restrictions are based upon the assumption that the Operating Companies, were they allowed to enter the forbidden markets, would use their monopoly power in an

anticompetitive manner. It is accordingly necessary for the Court first to determine whether these companies will actually have the incentive and opportunity to act anticompetitively. Second, the restrictions are, at least in one sense, directly anticompetitive because they prevent a potential competitor from entering the market. The Court must accordingly also consider the extent to which the participation of the Operating Companies would contribute to the creation of a competitive market. ***

A. Interexchange Services

The proposed decree prohibits the divested Operating Companies from providing interexchange services. This restriction is clearly necessary to preserve free competition in the interexchange market.

Access to the local exchange is essential for all interexchange carriers and, as the evidence in the *AT&T* action has suggested, there are many ways in which the company controlling the local exchange monopoly could discriminate against competitors in the interexchange market. After divestiture, the incentive of those who control the local networks to engage in such activity will remain unchanged: they would stand to gain business if other carriers were disadvantaged by poor access arrangements and high tariffs.

To permit the Operating Companies to compete in this market would be to undermine the very purpose of the proposed decree—to create a truly competitive environment in the telecommunications industry. The key to interexchange competition is the full implementation of the decree's equal exchange access provisions. If the Operating Companies were free to provide interexchange service in competition with the other carriers, they would have substantial incentives to subvert these equal access requirements. ***

B. Information Services

The proposed decree prohibits the Operating Companies from providing information services, an umbrella description of a variety of services including electronic publishing and other enhanced uses of telecommunications. ***

All information services are provided directly via the telecommunications network. The Operating Companies would therefore have the same incentives and the same ability to discriminate against competing information service providers that they would have with respect to competing interexchange carriers. Here, too, the Operating Companies could discriminate by providing more favorable access to the local network for their own information services than to the information services provided by competitors, and here, too, they would be able to subsidize the prices of their services with revenues from the local exchange monopoly. ***

C. Manufacture of Equipment

The provision in the proposed decree which prohibits the Operating Companies from manufacturing telecommunications equipment and customer premises equipment (CPE) is also an outgrowth of the government's case in the *AT&T* action. ***

There is a substantial likelihood that, should the Operating Companies be permitted to manufacture telecommunications equipment, nonaffiliated manufacturers would be disadvantaged in the sale of such equipment and the development of a competitive market would be frustrated. The Operating Companies would have an incentive to subsidize the prices of their equipment with the revenues from their monopoly services as well as to purchase their own equipment, even though it was more expensive

and not of the highest quality. In that respect, the Operating Companies lack the competitive restraints that ordinarily prevent the typical vertically-integrated company from engaging in such practices: the absence of competition in the end product market—exchange telecommunications—immunizes these purchasing decisions from competitive pressures. The Operating Companies therefore would be able to pay inflated prices for poor quality equipment and to reflect these costs in their rates without suffering a diminution in revenues. ***

D. Marketing of Customer Premises Equipment

The proposed decree would also prohibit the Operating Companies from selling or leasing customer premises equipment. While the Department of Justice's comments and briefs tend to blur the distinction between manufacturing and marketing, in fact the restrictions on the two activities present wholly different considerations. Based upon a realistic assessment, marketing of CPE presents little potential for anticompetitive behavior by the Operating Companies. While the Operating Companies would have the theoretical ability to engage in the types of anticompetitive activities which support the prohibition on manufacturing of CPE, their incentives and their practical ability to do so would be minimal.

The Court concludes that, for the reasons stated, the prohibition on marketing by the Operating Companies of customer premises equipment is not in the public interest, and it will therefore require that the proposed decree be modified to eliminate this prohibition.

E. Directory Advertising

Each Bell Operating Company presently publishes Yellow Pages directories for its service area. The proposed decree would bar the divested Operating Companies from all activities related to directory advertising, including the production of the so-called Yellow Pages. This restriction lacks an appropriate basis and is not in the public interest.

Neither of the reasons underlying the other restrictions on the Operating Companies—the need to prevent cross subsidization and the importance of preventing competitor discrimination—has any relevance to the printed directory market.

All parties concede that the Yellow Pages currently earn supra-competitive profits. There is no warrant therefore for proceeding on the premise that the advertising prices charged by the Operating Companies are artificially low as the result of a subsidy from local exchange service. Similarly, there is no possibility of improper discrimination by the Operating Companies against competing directory manufacturers since access to the local exchange network is not required for production of a printed directory. In short, the Operating Companies would have little or no ability to discriminate against competitors in the printed directory market, and this restriction thus has no procompetitive justification whatever.

To the contrary, the prohibition on directory production by the Operating Companies is distinctly anticompetitive in its effects, for at least two reasons. In the first place, the production of the Yellow Pages will be transferred from a number of smaller entities to one nationwide company—AT&T. This type of concentration is itself anathema to the antitrust laws. Furthermore, possession of the franchise for the printed directories will give AT&T a substantial advantage over its competitors in providing

electronic directory advertising—a market in which the Operating Companies will not be engaged.

In addition to these factors directly related to competition, there are other reasons why the prohibition on publication of the Yellow Pages by the Operating Companies is not in the public interest. All those who have commented on or have studied the issue agree that the Yellow Pages provide a significant subsidy to local telephone rates. This subsidy would most likely continue if the Operating Companies were permitted to continue to publish the Yellow Pages.

The loss of this large subsidy would have important consequences for the rates for local telephone service. For example, the State of California claims that a two dollar increase in the rates for monthly telephone service would be necessary to offset the loss of revenues from directory advertising. Other states assert that increases of a similar magnitude would be required. Evidence submitted during the *AT&T* trial indicates that large rate increases of this type will reduce the number of households with telephones and increase the disparity, in terms of the availability of telephone service, between low income and well-off citizens. This result is clearly contrary to the goal of providing affordable telephone service for all Americans.

In addition, as noted in Part III(C) *supra,* the Court must take care to intrude upon state regulation only to the extent necessary to vindicate the federal interest embodied in the antitrust laws. Where, as here, that interest is not furthered, intrusion constitutes an impermissible imposition upon the States.

For these various interrelated reasons, the Court concludes that the prohibition, express or implied, on publication by the Operating Companies of the Yellow Pages directories is not in the public interest. It will therefore require that the proposed judgment be modified to specify that there will be no such prohibition.

F. Removal of the Restrictions

It is probable that, over time, the Operating Companies will lose the ability to leverage their monopoly power into the competitive markets from which they must now be barred. This change could occur as a result of technological developments which eliminate the Operating Companies' local exchange monopoly or from changes in the structures of the competitive markets. In either event, the need for the restrictions upheld in Subparts A through C will disappear, and the decree should therefore contain a mechanism by which they may be removed. ***

The standard for removal of restrictions proposed by the parties incorporates the Department of Justice's view that the restrictions are justified by the mere existence of monopoly power. However, in the opinion of the Court, the removal of the restrictions should be governed by the same standard which the Court has applied in determining whether they are required in the first instance. Thus, a restriction will be removed upon a showing that there is no substantial possibility that an Operating Company could use its monopoly power to impede competition in the relevant market. ***

XII

Conclusion

The proposed reorganization of the Bell System raises issues of vast complexity. Because of their importance, not only to the parties but also to the telecommunications industry and to the public, the Court has discussed the various problems in substantial

detail. It is appropriate to summarize briefly the major issues and the Court's decisions which are central to the proceeding.

A. The American telecommunications industry is presently dominated by one company—AT&T. It provides local and long distance telephone service; it manufactures and markets the equipment used by telephone subscribers as well as that used in the telecommunications network; and it controls one of the leading communications research and development facilities in the world. According to credible evidence, this integrated structure has enabled AT&T for many years to undermine the efforts of competitors seeking to enter the telecommunications market.

The key to the Bell System's power to impede competition has been its control of local telephone service. The local telephone network functions as the gateway to individual telephone subscribers. It must be used by long-distance carriers seeking to connect one caller to another. Customers will only purchase equipment which can readily be connected to the local network through the telephone outlets in their homes and offices. The enormous cost of the wires, cables, switches, and other transmission facilities which comprise that network has completely insulated it from competition. Thus, access to AT&T's local network is crucial if long distance carriers and equipment manufacturers are to be viable competitors.

AT&T has allegedly used its control of this local monopoly to disadvantage these competitors in two principal ways. First, it has attempted to prevent competing long distance carriers and competing equipment manufacturers from gaining access to the local network, or to delay that access, thus placing them in an inferior position vis-a-vis AT&T's own services. Second, it has supposedly used profits earned from the monopoly local telephone operations to subsidize its long distance and equipment businesses in which it was competing with others.

For a great many years, the Federal Communications Commission has struggled, largely without success, to stop practices of this type through the regulatory tools at its command. A lawsuit the Department of Justice brought in 1949 to curb similar practices ended in an ineffectual consent decree. Some other remedy is plainly required; hence the divestiture of the local Operating Companies from the Bell System. This divestiture will sever the relationship between this local monopoly and the other, competitive segments of AT&T, and it will thus ensure—certainly better than could any other type of relief—that the practices which allegedly have lain heavy on the telecommunications industry will not recur.

B. With the loss of control over the local network, AT&T will be unable to disadvantage its competitors, and the restrictions imposed on AT&T after the government's first antitrust suit—which limited AT&T to the provision of telecommunications services—will no longer be necessary. The proposed decree accordingly removes these restrictions.

The decree will thus allow AT&T to become a vigorous competitor in the growing computer, computer-related, and information markets. Other large and experienced firms are presently operating in these markets, and there is therefore no reason to believe that AT&T will be able to achieve monopoly dominance in these industries as it did in telecommunications. At the same time, by use of its formidable scientific, engineering, and management resources, including particularly the capabilities of Bell Laboratories, AT&T should be able to make significant contributions to these fields, which are at the forefront of innovation and technology, to the benefit of American

consumers, national defense, and the position of American industry vis-a-vis foreign competition.

All of these developments are plainly in the public interest, and the Court will therefore approve this aspect of the proposed decree, with one exception. Electronic publishing, which is still in its infancy, holds promise to become an important provider of information—such as news, entertainment, and advertising—in competition with the traditional print, television, and radio media; indeed, it has the potential, in time, for actually replacing some of these methods of disseminating information.

Traditionally, the Bell System has simply distributed information provided by others; it has not been involved in the business of generating its own information. The proposed decree would, for the first time, allow AT&T to do both, and it would do so at a time when the electronic publishing industry is still in a fragile state of experimentation and growth and when electronic information can still most efficiently and most economically be distributed over AT&T's long distance network. If, under these circumstances, AT&T were permitted to engage both in the transmission and the generation of information, there would be a substantial risk not only that it would stifle the efforts of other electronic publishers but that it would acquire a substantial monopoly over the generation of news in the more general sense. Such a development would strike at a principle which lies at the heart of the First Amendment: that the American people are entitled to a diversity of sources of information. In order to prevent this from occurring, the Court will require, as a condition of its approval of the proposed decree, that it be modified to preclude AT&T from entering the field of electronic publishing until the risk of its domination of that field has abated.

C. After the divestiture, the Operating Companies will possess a monopoly over local telephone service. According to the Department of Justice, the Operating Companies must be barred from entering all competitive markets to ensure that they will not misuse their monopoly power. The Court will not impose restrictions simply for the sake of theoretical consistency. Restrictions must be based on an assessment of the realistic circumstances of the relevant markets, including the Operating Companies' ability to engage in anticompetitive behavior, their potential contribution to the market as an added competitor for AT&T, as well as upon the effects of the restrictions on the rates for local telephone service.

This standard requires that the Operating Companies be prohibited from providing long distance services and information services, and from manufacturing equipment used in the telecommunications industry. Participation in these fields carries with it a substantial risk that the Operating Companies will use the same anticompetitive techniques used by AT&T in order to thwart the growth of their own competitors. Moreover, contrary to the assumptions made by some, Operating Company involvement in these areas could not legitimately generate subsidies for local rates. Such involvement could produce substantial profits only if the local companies used their monopoly position to dislodge competitors or to provide subsidy for their competitive services or products—the very behavior the decree seeks to prevent.

Different considerations apply, however, to the marketing of customer premises equipment—the telephone and other devices used in subscribers' homes and offices—and the production of the Yellow Pages advertising directories. For a variety of reasons, there is little likelihood that these companies will be able to use their monopoly position to disadvantage competitors in these areas. In addition, their marketing of

equipment will provide needed competition for AT&T, and the elimination of the restriction on their production of the Yellow Pages will generate a substantial subsidy for local telephone rates. The Court will therefore require that the proposed decree be modified to remove the restrictions on these two types of activities.

D. With respect to a number of subjects, the proposed decree establishes merely general principles and objectives, leaving the specific implementing details for subsequent action, principally by the plan of reorganization which AT&T is required to file within six months after entry of the judgment. The parties have also made informal promises, either to each other or to the Court, as to how they intend to interpret or implement various provisions. The Court has decided that its public interest responsibilities require that it establish a process for determining whether the plan of reorganization and other, subsequent actions by AT&T actually implement these principles and promises in keeping with the objectives of the judgment. Absent such a process, AT&T would have the opportunity to interpret and implement the broad principles of the decree in such a manner as to disadvantage its competitors, the Operating Companies, or both, or otherwise to act in a manner contrary to the public interest as interpreted by the Court in this opinion.

For that reason, the Court is requiring that the judgment be modified (1) to vest authority in the Court to enforce the provisions and principles of that judgment on its own rather than only at the request of a party; and (2) to provide for a proceeding, accessible to third party intervenors and to the chief executives of the seven new regional Operating Companies, in which the Court will determine whether the plan of reorganization is consistent with the decree's general principles and promises.

E. For the reasons stated in this opinion, the Court will approve the proposed decree as in the public interest provided that the parties agree to the addition of the following new section ***.

AT&T Corp. v. Iowa Utilities Board

525 U.S. 366 (1999)

JUSTICE SCALIA delivered the opinion of the Court: In this case, we address *** whether the Commission's rules governing unbundled access *** are consistent with the statute.

I

Until the 1990s, local phone service was thought to be a natural monopoly. States typically granted an exclusive franchise in each local service area to a local exchange carrier (LEC), which owned, among other things, the local loops (wires connecting telephones to switches), the switches (equipment directing calls to their destinations), and the transport trunks (wires carrying calls between switches) that constitute a local exchange network. Technological advances, however, have made competition among multiple providers of local service seem possible, and Congress recently ended the longstanding regime of state-sanctioned monopolies.

The Telecommunications Act of 1996, Pub. L. 104-104, 110 Stat. 56, (1996 Act or Act) fundamentally restructures local telephone markets. States may no longer enforce laws that impede competition, and incumbent LECs are subject to a host of duties intended to facilitate market entry. Foremost among these duties is the LEC's obligation under 47 U.S.C. § 251(c) to share its network with competitors. Under this provision, a requesting carrier can obtain access to an incumbent's network in three ways: It can purchase local telephone services at wholesale rates for resale to end users; it can lease elements of the incumbent's network "on an unbundled basis"; and it can interconnect its own facilities with the incumbent's network.[1] When an entrant seeks

[1] 47 USC § 251(c) provides as follows:

> Additional Obligations of Incumbent Local Exchange Carriers.
>
> In addition to the duties contained in subsection (b) of this section, each incumbent local exchange carrier has the following duties:
>
> (1) Duty to Negotiate
>
> The duty to negotiate in good faith in accordance with section 252 of this title the particular terms and conditions of agreements to fulfill the duties described in paragraphs (1) through (5) of subsection (b) of this section, and this subsection. The requesting telecommunications carrier also has the duty to negotiate in good faith the terms and conditions of such agreements.
>
> (2) Interconnection
>
> The duty to provide, for the facilities and equipment of any requesting telecommunications carrier, interconnection with the local exchange carrier's network—
>
> (A) for the transmission and routing of telephone exchange service and exchange access;
>
> (B) at any technically feasible point within the carrier's network;
>
> (C) that is at least equal in quality to that provided by the local exchange carrier to itself or to any subsidiary, affiliate, or any other party to which the carrier provides interconnection; and
>
> (D) on rates, terms, and conditions that are just, reasonable, and nondiscriminatory, in accordance with the terms and conditions of the agreement and the requirements of this section and section 252 of this title.
>
> (3) Unbundled Access
>
> The duty to provide, to any requesting telecommunications carrier for the provision of a

access through any of these routes, the incumbent can negotiate an agreement without regard to the duties it would otherwise have under § 251(b)[2] or (c). See § 252(a)(1). But if private negotiation fails, either party can petition the state commission that regulates

telecommunications service, nondiscriminatory access to network elements on an unbundled basis at any technically feasible point on rates, terms, and conditions that are just, reasonable, and nondiscriminatory in accordance with the terms and conditions of the agreement and the requirements of this section and section 252 of this title. An incumbent local exchange carrier shall provide such unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service.

(4) Resale

The duty—

(A) to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers; and

(B) not to prohibit, and not to impose unreasonable or discriminatory conditions or limitations on, the resale of such telecommunications service, except that a State commission may, consistent with regulations prescribed by the Commission under this section, prohibit a reseller that obtains at wholesale rates a telecommunications service that is available at retail only to a category of subscribers from offering such service to a different category of subscribers.

(5) Notice of Changes

The duty to provide reasonable public notice of changes in the information necessary for the transmission and routing of services using that local exchange carrier's facilities or networks, as well as of any other changes that would affect the interoperability of those facilities and networks.

(6) Collocation

The duty to provide, on rates, terms, and conditions that are just, reasonable, and nondiscriminatory, for physical collocation of equipment necessary for interconnection or access to unbundled network elements at the premises of the local exchange carrier, except that the carrier may provide for virtual collocation if the local exchange carrier demonstrates to the State commission that physical collocation is not practical for technical reasons or because of space limitations.

[2] Section 251(b) imposes the following duties on incumbents:

(1) Resale

The duty not to prohibit, and not to impose unreasonable or discriminatory conditions or limitations on, the resale of its telecommunications services.

(2) Number Portability

The duty to provide, to the extent technically feasible, number portability in accordance with requirements prescribed by the Commission.

(3) Dialing Parity The duty to provide dialing parity to competing providers of telephone exchange service and telephone toll service, and the duty to permit all such providers to have nondiscriminatory access to telephone numbers, operator services, directory assistance, and directory listing, with no unreasonable dialing delays.

(4) Access to Rights-of-Way

The duty to afford access to the poles, ducts, conduits, and rights-of-way of such carrier to competing providers of telecommunications services on rates, terms, and conditions that are consistent with section 224 of this title.

(5) Reciprocal Compensation

The duty to establish reciprocal compensation arrangements for the transport and termination of telecommunications.

local phone service to arbitrate open issues, which arbitration is subject to § 251 and the FCC regulations promulgated thereunder.

Six months after the 1996 Act was passed, the FCC issued its First Report and Order implementing the local-competition provisions. *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 FCC Rcd 15499 (1996) (First Report & Order). The numerous challenges to this rulemaking, filed across the country by incumbent LECs and state utility commissions, were consolidated in the United States Court of Appeals for the Eighth Circuit.

*** Incumbent LECs also made several challenges, only some of which are relevant here, to the rules implementing the 1996 Act's requirement of unbundled access. See 47 U.S.C. § 251(c)(3). Rule 319, the primary unbundling rule, sets forth a minimum number of network elements that incumbents must make available to requesting carriers. See 47 CFR § 51.319 (1997). The LECs complained that, in compiling this list, the FCC had virtually ignored the 1996 Act's requirement that it consider whether access to proprietary elements was "necessary" and whether lack of access to nonproprietary elements would "impair" an entrant's ability to provide local service. See § 251(d)(2). In addition, the LECs thought that the list included items (like directory assistance and caller I.D.) that did not meet the statutory definition of "network element." See § 153(29). The Eighth Circuit rebuffed both arguments, holding that the Commission's interpretations of the "necessary and impair" standard and the definition of "network element" were reasonable and hence lawful under *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

When it promulgated its unbundling rules, the Commission explicitly declined to impose a requirement of facility ownership on carriers who sought to lease network elements. First Report & Order ¶¶ 328-340. Because the list of elements that Rule 319 made available was so extensive, the effect of this omission was to allow competitors to provide local phone service relying solely on the elements in an incumbent's network. The LECs argued that this "all elements" rule undermined the 1996 Act's goal of encouraging entrants to develop their own facilities. The Court of Appeals, however, deferred to the FCC's approach. Nothing in the 1996 Act itself imposed a requirement of facility ownership, and the court was of the view that the language of § 251(c)(3) indicated that "a requesting carrier may achieve the capability to provide telecommunications service completely through access to the unbundled elements of an incumbent LEC's network." 120 F.3d, at 814.

Given the sweep of the "all elements" rule, however, the Eighth Circuit thought that the FCC went too far in its Rule 315(b), which forbids incumbents to separate network elements before leasing them to competitors. 47 CFR § 51.315(b) (1997). Taken together, the two rules allowed requesting carriers to lease the incumbent's entire, preassembled network. The Court of Appeals believed that this would render the resale provision of the statute a dead letter, because by leasing the entire network rather than purchasing and reselling service offerings, entrants could obtain the same product—finished service—at a cost-based, rather than wholesale, rate. Apparently reasoning that the word "unbundled" in § 251(c)(3) meant "physically separated," the court vacated Rule 315(b) for requiring access to the incumbent LEC's network elements "on a bundled rather than an unbundled basis." Ibid. ***

III

A

We turn next to the unbundling rules, and come first to the incumbent LECs' complaint that the FCC included within the features and services that must be provided to competitors under Rule 319 items that do not (as they must) meet the statutory definition of "network element"—namely, operator services and directory assistance, operational support systems (OSS), and vertical switching functions such as caller I.D., call forwarding, and call waiting. See 47 CFR §§ 51.319(f)-(g) (1997). The statute defines "network element" as

> a 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.

47 U.S.C. § 153(29).

Given the breadth of this definition, it is impossible to credit the incumbents argument that a "network element" must be part of the physical facilities and equipment used to provide local phone service. Operator services and directory assistance, whether they involve live operators or automation, are "features, functions, and capabilities ... provided by means of" the network equipment. OSS, the incumbent's background software system, contains essential network information as well as programs to manage billing, repair ordering, and other functions. Section 153(29)'s reference to "databases ... and information sufficient for billing and collection or used in the transmission, routing, or other provision of a telecommunications service" provides ample basis for treating this system as a "network element." And vertical switching features, such as caller I.D., are "functions ... provided by means of" the switch, and thus fall squarely within the statutory definition. We agree with the Eighth Circuit that the Commission's application of the "network element" definition is eminently reasonable. See *Chevron v. NRDC*, 467 U.S., at 866.

B

We are of the view, however, that the FCC did not adequately consider the "necessary and impair" standards when it gave blanket access to these network elements, and others, in Rule 319. That rule requires an incumbent to provide requesting carriers with access to a minimum of seven network elements: the local loop, the network interface device, switching capability, interoffice transmission facilities, signaling networks and call-related databases, operations support systems functions, and operator services and directory assistance. 47 CFR § 51.319 (1997). If a requesting carrier wants access to additional elements, it may petition the state commission, which can make other elements available on a case-by-case basis. § 51.317.

Section 251(d)(2) of the Act provides:

> In determining what network elements should be made available for purposes of subsection (c)(3) of this section, the Commission shall consider, at a minimum, whether—
>
> > (A) access to such network elements as are proprietary in nature is necessary; and

> (B) the failure to provide access to such network elements would impair the ability of the telecommunications carrier seeking access to provide the services that it seeks to offer.

The incumbents argue that § 251(d)(2) codifies something akin to the "essential facilities" doctrine of antitrust theory, opening up only those "bottleneck" elements unavailable elsewhere in the marketplace. We need not decide whether, as a matter of law, the 1996 Act requires the FCC to apply *that* standard; it may be that some other standard would provide an equivalent or better criterion for the limitation upon network-element availability that the statute has in mind. But we do agree with the incumbents that the Act requires the FCC to apply *some* limiting standard, rationally related to the goals of the Act, which it has simply failed to do. In the general statement of its methodology set forth in the First Report and Order, the Commission announced that it would regard the "necessary" standard as having been met regardless of whether "requesting carriers can obtain the requested proprietary element from a source other than the incumbent," since "[r]equiring new entrants to duplicate unnecessarily even a part of the incumbent's network could generate delay and higher costs for new entrants, and thereby impede entry by competing local providers and delay competition, contrary to the goals of the 1996 Act." First Report & Order ¶ 283. And it announced that it would regard the "impairment" standard as having been met if "the failure of an incumbent to provide access to a network element would decrease the quality, or increase the financial or administrative cost of the service a requesting carrier seeks to offer, compared with providing that service *over other unbundled elements in the incumbent LEC's network," id.*, ¶ 285 (emphasis added)—which means that comparison with self-provision, or with purchasing from another provider, is excluded. Since any entrant will request the most efficient network element that the incumbent has to offer, it is hard to imagine when the incumbent's failure to give access to the element would not constitute an "impairment" under this standard. The Commission asserts that it deliberately limited its inquiry to the incumbent's own network because no rational entrant would seek access to network elements from an incumbent if it could get better service or prices elsewhere. That may be. But that judgment allows entrants, rather than the Commission, to determine whether access to proprietary elements is necessary, and whether the failure to obtain access to nonproprietary elements would impair the ability to provide services. The Commission cannot, consistent with the statute, blind itself to the availability of elements outside the incumbent's network. That failing alone would require the Commission's rule to be set aside. In addition, however, the Commission's assumption that *any* increase in cost (or decrease in quality) imposed by denial of a network element renders access to that element "necessary," and causes the failure to provide that element to "impair" the entrant's ability to furnish its desired services is simply not in accord with the ordinary and fair meaning of those terms. An entrant whose anticipated annual profits from the proposed service are reduced from 100% of investment to 99% of investment has perhaps been "impaired" in its ability to amass earnings, but has not *ipso facto* been "impair[ed] ... in its ability to provide the services it seeks to offer"; and it cannot realistically be said that the network element enabling it to raise its profits to 100% is "necessary."[11] In a world

[11] Justice Souter points out that one can say his ability to replace a light bulb is "impaired" by the absence of a ladder, and that a ladder is "necessary" to replace the bulb, even though one "could stand instead on a chair, a milk can, or eight volumes of Gibbon." True enough (and nicely put), but the proper analogy here, it seems to us, is not the absence of a ladder, but the

of perfect competition, in which all carriers are providing their service at marginal cost, the Commission's total equating of increased cost (or decreased quality) with "necessity" and "impairment" might be reasonable; but it has not established the existence of such an ideal world. We cannot avoid the conclusion that, if Congress had wanted to give blanket access to incumbents' networks on a basis as unrestricted as the scheme the Commission has come up with, it would not have included § 251(d)(2) in the statute at all. It would simply have said (as the Commission in effect has) that whatever requested element can be provided must be provided.

When the full record of these proceedings is examined, it appears that that is precisely what the Commission *thought* Congress had said. The FCC was content with its expansive methodology because of its misunderstanding of § 251(c)(3), which directs an incumbent to allow a requesting carrier access to its network elements "at any technically feasible point." The Commission interpreted this to "impos[e] on an incumbent LEC *the duty to provide all network elements for which it is technically feasible to provide access*," and went on to "conclude that we have authority to establish regulations that are coextensive" with this duty, First Report & Order ¶ 278 (emphasis added). See also *id.*, ¶ 286 ("[w]e conclude that the statute does not require us to interpret the "impairment" standard in a way that would significantly diminish the obligation imposed by section 251(c)(3)"). As the Eighth Circuit held, that was undoubtedly wrong: Section 251(c)(3) indicates "*where* unbundled access must occur, not *which* [network] elements must be unbundled." 120 F.3d, at 810. The Commission does not seek review of the Eighth Circuit's holding on this point, and we bring it into our discussion only because the Commission's application of § 251(d)(2) was colored by this error. The Commission began with the premise that an incumbent was obliged to turn over as much of its network as was "technically feasible," and viewed (d)(2) as merely permitting it to soften that obligation by regulatory grace:

> To give effect to both sections 251(c)(3) and 251(d)(2), we conclude that the proprietary and impairment standards in section 251(d)(2) grant us the authority to refrain from requiring incumbent LECs to provide all network elements for which it is technically feasible to provide access on an unbundled basis.

First Report & Order ¶ 279.

The Commission's premise was wrong. Section 251(d)(2) does not authorize the Commission to create isolated exemptions from some underlying duty to make all network elements available. It requires the Commission to determine on a rational basis which network elements must be made available, taking into account the objectives of the Act and giving some substance to the "necessary" and "impair" requirements. The latter is not achieved by disregarding entirely the availability of elements outside the network, and by regarding any "increased cost or decreased service quality" as establishing a "necessity" and an "impair[ment]" of the ability to "provide ... services."

The Commission generally applied the above described methodology as it considered the various network elements seriatim. Though some of these sections contain

---

presence of a ladder tall enough to enable one to do the job, but not without stretching one's arm to its full extension. A ladder one-half inch taller is not, "within an ordinary and fair meaning of the word," "necessary," nor does its absence "impair" one's ability to do the job. We similarly disagree with Justice Souter that a business can be impaired in its ability to provide services—even impaired in that ability "in an ordinary, weak sense of impairment," —when the business receives a handsome profit but is denied an even handsomer one.

statements suggesting that the Commission's action might be supported by a higher standard, no other standard is consistently applied and we must assume that the Commission's expansive methodology governed throughout. Because the Commission has not interpreted the terms of the statute in a reasonable fashion, we must vacate 47 CFR § 51.319 (1997).

C

The incumbent LECs also renew their challenge to the "all elements" rule, which allows competitors to provide local phone service relying solely on the elements in an incumbent's network. This issue may be largely academic in light of our disposition of Rule 319. If the FCC on remand makes fewer network elements unconditionally available through the unbundling requirement, an entrant will no longer be able to lease every component of the network. But whether a requesting carrier can access the incumbent's network in whole or in part, we think that the Commission reasonably omitted a facilities-ownership requirement. The 1996 Act imposes no such limitation; if anything, it suggests the opposite, by requiring in § 251(c)(3) that incumbents provide access to "any" requesting carrier. We agree with the Court of Appeals that the Commission's refusal to impose a facilities-ownership requirement was proper.

D

Rule 315(b) forbids an incumbent to separate already-combined network elements before leasing them to a competitor. As they did in the Court of Appeals, the incumbents object to the effect of this rule when it is combined with others before us today. TELRIC[3] allows an entrant to lease network elements based on forward-looking costs, Rule 319 subjects virtually all network elements to the unbundling requirement, and the all-elements rule allows requesting carriers to rely only on the incumbent's network in providing service. When Rule 315(b) is added to these, a competitor can lease a complete, preassembled network at (allegedly very low) cost-based rates.

The incumbents argue that this result is totally inconsistent with the 1996 Act. They say that it not only eviscerates the distinction between resale and unbundled access, but that it also amounts to Government-sanctioned regulatory arbitrage. Currently, state laws require local phone rates to include a "universal service" subsidy. Business customers, for whom the cost of service is relatively low, are charged significantly above cost to subsidize service to rural and residential customers, for whom the cost of service is relatively high. Because this universal-service subsidy is built into retail rates, it is passed on to carriers who enter the market through the resale provision. Carriers who purchase network elements at cost, however, avoid the subsidy altogether and can lure business customers away from incumbents by offering rates closer to cost. This, of course, would leave the incumbents holding the bag for universal service.

As was the case for the all-elements rule, our remand of Rule 319 may render the incumbents concern on this score academic. Moreover, § 254 requires that universal-service subsidies be phased out, so whatever possibility of arbitrage remains will be

[3] TELRIC pricing is based upon the cost of operating a hypothetical network built with the most efficient technology available. Incumbents argued below that this method was unreasonable because it stranded their historic costs and underestimated the actual costs of providing interconnection and unbundled access. The Eighth Circuit did not reach this issue, and the merits of TELRIC are not before us. [footnote moved from original location]

only temporary. In any event, we cannot say that Rule 315(b) unreasonably interprets the statute.

Section 251(c)(3) establishes:

> The duty to provide, to any requesting telecommunications carrier for the provision of a telecommunications service, nondiscriminatory access to network elements on an unbundled basis at any technically feasible point on rates, terms, and conditions that are just, reasonable, and nondiscriminatory in accordance with the terms and conditions of the agreement and the requirements of this section and section 252 ... . An incumbent local exchange carrier shall provide such unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service.

Because this provision requires elements to be provided in a manner that "allows requesting carriers to combine" them, incumbents say that it contemplates the leasing of network elements in discrete pieces. It was entirely reasonable for the Commission to find that the text does not command this conclusion. It forbids incumbents to sabotage network elements that are provided in discrete pieces, and thus assuredly contemplates that elements may be requested and provided in this form (which the Commission's rules do not prohibit). But it does not say, or even remotely imply, that elements must be provided only in this fashion and never in combined form. Nor are we persuaded by the incumbents' insistence that the phrase "on an unbundled basis" in § 251(c)(3) means "physically separated." The dictionary definition of "unbundled" (and the only definition given, we might add) matches the FCC's interpretation of the word: "to give separate prices for equipment and supporting services." Webster's Ninth New Collegiate Dictionary 1283 (1985).

The reality is that § 251(c)(3) is ambiguous on whether leased network elements may or must be separated, and the rule the Commission has prescribed is entirely rational, finding its basis in § 251(c)(3)'s nondiscrimination requirement. As the Commission explains, it is aimed at preventing incumbent LECs from "disconnect[ing] previously connected elements, over the objection of the requesting carrier, not for any productive reason, but just to impose wasteful reconnection costs on new entrants." Reply Brief for Federal Petitioners 23. It is true that Rule 315(b) could allow entrants access to an entire preassembled network. In the absence of Rule 315(b), however, incumbents could impose wasteful costs on even those carriers who requested less than the whole network. It is well within the bounds of the reasonable for the Commission to opt in favor of ensuring against an anticompetitive practice. ***

* * *

It would be gross understatement to say that the Telecommunications Act of 1996 is not a model of clarity. It is in many important respects a model of ambiguity or indeed even self-contradiction. That is most unfortunate for a piece of legislation that profoundly affects a crucial segment of the economy worth tens of billions of dollars. The 1996 Act can be read to grant (borrowing a phrase from incumbent GTE) "most promiscuous rights" to the FCC vis-à-vis the state commissions and to competing carriers vis-a-vis the incumbents—and the Commission has chosen in some instances to read it that way. But Congress is well aware that the ambiguities it chooses to produce in a statute will be resolved by the implementing agency, see *Chevron v. NRDC*, 467 U.S., at 842-843. We can only enforce the clear limits that the 1996 Act contains, which in the present case invalidate only Rule 319.

For the reasons stated, the July 18, 1997 judgment of the Court of Appeals, 120 F.3d 753, is reversed in part and affirmed in part; the August 22, 1997 judgment of the Court of Appeals, 124 F.3d 934, is reversed in part; and the cases are remanded for proceedings consistent with this opinion.

It is so ordered.

JUSTICE SOUTER, concurring in part and dissenting in part: *** I disagree with the Court's holding that the Commission was unreasonable in its interpretation of 47 U.S.C. § 251(d)(2), which requires it to consider whether competitors" access to network elements owned by Local Exchange Companies (LECs) is "necessary" and whether failure to provide access to such elements would "impair" competitors" ability to provide services. Because I think that, under *Chevron*, the Commission reasonably interpreted its duty to consider necessity and impairment, I respectfully dissent from Part III-B of the Court's opinion.

The statutory provision in question specifies that in determining what network elements should be made available on an unbundled basis to potential competitors of the LECs, the Commission "shall consider" whether "access to such network elements as are proprietary in nature is necessary," § 251(d)(2)(A), and whether "the failure to provide access" to network elements "would impair the ability of the telecommunications carrier seeking access to provide the services that it seeks to offer," § 251(d)(2)(B). The Commission interpreted "necessary" to mean "prerequisite for competition," in the sense that without access to certain proprietary network elements, competitors "ability to compete would be significantly impaired or thwarted." *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, ¶ 282, 11 FCC Rcd 15,499, 15641-15642 (1996) (First Report & Order). On this basis, it decided to require access to such elements unless the incumbent LEC could prove both that the requested network element was proprietary and that the requesting competitor could offer the same service through the use of another, nonproprietary element offered by the incumbent

The Commission interpreted "impair" to mean "diminished in value," and explained that a potential competitor's ability to offer services would diminish in value when the quality of those services would decline or their price rise, absent the element in question. The Commission chose to apply this standard "by evaluating whether a carrier could offer a service using other unbundled elements within an incumbent LEC's network," *ibid.*, and decided that whenever it would be more expensive for a competitor to offer a service using other available network elements, or whenever the service offered using those other elements would be of lower quality, the LEC must offer the desired element to the competitor, *ibid.*

In practice, as the Court observes, the Commission's interpretation will probably allow a competitor to obtain access to any network element that it wants; a competitor is unlikely in fact to want an element that would be economically unjustifiable, and a weak economic justification will do. Under *Chevron*, the only question before us is whether the Commission's interpretation, obviously favorable to potential competitors, falls outside the bounds of reasonableness.

As a matter of textual justification, certainly, the Commission is not to be faulted. The words "necessary" and "impair" are ambiguous in being susceptible to a fairly wide range of meanings, and doubtless can carry the meanings the Commission identified. If I want to replace a light bulb, I would be within an ordinary and fair meaning of the word "necessary" to say that a stepladder is "necessary" to install the bulb, even

though I could stand instead on a chair, a milk can, or eight volumes of Gibbon. I could just as easily say that the want of a ladder would "impair" my ability to install the bulb under the same circumstances. These examples use the concepts of necessity and impairment in what might be called their weak senses, but these are unquestionably still ordinary uses of the words.

Accordingly, the Court goes too far when it says that under "the ordinary and fair meaning" of "necessary" and "impair," "[a]n entrant whose anticipated annual profits from the proposed service are reduced from 100% of investment to 99% of investment ... has not ipso facto been 'impair[ed] ... in its ability to provide the services it seeks to offer'; and it cannot realistically be said that the network element enabling it to raise profits to 100% is 'necessary.'" A service is surely "necessary" to my business in an ordinary, weak sense of necessity when that service would allow me to realize more profits, and a business can be said to be "impaired" in delivery of services in an ordinary, weak sense of impairment when something stops the business from getting the profit it wants for those services. ***

Verizon Communications, Inc. v. Federal Communications Commission

535 U.S. 467 (2002)

SOUTER, J., delivered the opinion of the Court: These cases arise under the Telecommunications Act of 1996. Each is about the power of the Federal Communications Commission to regulate a relationship between monopolistic companies providing local telephone service and companies entering local markets to compete with the incumbents. Under the Act, the new entrants are entitled, among other things, to lease elements of the local telephone networks from the incumbent monopolists. The issue [is] whether the FCC is authorized to require state utility commissions to set the rates charged by the incumbents for leased elements on a forward-looking basis untied to the incumbents' investment ***.

II

The 1996 Act both prohibits state and local regulation that impedes the provision of "telecommunications service," § 253(a), and obligates incumbent carriers to allow competitors to enter their local markets, § 251(c). Section 251(c) addresses the practical difficulties of fostering local competition by recognizing three strategies that a potential competitor may pursue. First, a competitor entering the market (a "requesting" carrier, § 251(c)(2)), may decide to engage in pure facilities-based competition, that is, to build its own network to replace or supplement the network of the incumbent. If an entrant takes this course, the Act obligates the incumbent to "interconnect" the competitor's facilities to its own network to whatever extent is necessary to allow the competitor's facilities to operate. §§ 251(a) and (c)(2). At the other end of the spectrum, the statute permits an entrant to skip construction and instead simply to buy and resell "telecommunications service," which the incumbent has a duty to sell at wholesale. §§ 251(b)(1) and (c)(4). Between these extremes, an entering competitor may choose to lease certain of an incumbent's "network elements," which the incumbent has a duty to provide "on an unbundled basis' at terms that are "just, reasonable, and nondiscriminatory." § 251(c)(3).

Since wholesale markets for companies engaged in resale, leasing, or interconnection of facilities cannot be created without addressing rates, Congress provided for rates to be set either by contracts between carriers or by state utility commission rate orders. §§ 252(a)-(b). Like other federal utility statutes that authorize contracts approved by a regulatory agency in setting rates between businesses, *e.g.,* 16 U.S.C. § 824d(d) (Federal Power Act); 15 U.S.C. § 717c(c) (Natural Gas Act), the Act permits incumbent and entering carriers to negotiate private rate agreements, 47 U.S.C. § 252(a); see also § 251(c)(1) (duty to negotiate in good faith). State utility commissions are required to accept any such agreement unless it discriminates against a carrier not a party to the contract, or is otherwise shown to be contrary to the public interest. §§ 252(e)(1) and (e)(2)(A). Carriers, of course, might well not agree, in which case an entering carrier has a statutory option to request mediation by a state commission, § 252(a)(2). But the option comes with strings, for mediation subjects the parties to the duties specified in § 251 and the pricing standards set forth in § 252(d), as interpreted by the FCC's regulations, § 252(e)(2)(B). These regulations are at issue here.

As to pricing, the Act provides that when incumbent and requesting carriers fail to agree, state commissions will set a "just and reasonable" and "nondiscriminatory" rate for interconnection or the lease of network elements based on "the cost of providing the ... network element," which "may include a reasonable profit." § 252(d)(1). In setting these rates, the state commissions are, however, subject to that important limitation previously unknown to utility regulation: the rate must be "determined without reference to a rate-of-return or other rate-based proceeding." *Ibid.* In *AT&T Corp. v. Iowa Utilities Bd.,* 525 U.S. 366, 384-385 (1999), this Court upheld the FCC's jurisdiction to impose a new methodology on the States when setting these rates. The attack today is on the legality and logic of the particular methodology the Commission chose.

*** So far as it bears on where we are today, the initial decision by the Eighth Circuit held that the FCC had no authority to control the methodology of state commissions setting the rates incumbent local-exchange carriers could charge entrants for network elements, 47 CFR § 51.505(b)(1) (1997). *Iowa Utilities Bd. v. FCC,* 120 F.3d 753, 800 (1997), aff'd in part and rev'd in part, 525 U.S. 366 (1999). *** This Court affirmed in part and in larger part reversed. *AT&T Corp. v. Iowa Utilities Bd.,* 525 U.S. 366, 397 (1999). We reversed in upholding the FCC's jurisdiction to "design a pricing methodology" to bind state ratemaking commissions, *id.,* at 385 ***. The case then returned to the Eighth Circuit. *Id.,* at 397.

With the FCC's general authority to establish a pricing methodology secure, the incumbent carriers" primary challenge on remand went to the method that the Commission chose. *** As for the method to derive a "nondiscriminatory," "just and reasonable rate for network elements," the Act requires the FCC to decide how to value "the cost ... of providing the ... network element [which] may include a reasonable profit," although the FCC is (as already seen) forbidden to allow any "reference to a rate-of-return or other rate-based proceeding," § 252(d)(1). Within the discretion left to it after eliminating any dependence on a "rate of return or other rate-based proceeding," the Commission chose a way of treating "cost" as "forward-looking economic cost," 47 CFR § 51.505 (1997), something distinct from the kind of historically based cost generally relied upon in valuing a rate base after *FPC v. Hope Natural Gas*, 320 U.S. 591 (1944). In Rule 505, the FCC defined the "forward-looking economic cost of an element [as] the sum of (1) the total element long-run incremental cost of the element

[TELRIC]; [and] (2) a reasonable allocation of forward-looking common costs," § 51.505(a), common costs being "costs incurred in providing a group of elements that "cannot be attributed directly to individual elements," § 51.505(c)(1). Most important of all, the FCC decided that the TELRIC "should be measured based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent['s] wire centers." § 51.505(b)(1).

"The TELRIC of an element has three components, the operating expenses, the depreciation cost, and the appropriate risk-adjusted cost of capital." First Report and Order ¶ 703 (footnote omitted). A concrete example may help. Assume that it would cost $1 a year to operate a most-efficient loop element; that it would take $10 for interest payments on the capital a carrier would have to invest to build the lowest cost loop centered upon an incumbent carrier's existing wire centers (say $100, at 10 percent per annum); and that $9 would be reasonable for depreciation on that loop (an 11-year useful life); then the annual TELRIC for the loop element would be $20.

The Court of Appeals understood § 252(d)(1)'s reference to "the cost ... of providing the ... network element" to be ambiguous as between "forward-looking" and "historical" cost, so that a forward-looking ratesetting method would presumably be a reasonable implementation of the statute. But the Eighth Circuit thought the ambiguity afforded no leeway beyond that, and read the Act to require any forward-looking methodology to be "based on the incremental costs that an [incumbent] actually incurs or will incur in providing ... the unbundled access to its specific network elements." 219 F.3d, at 751-753. Hence, the Eighth Circuit held that § 252(d)(1) foreclosed the use of the TELRIC methodology. In other words, the court read the Act as plainly requiring rates based on the "actual" not "hypothetical" "cost ... of providing the ... network element," and reasoned that TELRIC was clearly the latter. *Id.*, at 750-751. The Eighth Circuit added, however, that if it were wrong and TELRIC were permitted, the claim that in prescribing TELRIC the FCC had effected an unconstitutional taking would not be "ripe" until "resulting rates have been determined and applied." *Id.,* at 753-754.

*** Before us, the incumbent local-exchange carriers claim error in the Eighth Circuit's holding that a "forward-looking cost" methodology (as opposed to the use of "historical" cost) is consistent with § 252(d)(1), and its conclusion that the use of the TELRIC forward-looking cost methodology presents no "ripe" takings claim. The FCC and the entrants, on the other side, seek review of the Eighth Circuit's invalidation of the TELRIC methodology ***

III

A

The incumbent carriers' first attack charges the FCC with ignoring the plain meaning of the word "cost" as it occurs in the provision of § 252(d)(1) that "the just and reasonable rate for network elements ... shall be ... based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the ... network element ... ." The incumbents do not argue that in theory the statute precludes any forward-looking methodology, but they do claim that the cost of providing a competitor with a network element in the future must be calculated using the incumbent's past investment in the element and the means of providing it. They contend that "cost" in the statute refers to "historical" cost, which they define as "what was in fact paid"

for a capital asset, as distinct from "value," or "the price that would be paid on the open market." Brief for Petitioners in No. 00-511, p. 19. They say that the technical meaning of "cost" is "past capital expenditure," *ibid.*, and they suggest an equation between "historical" and "embedded" costs, *id.*, at 20, which the FCC defines as "the costs that the incumbent LEC incurred in the past and that are recorded in the incumbent LEC's books of accounts," 47 CFR § 51.505(d)(1) (1997). The argument boils down to the proposition that "the cost of providing the network element" can only mean, in plain language and in this particular technical context, the past cost to an incumbent of furnishing the specific network element actually, physically, to be provided.

The incumbents have picked an uphill battle. At the most basic level of common usage, "cost" has no such clear implication. A merchant who is asked about "the cost of providing the goods" he sells may reasonably quote their current wholesale market price, not the cost of the particular items he happens to have on his shelves, which may have been bought at higher or lower prices.

When the reference shifts from common speech into the technical realm, the incumbents still have to attack uphill. To begin with, even when we have dealt with historical costs as a ratesetting basis, the cases have never assumed a sense of "cost" as generous as the incumbents seem to claim. "Cost" as used in calculating the rate base under the traditional cost-of-service method did not stand for all past capital expenditures, but at most for those that were prudent, while prudent investment itself could be denied recovery when unexpected events rendered investment useless, *Duquesne Light Co. v. Barasch,* 488 U.S. 299, 312 (1989). And even when investment was wholly includable in the rate base, ratemakers often rejected the utilities' "embedded costs," their own book-value estimates, which typically were geared to maximize the rate base with high statements of past expenditures and working capital, combined with unduly low rates of depreciation. See, *e.g., Hope Natural Gas,* 320 U.S., at 597-598. It would also be a mistake to forget that "cost" was a term in value-based ratemaking and has figured in contemporary state and federal ratemaking untethered to historical valuation.

What is equally important is that the incumbents' plain-meaning argument ignores the statutory setting in which the mandate to use "cost" in valuing network elements occurs. First, the Act uses "cost" as an intermediate term in the calculation of "just and reasonable rates," 47 U.S.C. § 252(d)(1), and it was the very point of *Hope Natural Gas* that regulatory bodies required to set rates expressed in these terms have ample discretion to choose methodology, 320 U.S., at 602. Second, it would have been passing strange to think Congress tied "cost" to historical cost without a more specific indication, when the very same sentence that requires "cost" pricing also prohibits any reference to a "rate-of-return or other rate-based proceeding," § 252(d)(1), each of which has been identified with historical cost ever since *Hope Natural Gas* was decided.
***

B

The incumbents' alternative argument is that even without a stern anchor in calculating "the cost ... of providing the ... network element," the particular forward-looking methodology the FCC chose is neither consistent with the plain language of § 252(d)(1) nor within the zone of reasonable interpretation subject to deference under *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.,* 467 U.S. 837, 843-845 (1984). This is so,

they say, because TELRIC calculates the forward-looking cost by reference to a hypothetical, most efficient element at existing wire-centers, not the actual network element being provided.

1

The short answer to the objection that TELRIC violates plain language is much the same as the answer to the previous plain-language argument, for what the incumbents call the "hypothetical" element is simply the element valued in terms of a piece of equipment an incumbent may not own. This claim, like the one just considered, is that plain language bars a definition of "cost" untethered to historical investment, and as explained already, the term "cost" is simply too protean to support the incumbents' argument.

2

Similarly, the claim that TELRIC exceeds reasonable interpretative leeway is open to the objection already noted, that responsibility for "just and reasonable" rates leaves methodology largely subject to discretion. The incumbents nevertheless field three arguments. They contend, first, that a method of calculating wholesale lease rates based on the costs of providing hypothetical, most efficient elements, may simulate the competition envisioned by the Act but does not induce it. Second, they argue that even if rates based on hypothetical elements could induce competition in theory, TELRIC cannot do this, because it does not provide the depreciation and risk-adjusted capital costs that the theory compels. Finally, the incumbents say that even if these objections can be answered, TELRIC is needlessly, and hence unreasonably, complicated and impracticable.

a

The incumbents' *** basic critique of TELRIC is that by setting rates for leased network elements on the assumption of perfect competition, TELRIC perversely creates incentives against competition in fact. The incumbents say that in purporting to set incumbents' wholesale prices at the level that would exist in a perfectly competitive market (in order to make retail prices similarly competitive), TELRIC sets rates so low that entrants will always lease and never build network elements. And even if an entrant would otherwise consider building a network element more efficient than the best one then on the market (the one assumed in setting the TELRIC rate), it would likewise be deterred by the prospect that its lower cost in building and operating this new element would be immediately available to its competitors; under TELRIC, the incumbents assert, the lease rate for an incumbent's existing element would instantly drop to match the marginal cost of the entrant's new element once built. According to the incumbents, the result will be, not competition, but a sort of parasitic free-riding, leaving TELRIC incapable of stimulating the facilities-based competition intended by Congress.

We think there are basically three answers to this no-stimulation claim of unreasonableness: (1) the TELRIC methodology does not assume that the relevant markets are perfectly competitive, and the scheme includes several features of inefficiency that undermine the plausibility of the incumbents' no-stimulation argument; (2) comparison of TELRIC with alternatives proposed by the incumbents as more reasonable are plausibly answered by the FCC's stated reasons to reject the alternatives; and (3) actual

investment in competing facilities since the effective date of the Act simply belies the no-stimulation argument's conclusion.

(1)

The basic assumption of the incumbents' no-stimulation argument is contrary to fact. As we explained, the argument rests on the assumption that in a perfectly efficient market, no one who can lease at a TELRIC rate will ever build. But TELRIC does not assume a perfectly efficient wholesale market or one that is likely to resemble perfection in any foreseeable time. ***

Not only that, but the FCC has of its own accord allowed for inefficiency in the TELRIC design in additional ways affecting the likelihood that TELRIC will squelch competition in facilities. First, the Commission has qualified any assumption of efficiency by requiring ratesetters to calculate cost on the basis of "the existing location of the incumbent['s] wire centers." 47 CFR § 51.505(b)(1) (1997). This means that certain network elements, principally local-loop elements, will not be priced at their most efficient cost and configuration to the extent, say, that a shorter loop could serve a local exchange if the incumbent's wire centers were relocated for a snugger fit with the current geography of terminal locations.

Second, TELRIC rates in practice will differ from the products of a perfectly competitive market owing to built-in lags in price adjustments. In a perfectly competitive market, retail prices drop instantly to the marginal cost of the most efficient company. As the incumbents point out, this would deter market entry because a potential entrant would know that even if it could provide a retail service at a lower marginal cost, it would instantly lose that competitive edge once it entered the market and competitors adjusted to match its price. Wholesale TELRIC rates, however, are set by state commissions, usually by arbitrated agreements with 3- or 4-year terms, and no one claims that a competitor could receive immediately on demand a TELRIC rate on a leased element at the marginal cost of the entrant who introduces a more efficient element.

But even if a competitor could call for a new TELRIC rate proceeding immediately upon the introduction of a more efficient element by a competing entrant, the competitor would not necessarily know enough to make the call; the fact of the element's greater efficiency would only become apparent when reflected in lower retail prices drawing demand away from existing competitors (including the incumbent), forcing them to look to lowering their own marginal costs. In practice, it would take some time for the innovating entrant to install the new equipment, to engage in marketing offering a lower retail price to attract business, and to steal away enough customer subscriptions (given the limited opportunity to capture untapped customers for local telephone service) for competitors to register the drop in demand.

Finally, it bears reminding that the FCC prescribes measurement of the TELRIC "based on the use of the most efficient telecommunications technology currently available," 47 CFR § 51.505(b)(1) (1997). Owing to that condition of current availability, the marginal cost of a most-efficient element that an entrant alone has built and uses would not set a new pricing standard until it became available to competitors as an alternative to the incumbent's corresponding element.

As a reviewing Court we are, of course, in no position to assess the precise economic significance of these and other exceptions to the perfectly functioning market that the incumbents' criticism assumes. Instead, it is enough to recognize that the incumbents'

assumption may well be incorrect. Inefficiencies built into the scheme may provide incentives and opportunities for competitors to build their own network elements, perhaps for reasons unrelated to pricing (such as the possibility of expansion into data-transmission markets by deploying "broadband" technologies, cf. *post* (BREYER, J., concurring in part and dissenting in part), or the desirability of independence from an incumbent's management and maintenance of network elements). In any event, the significance of the incumbents' mistake of fact may be indicated best not by argument here, but by the evidence of actual investment in facilities-based competition since TELRIC went into effect, to be discussed at Part III-B-2-a-(3), *infra*.

(2)

Perhaps sensing the futility of an unsupported theoretical attack, the incumbents make the complementary argument that the FCC's choice of TELRIC, whatever might be said about it on its own terms, was unreasonable as a matter of law because other methods of determining cost would have done a better job of inducing competition. Having considered the proffered alternatives and the reasons the FCC gave for rejecting them, 47 CFR § 51.505(d) (1997); First Report and Order ¶ ¶ 630-711, we cannot say that the FCC acted unreasonably in picking TELRIC to promote the mandated competition.

The incumbents present three principal alternatives for setting rates for network elements: embedded-cost methodologies, the efficient component pricing rule, and Ramsey pricing. The arguments that one or another of these methodologies is preferable to TELRIC share a basic claim: it was unreasonable for the FCC to choose a method of setting rates that fails to include, at least in theory, some additional costs beyond what would be most efficient in the long run, because lease rates that incorporate such costs will do a better job of inducing competition. The theory is that once an entrant has its foot in the door, it will have a greater incentive to build and operate its own more efficient network element if the lease rates reflect something of the incumbents' actual and inefficient marginal costs. And once the entrant develops the element at its lower marginal cost and the retail price drops accordingly, the incumbent will have no choice but to innovate itself by building the most efficient element or finding ways to reduce its marginal cost to retain its market share.

The generic feature of the incumbents' proposed alternatives, in other words, is that some degree of long-run inefficiency ought to be preserved through the lease rates, in order to give an entrant a more efficient alternative to leasing. Of course, we have already seen that TELRIC itself tolerates some degree of inefficient pricing in its existing wire-center configuration requirement and through the ratemaking and development lags just described. This aside, however, there are at least two objections that generally undercut any desirability that such alternatives may seem to offer over TELRIC.

The first objection turns on the fact that a lease rate that compensates the lessor for some degree of existing inefficiency (at least from the perspective of the long run) is simply a higher rate, and the difference between such a higher rate and the TELRIC rate could be the difference that keeps a potential competitor from entering the market. Cf. First Report and Order ¶ 378 ("[I]n some areas, the most efficient means of providing competing service may be through the use of unbundled loops. In such cases, preventing access to unbundled loops would either discourage a potential competitor from entering the market in that area, thereby denying those consumers the

benefits of competition, or cause the competitor to construct unnecessarily duplicative facilities, thereby misallocating societal resources"). If the TELRIC rate for bottleneck elements is $100 and for other elements (say switches) is $10, an entering competitor that can provide its own, more efficient switch at what amounts to a $7 rate can enter the market for $107. If the lease rate for the bottleneck elements were higher (say, $110) to reflect some of the inefficiency of bottleneck elements that actually cost the incumbent $150, then the entrant with only $107 will be kept out. Is it better to risk keeping more potential entrants out, or to induce them to compete in less capital-intensive facilities with lessened incentives to build their own bottleneck facilities? It was not obviously unreasonable for the FCC to prefer the latter.

The second general objection turns the incumbents' attack on TELRIC against the incumbents' own alternatives. If the problem with TELRIC is that an entrant will never build because at the instant it builds, other competitors can lease the analogous existing (but less efficient) element from an incumbent at a rate assuming the same most efficient marginal cost, then the same problem persists under the incumbents' methods. For as soon as an entrant builds a more efficient element, the incumbent will be forced to price to match, and that rate will be available to all other competitors. The point, of course, is that things are not this simple. As we have said, under TELRIC, price adjustment is not instantaneous in rates for a leased element corresponding to an innovating entrant's more efficient element; the same would presumably be true under the incumbents' alternative methods, though they do not come out and say it.

Once we get into the details of the specific alternative methods, other infirmities become evident that undermine the claim that the FCC could not reasonably have preferred TELRIC. As for an embedded-cost methodology, the problem with a method that relies in any part on historical cost, the cost the incumbents say they actually incur in leasing network elements, is that it will pass on to lessees the difference between most-efficient cost and embedded cost. See First Report and Order ¶ 705. Any such cost difference is an inefficiency, whether caused by poor management resulting in higher operating costs or poor investment strategies that have inflated capital and depreciation. If leased elements were priced according to embedded costs, the incumbents could pass these inefficiencies to competitors in need of their wholesale elements, and to that extent defeat the competitive purpose of forcing efficient choices on all carriers whether incumbents or entrants. The upshot would be higher retail prices consumers would have to pay. *Id.,*¶¶ 655 and 705.

There are, of course, objections other than inefficiency to any method of ratemaking that relies on embedded costs as allegedly reflected in incumbents' book-cost data, with the possibilities for manipulation this presents. Even if incumbents have built and are operating leased elements at economically efficient costs, the temptation would remain to overstate book costs to ratemaking commissions and so perpetuate the intractable problems that led to the price-cap innovation.

There is even an argument that the Act itself forbids embedded-cost methods, and while the FCC rejected this absolutistic reading of the statute, First Report and Order ¶ 704, it seems safe to say that the statutory language places a heavy presumption against any method resembling the traditional embedded-cost-of-service model of ratesetting. At the very least, proposing an embedded-cost alternative is a counterintuitive way to show that selecting TELRIC was unreasonable.

Other incumbents say the FCC was unreasonable to pick TELRIC over a method of ratesetting commonly called the efficient component pricing rule (ECPR). ECPR would base the rate for a leased element on its most efficient long-run incremental cost (presumably, something like the TELRIC) plus the opportunity cost to the incumbent when the entrant leasing the element provides a competing telecommunications service using it. The opportunity cost is pegged to the retail revenue loss suffered by the incumbent when the entrant provides the service in its stead to its former customers.

The FCC rejected ECPR because its calculation of opportunity cost relied on existing retail prices in monopolistic local-exchange markets, which bore no relation to efficient marginal cost. "We conclude that ECPR is an improper method for setting prices of interconnection and unbundled network elements because the existing retail prices that would be used to compute incremental opportunity costs under ECPR are not cost-based. Moreover, the ECPR does not provide any mechanism for moving prices towards competitive levels; it simply takes prices as given." *Id.,* ¶ 709. In effect, the adjustment for opportunity cost, because it turns on pre-existing retail prices generated by embedded costs, would pass on the same inefficiencies and be vulnerable to the same asymmetries of information in ratemaking as a straightforward embeded-cost scheme.

The third category of alternative methodologies proposed focuses on costs over an intermediate term where some fixed costs are unavoidable, as opposed to TELRIC's long run. The fundamental intuition underlying this method of ratesetting is that competition is actually favored by allowing incumbents rate recovery of certain fixed costs efficiently incurred in the intermediate term.

The most commonly proposed variant of fixed-cost recovery ratesetting is "Ramsey pricing." The underlying principle is that goods should be taxed or priced according to demand: taxes or prices should be higher as to goods for which demand is relatively inelastic. As applied to the local-exchange wholesale market, Ramsey pricing would allow rate recovery of certain costs incurred by an incumbent above marginal cost, costs associated with providing an unbundled network element that are fixed and unavoidable over the intermediate run, typically the 3- or 4-year term of a rate arbitration agreement. The specific mechanism for recovery through wholesale lease rates would be to spread such costs across the different elements to be leased according to the demand for each particular element. Thus, when demand among entrants for loop elements is high as compared with demand for switch elements, a higher proportion of fixed costs would be added as a premium to the loop-element lease rate than to the switch lease rate.

But this very feature appears to be a drawback when used as a method of setting rates for the wholesale market in unbundled network elements. Because the elements for which demand among entrants will be highest are the costly bottleneck elements, duplication of which is neither likely nor desired, high lease rates for these elements would be the rates most likely to deter market entry, as our earlier example showed: if the rate for bottleneck elements went from $100 to $110, the $107 competitor would be kept out. This is what the FCC has said:

> [W]e conclude that an allocation methodology that relies exclusively on allocating common costs in inverse proportion to the sensitivity of demand for various network elements and services may not be used. We conclude that such an allocation

> could unreasonably limit the extent of entry into local exchange markets by allocating more costs to, and thus raising the prices of, the most critical bottleneck inputs, the demand for which tends to be relatively inelastic. Such an allocation of these costs would undermine the pro-competitive objectives of the 1996 Act.

First Report and Order ¶ 696 (footnote omitted).

(3)

At the end of the day, theory aside, the claim that TELRIC is unreasonable as a matter of law because it simulates but does not produce facilities-based competition founders on fact. The entrants have presented figures showing that they have invested in new facilities to the tune of $55 billion since the passage of the Act (through 2000). ***

* * *

*** In short, the incumbents have failed to carry their burden of showing unreasonableness to defeat the deference due the Commission. We therefore reverse the Eighth Circuit's judgment insofar as it invalidated TELRIC as a method for setting rates under the Act.

National Cable & Telecommunications Ass'n v. Brand X Internet Services

545 U.S. 967 (2005)

Justice THOMAS delivered the opinion of the Court: Title II of the Communications Act of 1934, 48 Stat. 1064, as amended, 47 U.S.C. § 151 *et seq.,* subjects all providers of "telecommunications servic[e]" to mandatory common-carrier regulation, § 153(44). In the order under review, the Federal Communications Commission concluded that cable companies that sell broadband Internet service do not provide "telecommunications servic[e]" as the Communications Act defines that term, and hence are exempt from mandatory common-carrier regulation under Title II. We must decide whether that conclusion is a lawful construction of the Communications Act under *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.,* 467 U.S. 837 (1984), and the Administrative Procedure Act, 5 U.S.C. § 555 *et seq.* We hold that it is.

I

The traditional means by which consumers in the United States access the network of interconnected computers that make up the Internet is through "dial-up" connections provided over local telephone facilities. See 345 F.3d 1120, 1123-1124 (C.A.9 2003) (cases below); *In re Inquiry Concerning High-Speed Access to the Internet Over Cable and Other Facilities,* 17 FCC Rcd. 4798, 4802-4803, ¶ 9, 2002 WL 407567 (2002) (hereinafter *Declaratory Ruling*). Using these connections, consumers access the Internet by making calls with computer modems through the telephone wires owned by local phone companies. See *Verizon Communications Inc. v. FCC,* 535 U.S. 467, 489-490 (2002) (describing the physical structure of a local telephone exchange). Internet service providers (ISPs), in turn, link those calls to the Internet network, not only by providing a physical connection, but also by offering consumers the ability to translate raw Internet data into information they may both view on their personal computers and transmit to other computers connected to the Internet. See *In re Federal-State Joint Board on Universal Service,* 13 FCC Rcd. 11501, 11531, ¶ 63, 1998 WL 166178 (1998) (hereinafter *Universal Service Report*); P. Huber, M. Kellogg, & J. Thorne, Federal Telecommunications Law 988 (2d ed. 1999) (hereinafter Huber). Technological limitations of local telephone wires, however, retard the speed at which data from the Internet may be transmitted through end users' dial-up connections. Dial-up connections are therefore known as "narrowband," or slower speed, connections.

"Broadband" Internet service, by contrast, transmits data at much higher speeds. There are two principal kinds of broadband Internet service: cable modem service and Digital Subscriber Line (DSL) service. Cable modem service transmits data between the Internet and users' computers via the network of television cable lines owned by cable companies. DSL service provides high-speed access using the local telephone wires owned by local telephone companies. Cable companies and telephone companies can either provide Internet access directly to consumers, thus acting as ISPs themselves, or can lease their transmission facilities to independent ISPs that then use the facilities to provide consumers with Internet access. Other ways of transmitting high-speed Internet data into homes, including terrestrial- and satellite-based wireless networks, are also emerging.

II

At issue in these cases is the proper regulatory classification under the Communications Act of broadband cable Internet service. The Act, as amended by the Telecommunications Act of 1996, defines two categories of regulated entities relevant to these cases: telecommunications carriers and information-service providers. The Act regulates telecommunications carriers, but not information-service providers, as common carriers. Telecommunications carriers, for example, must charge just and reasonable, nondiscriminatory rates to their customers, 47 U.S.C. § § 201-209, design their systems so that other carriers can interconnect with their communications networks, § 251(a)(1), and contribute to the federal "universal service" fund, § 254(d). These provisions are mandatory, but the Commission must forbear from applying them if it determines that the public interest requires it. § § 160(a), (b). Information-service providers, by contrast, are not subject to mandatory common-carrier regulation under Title II, though the Commission has jurisdiction to impose additional regulatory obligations under its Title I ancillary jurisdiction to regulate interstate and foreign communications, see § § 151-161.

These two statutory classifications originated in the late 1970's, as the Commission developed rules to regulate data-processing services offered over telephone wires. That regime, the "*Computer II*" rules, distinguished between "basic" service (like telephone service) and "enhanced" service (computer-processing service offered over telephone lines). *In re Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry),* 77 F.C.C.2d 384, 417-423, ¶ ¶ 86-101 (1980) (hereinafter *Computer II Order*). The *Computer II* rules defined both basic and enhanced services by reference to how the consumer perceives the service being offered.

In particular, the Commission defined "basic service" as "a pure transmission capability over a communications path that is virtually transparent in terms of its interaction with customer supplied information." *Id.,* at 420, ¶ 96. By "pure" or "transparent" transmission, the Commission meant a communications path that enabled the consumer to transmit an ordinary-language message to another point, with no computer processing or storage of the information, other than the processing or storage needed to convert the message into electronic form and then back into ordinary language for purposes of transmitting it over the network—such as via a telephone or a facsimile. Basic service was subject to common-carrier regulation.

"[E]nhanced service," however, was service in which "computer processing applications [were] used to act on the content, code, protocol, and other aspects of the subscriber's information," such as voice and data storage services, *id.,* at 420-421, ¶ 97, as well as "protocol conversion" (*i.e.,* ability to communicate between networks that employ different data-transmission formats), *id.,* at 421-422, ¶ 99. By contrast to basic service, the Commission decided not to subject providers of enhanced service, even enhanced service offered via transmission wires, to Title II common-carrier regulation. The Commission explained that it was unwise to subject enhanced service to common-carrier regulation given the "fast-moving, competitive market" in which they were offered. *Id.,* at 434, ¶ 129.

The definitions of the terms "telecommunications service" and "information service" established by the 1996 Act are similar to the *Computer II* basic- and enhanced-service classifications. "Telecommunications service"—the analog to basic service—is "the offering of telecommunications for a fee directly to the public ... regardless of

the facilities used." 47 U.S.C. § 153(46). "Telecommunications" is "the transmission, between or among points specified by the user, of information of the user's choosing, without change in the form or content of the information as sent and received." § 153(43). "Telecommunications carrier[s]"—those subjected to mandatory Title II common-carrier regulation—are defined as "provider[s] of telecommunications services." § 153(44). And "information service"—the analog to enhanced service—is "the offering of a capability for generating, acquiring, storing, transforming, processing, retrieving, utilizing, or making available information via telecommunications ..." § 153(20).

In September 2000, the Commission initiated a rulemaking proceeding to, among other things, apply these classifications to cable companies that offer broadband Internet service directly to consumers. In March 2002, that rulemaking culminated in the *Declaratory Ruling* under review in these cases. In the *Declaratory Ruling,* the Commission concluded that broadband Internet service provided by cable companies is an "information service" but not a "telecommunications service" under the Act, and therefore not subject to mandatory Title II common-carrier regulation. In support of this conclusion, the Commission relied heavily on its *Universal Service Report*. See *Declaratory Ruling* 4821-4822, ¶ ¶ 36-37 (citing *Universal Service Report* or *Report*). The *Universal Service Report* classified "non-facilities-based" ISPs—those that do not own the transmission facilities they use to connect the end user to the Internet—solely as information-service providers. Unlike those ISPs, cable companies own the cable lines they use to provide Internet access. Nevertheless, in the *Declaratory Ruling,* the Commission found no basis in the statutory definitions for treating cable companies differently from non-facilities-based ISPs: Both offer "a single, integrated service that enables the subscriber to utilize Internet access service ... and to realize the benefits of a comprehensive service offering." *Declaratory Ruling* 4823, ¶ 38. Because Internet access provides a capability for manipulating and storing information, the Commission concluded that it was an information service.

The integrated nature of Internet access and the high-speed wire used to provide Internet access led the Commission to conclude that cable companies providing Internet access are not telecommunications providers. This conclusion, the Commission reasoned, followed from the logic of the *Universal Service Report*. The *Report* had concluded that, though Internet service "involves data transport elements" because "an Internet access provider must enable the movement of information between customers' own computers and distant computers with which those customers seek to interact," it also "offers end users information-service capabilities inextricably intertwined with data transport." *Universal Service Report* 11539-11540, ¶ 80. ISPs, therefore, were not "offering ... telecommunications ... directly to the public," § 153(46), and so were not properly classified as telecommunications carriers, see *id.,* at 11540, ¶ 81. In other words, the Commission reasoned that consumers use their cable modems not to transmit information "transparently," such as by using a telephone, but instead to obtain Internet access.

The Commission applied this same reasoning to cable companies offering broadband Internet access. Its logic was that, like non-facilities-based ISPs, cable companies do not "offe[r] telecommunications service to the end user, but rather ... merely us[e] telecommunications to provide end users with cable modem service." *Declaratory Ruling* 4824, ¶ 41. Though the Commission declined to apply mandatory Title II common-

carrier regulation to cable companies, it invited comment on whether under its Title I jurisdiction it should require cable companies to offer other ISPs access to their facilities on common-carrier terms. Numerous parties petitioned for judicial review, challenging the Commission's conclusion that cable modem service was not telecommunications service. By judicial lottery, the Court of Appeals for the Ninth Circuit was selected as the venue for the challenge.

The Court of Appeals granted the petitions in part, vacated the *Declaratory Ruling* in part, and remanded to the Commission for further proceedings. In particular, the Court of Appeals vacated the ruling to the extent it concluded that cable modem service was not "telecommunications service" under the Communications Act. It held that the Commission could not permissibly construe the Communications Act to exempt cable companies providing Internet service from Title II regulation. Rather than analyzing the permissibility of that construction under the deferential framework of *Chevron,* 467 U.S. 837, however, the Court of Appeals grounded its holding in the *stare decisis* effect of *AT&T Corp. v. Portland,* 216 F.3d 871 (C.A.9 2000). *Portland* held that cable modem service was a "telecommunications service," though the court in that case was not reviewing an administrative proceeding and the Commission was not a party to the case. Nevertheless, *Portland's* holding, the Court of Appeals reasoned, overrode the contrary interpretation reached by the Commission in the *Declaratory Ruling.* ***

We granted certiorari to settle the important questions of federal law that these cases present. 543 U.S. 1018, (2004).

III

We first consider whether we should apply *Chevron's* framework to the Commission's interpretation of the term "telecommunications service." We conclude that we should. We also conclude that the Court of Appeals should have done the same, instead of following the contrary construction it adopted in *Portland.* ***

IV

We next address whether the Commission's construction of the definition of "telecommunications service," 47 U.S.C. § 153(46), is a permissible reading of the Communications Act under the *Chevron* framework. *Chevron* established a familiar two-step procedure for evaluating whether an agency's interpretation of a statute is lawful. At the first step, we ask whether the statute's plain terms "directly addres[s] the precise question at issue." 467 U.S., at 843. If the statute is ambiguous on the point, we defer at step two to the agency's interpretation so long as the construction is "a reasonable policy choice for the agency to make." *Id.,* at 845. The Commission's interpretation is permissible at both steps.

A

We first set forth our understanding of the interpretation of the Communications Act that the Commission embraced. The issue before the Commission was whether cable companies providing cable modem service are providing a "telecommunications service" in addition to an "information service."

The Commission first concluded that cable modem service is an "information service," a conclusion unchallenged here. The Act defines "information service" as "the offering of a capability for generating, acquiring, storing, transforming, processing, retrieving, utilizing, or making available information via telecommunications ...."

§ 153(20). Cable modem service is an information service, the Commission reasoned, because it provides consumers with a comprehensive capability for manipulating information using the Internet via high-speed telecommunications. That service enables users, for example, to browse the World Wide Web, to transfer files from file archives available on the Internet via the "File Transfer Protocol," and to access e-mail and Usenet newsgroups. *Declaratory Ruling* 4821, ¶ 37; *Universal Service Report* 11537, ¶ 76. Like other forms of Internet service, cable modem service also gives users access to the Domain Name System (DNS). DNS, among other things, matches the Web page addresses that end users type into their browsers (or "click" on) with the Internet Protocol (IP) addresses of the servers containing the Web pages the users wish to access. *Declaratory Ruling* 4821- 4822, ¶ 37. All of these features, the Commission concluded, were part of the information service that cable companies provide consumers.

At the same time, the Commission concluded that cable modem service was not "telecommunications service." "Telecommunications service" is "the offering of telecommunications for a fee directly to the public." 47 U.S.C. § 153(46). "Telecommunications," in turn, is defined as "the transmission, between or among points specified by the user, of information of the user's choosing, without change in the form or content of the information as sent and received." § 153(43). The Commission conceded that, like all information-service providers, cable companies use "telecommunications" to provide consumers with Internet service; cable companies provide such service via the high-speed wire that transmits signals to and from an end user's computer. *Declaratory Ruling* 4823, ¶ 40. For the Commission, however, the question whether cable broadband Internet providers "offer" telecommunications involved more than whether telecommunications was one necessary component of cable modem service. Instead, whether that service also includes a telecommunications "offering" "tur[ned] on the nature of the functions the *end user* is offered," *id.,* at 4822, ¶ 38 (emphasis added), for the statutory definition of "telecommunications service" does not "res[t] on the particular types of facilities used," *id.,* at 4821, ¶ 35; see § 153(46) (definition of "telecommunications service" applies "regardless of the facilities used").

Seen from the consumer's point of view, the Commission concluded, cable modem service is not a telecommunications offering because the consumer uses the high-speed wire always in connection with the information-processing capabilities provided by Internet access, and because the transmission is a necessary component of Internet access: "As provided to the end user the telecommunications is part and parcel of cable modem service and is integral to its other capabilities." *Declaratory Ruling* 4823, ¶ 39. The wire is used, in other words, to access the World Wide Web, newsgroups, and so forth, rather than "transparently" to transmit and receive ordinary-language messages without computer processing or storage of the message. The integrated character of this offering led the Commission to conclude that cable modem service is not a "stand-alone," transparent offering of telecommunications.

B

This construction passes *Chevron's* first step. Respondents argue that it does not, on the ground that cable companies providing Internet service necessarily "offe[r]" the underlying telecommunications used to transmit that service. The word "offering" as used in § 153(46), however, does not unambiguously require that result. Instead, "offering" can reasonably be read to mean a "stand-alone" offering of telecommunica-

tions, *i.e.,* an offered service that, from the user's perspective, transmits messages unadulterated by computer processing. That conclusion follows not only from the ordinary meaning of the word "offering," but also from the regulatory history of the Communications Act.

1

Cable companies in the broadband Internet service business "offe[r]" consumers an information service in the form of Internet access and they do so "via telecommunications," § 153(20), but it does not inexorably follow as a matter of ordinary language that they also "offe[r]" consumers the high-speed data transmission (telecommunications) that is an input used to provide this service, § 153(46). We have held that where a statute's plain terms admit of two or more reasonable ordinary usages, the Commission's choice of one of them is entitled to deference. See *Verizon,* 535 U.S., at 498 (deferring to the Commission's interpretation of the term "cost" by reference to an alternative linguistic usage defined by what "[a] merchant who is asked about 'the cost of providing the goods' " might "reasonably" say). The term "offe[r]" as used in the definition of telecommunications service, 47 U.S.C. § 153(46), is ambiguous in this way.

It is common usage to describe what a company "offers" to a consumer as what the consumer perceives to be the integrated finished product, even to the exclusion of discrete components that compose the product, as the dissent concedes. One might well say that a car dealership "offers" cars, but does not "offer" the integrated major inputs that make purchasing the car valuable, such as the engine or the chassis. It would, in fact, be odd to describe a car dealership as "offering" consumers the car's components in addition to the car itself. Even if it is linguistically permissible to say that the car dealership "offers" engines when it offers cars, that shows, at most, that the term "offer," when applied to a commercial transaction, is ambiguous about whether it describes only the offered finished product, or the product's discrete components as well. It does not show that no other usage is permitted.

The question, then, is whether the transmission component of cable modem service is sufficiently integrated with the finished service to make it reasonable to describe the two as a single, integrated offering. We think that they are sufficiently integrated, because "[a] consumer uses the high-speed wire always in connection with the information-processing capabilities provided by Internet access, and because the transmission is a necessary component of Internet access." *Supra.* In the telecommunications context, it is at least reasonable to describe companies as not "offering" to consumers each discrete input that is necessary to providing, and is always used in connection with, a finished service. We think it no misuse of language, for example, to say that cable companies providing Internet service do not "offer" consumers DNS, even though DNS is essential to providing Internet access. *Declaratory Ruling* 4810, n. 74, 4822-4823, ¶ 38. Likewise, a telephone company "offers" consumers a transparent transmission path that conveys an ordinary-language message, not necessarily the data transmission facilities that also "transmi[t] ... information of the user's choosing," § 153(43), or other physical elements of the facilities used to provide telephone service, like the trunks and switches, or the copper in the wires. What cable companies providing cable modem service and telephone companies providing telephone service "offer" is Internet service and telephone service respectively—the finished services,

though they do so using (or "via") the discrete components composing the end product, including data transmission. Such functionally integrated components need not be described as distinct "offerings."

In response, the dissent argues that the high-speed transmission component necessary to providing cable modem service is necessarily "offered" with Internet service because cable modem service is like the offering of pizza delivery service together with pizza, and the offering of puppies together with dog leashes. The dissent's appeal to these analogies only underscores that the term "offer" is ambiguous in the way that we have described. The entire question is whether the products here are functionally integrated (like the components of a car) or functionally separate (like pets and leashes). That question turns not on the language of the Act, but on the factual particulars of how Internet technology works and how it is provided, questions *Chevron* leaves to the Commission to resolve in the first instance. As the Commission has candidly recognized, "the question may not always be straightforward whether, on the one hand, an entity is providing a single information service with communications and computing components, or, on the other hand, is providing two distinct services, one of which is a telecommunications service." *Universal Service Report* 11530, ¶ 60. Because the term "offer" can sometimes refer to a single, finished product and sometimes to the "individual components in a package being offered" (depending on whether the components "still possess sufficient identity to be described as separate objects"), the statute fails unambiguously to classify the telecommunications component of cable modem service as a distinct offering. This leaves federal telecommunications policy in this technical and complex area to be set by the Commission, not by warring analogies.

We also do not share the dissent's certainty that cable modem service is so obviously like pizza delivery service and the combination of dog leashes and dogs that the Commission could not reasonably have thought otherwise. For example, unlike the transmission component of Internet service, delivery service and dog leashes are not integral components of the finished products (pizzas and pet dogs). One can pick up a pizza rather than having it delivered, and one can own a dog without buying a leash. By contrast, the Commission reasonably concluded, a consumer cannot purchase Internet service without also purchasing a connection to the Internet and the transmission always occurs in connection with information processing. In any event, we doubt that a statute that, for example, subjected offerors of "delivery" service (such as Federal Express and United Parcel Service) to common-carrier regulation would unambiguously require pizza-delivery companies to offer their delivery services on a common carrier basis.

2

The Commission's traditional distinction between basic and enhanced service, see *supra*, also supports the conclusion that the Communications Act is ambiguous about whether cable companies "offer" telecommunications with cable modem service. Congress passed the definitions in the Communications Act against the background of this regulatory history, and we may assume that the parallel terms "telecommunications service" and "information service" substantially incorporated their meaning, as the Commission has held. The regulatory history in at least two respects confirms that the term "telecommunications service" is ambiguous.

First, in the *Computer II Order* that established the terms "basic" and "enhanced" services, the Commission defined those terms functionally, based on how the consumer interacts with the provided information, just as the Commission did in the order below. As we have explained, Internet service is not "'transparent in terms of its interaction with customer-supplied information,'" *Computer II Order* 420, ¶ 96; the transmission occurs in connection with information processing. It was therefore consistent with the statute's terms for the Commission to assume that the parallel term "telecommunications service" in 47 U.S.C. § 153(46) likewise describes a "pure" or "transparent" communications path not necessarily separately present, from the end user's perspective, in an integrated information-service offering.

The Commission's application of the basic/enhanced service distinction to non-facilities-based ISPs also supports this conclusion. The Commission has long held that "all those who provide some form of transmission services are not necessarily common carriers." *Computer II Order* 431, ¶ 122. For example, the Commission did not subject to common-carrier regulation those service providers that offered enhanced services over telecommunications facilities, but that did not themselves own the underlying facilities—so-called "non-facilities-based" providers. Examples of these services included database services in which a customer used telecommunications to access information, such as Dow Jones News and Lexis, as well as "value added networks," which lease wires from common carriers and provide transmission as well as protocol-processing service over those wires. These services "combin[ed] communications and computing components," yet the Commission held that they should "always be deemed enhanced" and therefore not subject to common-carrier regulation. Following this traditional distinction, the Commission in the *Universal Service Report* classified ISPs that leased rather than owned their transmission facilities as pure information-service providers.

Respondents' statutory arguments conflict with this regulatory history. They claim that the Communications Act unambiguously classifies as telecommunications carriers all entities that use telecommunications inputs to provide information service. As respondent MCI concedes, this argument would subject to mandatory common-carrier regulation all information-service providers that use telecommunications as an input to provide information service to the public. For example, it would subject to common-carrier regulation non-facilities-based ISPs that own no transmission facilities. Those ISPs provide consumers with transmission facilities used to connect to the Internet, and so, under respondents' argument, necessarily "offer" telecommunications to consumers. Respondents' position that all such entities are necessarily "offering telecommunications" therefore entails mandatory common-carrier regulation of entities that the Commission never classified as "offerors" of basic transmission service, and therefore common carriers, under the *Computer II* regime.[2] We doubt that the parallel term "telecommunications service" unambiguously worked this abrupt shift in Commission policy.

[2] The dissent attempts to escape this consequence of respondents' position by way of an elaborate analogy between ISPs and pizzerias. This analogy is flawed. A pizzeria "delivers" nothing, but ISPs plainly provide transmission service directly to the public in connection with Internet service. For example, with dial-up service, ISPs process the electronic signal that travels over local telephone wires, and transmit it to the Internet. The dissent therefore cannot deny that its position logically would require applying presumptively mandatory Title II regulation to all ISPs.

Respondents' analogy between cable companies that provide cable modem service and facilities-based enhanced-service providers—that is, enhanced-service providers who own the transmission facilities used to provide those services— fares no better. Respondents stress that under the *Computer II* rules the Commission regulated such providers more heavily than non-facilities-based providers. The Commission required, for example, local telephone companies that provided enhanced services to offer their wires on a common-carrier basis to competing enhanced-service providers. See, *e.g., In re Amendment of Sections 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry),* 104 F.C.C.2d 958, 964, ¶ 4 (1986) (hereinafter *Computer III Order*). Respondents argue that the Communications Act unambiguously requires the same treatment for cable companies because cable companies also own the facilities they use to provide cable modem service (and therefore information service).

We disagree. We think it improbable that the Communications Act unambiguously freezes in time the *Computer II* treatment of facilities-based information-service providers. The Act's definition of "telecommunications service" says nothing about imposing more stringent regulatory duties on facilities-based information-service providers. The definition hinges solely on whether the entity "offer[s] telecommunications for a fee directly to the public," 47 U.S.C. § 153(46), though the Act elsewhere subjects facilities-based carriers to stricter regulation, see § 251(c) (imposing various duties on facilities-based local telephone companies). In the *Computer II* rules, the Commission subjected facilities-based providers to common-carrier duties not because of the nature of the "offering" made by those carriers, but rather because of the concern that local telephone companies would abuse the monopoly power they possessed by virtue of the "bottleneck" local telephone facilities they owned. See *Computer II Order* 474-475, ¶ ¶ 229, 231; *Computer III Order* 968-969, ¶ 12; *Verizon,* 535 U.S., at 489-490 (describing the naturally monopolistic physical structure of a local telephone exchange). The differential treatment of facilities-based carriers was therefore a function not of the definitions of "enhanced-service" and "basic service," but instead of a choice by the Commission to regulate more stringently, in its discretion, certain entities that provided enhanced service. The Act's definitions, however, parallel the definitions of enhanced and basic service, not the facilities-based grounds on which that policy choice was based, and the Commission remains free to impose special regulatory duties on facilities-based ISPs under its Title I ancillary jurisdiction. In fact, it has invited comment on whether it can and should do so.

In sum, if the Act fails unambiguously to classify non-facilities-based information-service providers that use telecommunications inputs to provide an information service as "offer[ors]" of "telecommunications," then it also fails unambiguously to classify facilities-based information-service providers as telecommunications-service offerors; the relevant definitions do not distinguish facilities-based and non-facilities-based carriers. That silence suggests, instead, that the Commission has the discretion to fill the consequent statutory gap.

C

We also conclude that the Commission's construction was "a reasonable policy choice for the [Commission] to make" at *Chevron's* second step. 467 U.S., at 845.

Respondents argue that the Commission's construction is unreasonable because it allows any communications provider to "evade" common-carrier regulation by the

expedient of bundling information service with telecommunications. Respondents argue that under the Commission's construction a telephone company could, for example, offer an information service like voice mail together with telephone service, thereby avoiding common-carrier regulation of its telephone service.

We need not decide whether a construction that resulted in these consequences would be unreasonable because we do not believe that these results follow from the construction the Commission adopted. As we understand the *Declaratory Ruling*, the Commission did not say that any telecommunications service that is priced or bundled with an information service is automatically unregulated under Title II. The Commission said that a telecommunications input used to provide an information service that is not "separable from the data-processing capabilities of the service" and is instead "part and parcel of [the information service] and is integral to [the information service's] other capabilities" is not a telecommunications offering. *Declaratory Ruling* 4823, ¶ 39; see *supra,* at 2703-2704.

This construction does not leave all information service offerings exempt from mandatory Title II regulation. "It is plain," for example, that a local telephone company "cannot escape Title II regulation of its residential local exchange service simply by packaging that service with voice mail." *Universal Service Report* 11530, ¶ 60. That is because a telephone company that packages voice mail with telephone service offers a transparent transmission path—telephone service—that transmits information independent of the information-storage capabilities provided by voice mail. For instance, when a person makes a telephone call, his ability to convey and receive information using the call is only trivially affected by the additional voice-mail capability. Equally, were a telephone company to add a time-of-day announcement that played every time the user picked up his telephone, the "transparent" information transmitted in the ensuing call would be only trivially dependent on the information service the announcement provides. By contrast, the high-speed transmission used to provide cable modem service is a functionally integrated component of that service because it transmits data only in connection with the further processing of information and is necessary to provide Internet service. The Commission's construction therefore was more limited than respondents assume.

Respondents answer that cable modem service does, in fact, provide "transparent" transmission from the consumer's perspective, but this argument, too, is mistaken. Respondents characterize the "information-service" offering of Internet access as consisting only of access to a cable company's e-mail service, its Web page, and the ability it provides consumers to create a personal Web page. When a consumer goes beyond those offerings and accesses content provided by parties other than the cable company, respondents argue, the consumer uses "pure transmission" no less than a consumer who purchases phone service together with voice mail.

This argument, we believe, conflicts with the Commission's understanding of the nature of cable modem service, an understanding we find to be reasonable. When an end user accesses a third-party's Web site, the Commission concluded, he is equally using the information service provided by the cable company that offers him Internet access as when he accesses the company's own Web site, its e-mail service, or his personal Web page. For example, as the Commission found below, part of the information service cable companies provide is access to DNS service. A user cannot reach a third-party's Web site without DNS, which (among other things) matches the Web

site address the end user types into his browser (or "clicks" on with his mouse) with the IP address of the Web page's host server. It is at least reasonable to think of DNS as a "capability for ... acquiring ... retrieving, utilizing, or making available" Web site addresses and therefore part of the information service cable companies provide. 47 U.S.C. § 153(20). Similarly, the Internet service provided by cable companies facilitates access to third-party Web pages by offering consumers the ability to store, or "cache," popular content on local computer servers. See *Declaratory Ruling* 4810, ¶ 17, and n. 76. Cacheing obviates the need for the end user to download anew information from third-party Web sites each time the consumer attempts to access them, thereby increasing the speed of information retrieval. In other words, subscribers can reach third-party Web sites via "the World Wide Web, and browse their contents, [only] because their service provider offers the 'capability for ... acquiring, [storing] ... retrieving [and] utilizing ... information.' " *Universal Service Report* 11538, ¶ 76 (quoting 47 U.S.C. § 153(20)). "The service that Internet access providers offer to members of the public is Internet access," *Universal Service Report* 11539, ¶ 79, not a transparent ability (from the end user's perspective) to transmit information. We therefore conclude that the Commission's construction was reasonable.

V

Respondent MCI, Inc., urges that the Commission's treatment of cable modem service is inconsistent with its treatment of DSL service and therefore is an arbitrary and capricious deviation from agency policy. See 5 U.S.C. § 706(2)(A). MCI points out that when local telephone companies began to offer Internet access through DSL technology in addition to telephone service, the Commission applied its *Computer II* facilities-based classification to them and required them to make the telephone lines used to transmit DSL service available to competing ISPs on nondiscriminatory, common-carrier terms. MCI claims that the Commission's decision not to regulate cable companies similarly under Title II is inconsistent with its DSL policy.

We conclude, however, that the Commission provided a reasoned explanation for treating cable modem service differently from DSL service. As we have already noted, the Commission is free within the limits of reasoned interpretation to change course if it adequately justifies the change. It has done so here. The traditional reason for its *Computer II* common-carrier treatment of facilities-based carriers (including DSL carriers), as the Commission explained, was "that the *telephone network* [was] the primary, if not exclusive, means through which information service providers can gain access to their customers." *Declaratory Ruling* 4825, ¶ 44 (emphasis in original; internal quotation marks omitted). The Commission applied the same treatment to DSL service based on that history, rather than on an analysis of contemporaneous market conditions.

The Commission in the order under review, by contrast, concluded that changed market conditions warrant different treatment of facilities-based cable companies providing Internet access. Unlike at the time of *Computer II,* substitute forms of Internet transmission exist today: "[R]esidential high-speed access to the Internet is evolving over multiple electronic platforms, including wireline, cable, terrestrial wireless and satellite." *Declaratory Ruling* 4802, ¶ 6. The Commission concluded that "'broadband services should exist in a minimal regulatory environment that promotes investment and innovation in a competitive market.'" *Declaratory Ruling* 4802, ¶ 5. This, the Com-

mission reasoned, warranted treating cable companies unlike the facilities-based enhanced-service providers of the past. We find nothing arbitrary about the Commission's providing a fresh analysis of the problem as applied to the cable industry, which it has never subjected to these rules. This is adequate rational justification for the Commission's conclusions.

Respondents argue, in effect, that the Commission's justification for exempting cable modem service providers from common-carrier regulation applies with similar force to DSL providers. We need not address that argument. The Commission's decision appears to be a first step in an effort to reshape the way the Commission regulates information-service providers; that may be why it has tentatively concluded that DSL service provided by facilities-based telephone companies should also be classified solely as an information service. The Commission need not immediately apply the policy reasoning in the *Declaratory Ruling* to all types of information-service providers. It apparently has decided to revisit its longstanding *Computer II* classification of facilities-based information-service providers incrementally. Any inconsistency between the order under review and the Commission's treatment of DSL service can be adequately addressed when the Commission fully reconsiders its treatment of DSL service and when it decides whether, pursuant to its ancillary Title I jurisdiction, to require cable companies to allow independent ISPs access to their facilities. We express no view on those matters. In particular, we express no view on how the Commission should, or lawfully may, classify DSL service.

* * *

The questions the Commission resolved in the order under review involve a "subject matter [that] is technical, complex, and dynamic." *Gulf Power,* 534 U.S., at 339. The Commission is in a far better position to address these questions than we are. Nothing in the Communications Act or the Administrative Procedure Act makes unlawful the Commission's use of its expert policy judgment to resolve these difficult questions. The judgment of the Court of Appeals is reversed, and the cases are remanded for further proceedings consistent with this opinion.

It is so ordered.

Justice SCALIA, with whom Justice SOUTER and Justice GINSBURG join as to Part I, dissenting: The Federal Communications Commission (FCC or Commission) has once again attempted to concoct "a whole new regime of regulation (or of free-market competition)" under the guise of statutory construction. *MCI Telecommunications Corp. v. American Telephone & Telegraph Co.,* 512 U.S. 218, 234 (1994). Actually, in these cases, it might be more accurate to say the Commission has attempted to establish a whole new regime of *non*-regulation, which will make for more or less free-market competition, depending upon whose experts are believed. The important fact, however, is that the Commission has chosen to achieve this through an implausible reading of the statute, and has thus exceeded the authority given it by Congress.

I

The first sentence of the FCC ruling under review reads as follows: "Cable modem service provides high-speed access to the Internet, *as well as* many applications or functions that can be used with that access, over cable system facilities." *In re Inquiry Concerning High-Speed Access to the Internet Over Cable and Other Facilities,* 17 FCC Rcd. 4798, 4799, ¶ 1, 2002 WL 407567 (2002) (hereinafter *Declaratory Ruling*) (emphasis added,

footnote omitted). Does this mean that cable companies "offer" high-speed access to the Internet? Surprisingly not, if the Commission and the Court are to be believed.

It happens that cable-modem service is popular precisely because of the high-speed access it provides, and that, once connected with the Internet, cable-modem subscribers often use Internet applications and functions from providers other than the cable company. Nevertheless, for purposes of classifying what the cable company does, the Commission (with the Court's approval) puts all the emphasis on the rest of the package (the additional "applications or functions"). It does so by claiming that the cable company does not "offe[r]" its customers high-speed Internet access because it offers that access only in conjunction with particular applications and functions, rather than "separate[ly]," as a "stand-alone offering." *Id.,* at 4802, ¶ 7, 4823, ¶ 40.

The focus on the term "offer" appropriately derives from the statutory definitions at issue in these cases. Under the Telecommunications Act of 1996, 110 Stat. 56, " 'information service' " involves the capacity to generate, store, interact with, or otherwise manipulate "information via telecommunications." 47 U.S.C. § 153(20). In turn, "'telecommunications'" is defined as "the transmission, between or among points specified by the user, of information of the user's choosing, without change in the form or content of the information as sent and received." § 153(43). Finally, " 'telecommunications service' " is defined as "the offering of telecommunications for a fee directly to the public ... regardless of the facilities used." § 153(46). The question here is whether cable-modem-service providers "offe[r] ... telecommunications for a fee directly to the public." If so, they are subject to Title II regulation as common carriers, like their chief competitors who provide Internet access through other technologies.

The Court concludes that the word "offer" is ambiguous in the sense that it has "'alternative dictionary definitions' " that might be relevant. *Ante* (quoting *National Railroad Passenger Corporation v. Boston & Maine Corp.,* 503 U.S. 407, 418 (1992)). It seems to me, however, that the analytic problem pertains not really to the meaning of "offer," but to the identity of what is offered. The relevant question is whether the individual components in a package being offered still possess sufficient identity to be described as separate objects of the offer, or whether they have been so changed by their combination with the other components that it is no longer reasonable to describe them in that way.

Thus, I agree (to adapt the Court's example, *ante*) that it would be odd to say that a car dealer is in the business of selling steel or carpets because the cars he sells include both steel frames and carpeting. Nor does the water company sell hydrogen, nor the pet store water (though dogs and cats are largely water at the molecular level). But what is sometimes true is not, as the Court seems to assume, *always* true. There are instances in which it is ridiculous to deny that one part of a joint offering is being offered merely because it is not offered on a "'stand-alone'" basis.

If, for example, I call up a pizzeria and ask whether they offer delivery, both common sense and common "usage," *ante*, would prevent them from answering: "No, we do not offer delivery—but if you order a pizza from us, we'll bake it for you and then bring it to your house." The logical response to this would be something on the order of, "so, you *do* offer delivery." But our pizza-man may continue to deny the obvious and explain, paraphrasing the FCC and the Court: "No, even though we bring the pizza to your house, we are not actually 'offering' you delivery, because the delivery that we provide to our end users is 'part and parcel' of our pizzeria-pizza-at-home

service and is 'integral to its other capabilities.'" Cf. *Declaratory Ruling* 4823, ¶ 39.[1] Any reasonable customer would conclude at that point that his interlocutor was either crazy or following some too-clever-by-half legal advice.

In short, for the inputs of a finished service to qualify as the objects of an "offer" (as that term is reasonably understood), it is perhaps a sufficient, *but surely not a necessary,* condition that the seller offer separately "each discrete input that is necessary to providing ... a finished service." The pet store may have a policy of selling puppies only with leashes, but any customer will say that it *does* offer puppies—because a leashed puppy is still a puppy, even though it is not offered on a "stand-alone" basis.

Despite the Court's mighty labors to prove otherwise, the telecommunications component of cable-modem service retains such ample independent identity that it must be regarded as being on offer— especially when seen from the perspective of the consumer or the end user, which the Court purports to find determinative. The Commission's ruling began by noting that cable-modem service provides *both* "high-speed access to the Internet" *and* other "applications and functions," *Declaratory Ruling* 4799, ¶ 1, because that is exactly how any reasonable consumer would perceive it: as consisting of two separate things.

The consumer's view of the matter is best assessed by asking what other products cable-modem service substitutes for in the marketplace. Broadband Internet service provided by cable companies is one of the three most common forms of Internet service, the other two being dial-up access and broadband Digital Subscriber Line (DSL) service. In each of the other two, the physical transmission pathway to the Internet is sold—indeed, *is legally required* to be sold—separately from the Internet functionality. With dial-up access, the physical pathway comes from the telephone company and the Internet service provider (ISP) provides the functionality.

"In the case of Internet access, the end user utilizes two different and distinct services. One is the transmission pathway, a telecommunications service that the end user purchases from the telephone company. The second is the Internet access service, which is an enhanced service provided by an ISP .... Th[e] functions [provided by the ISP] are separate from the transmission pathway over which that data travels. The pathway is a regulated telecommunications service; the enhanced service offered over it is not." Oxman, The FCC and the Unregulation of the Internet, p. 13 (FCC, Office of Plans and Policy, Working Paper No. 31, July 1999), available at http://www.fcc.gov/ Bureaus/OPP/working_papers/oppwp31.pdf (as visited June 24, 2005, and available in the Clerk of Court's case file).

As the Court acknowledges, DSL service has been similar to dial-up service in the respect that the physical connection to the Internet must be offered separately from Internet functionality.[3] Thus, customers shopping for dial-up or DSL service will not

[1] The myth that the pizzeria does not offer delivery becomes even more difficult to maintain when the pizzeria advertises quick delivery as one of its advantages over competitors. That, of course, is the case with cable broadband.

[3] In the DSL context, the physical connection is generally resold to the consumer by an ISP that has taken advantage of the telephone company's offer. The consumer knows very well, however, that the physical connection is a necessary component for Internet access which, just as in the dial-up context, is not provided by the ISP.

be able to use the Internet unless they get both someone to provide them with a physical connection and someone to provide them with applications and functions such as e-mail and Web access. It is therefore inevitable that customers will regard the competing cable-modem service as giving them *both* computing functionality *and* the physical pipe by which that functionality comes to their computer—both the pizza and the delivery service that nondelivery pizzerias require to be purchased from the cab company.[4]

Since the delivery service provided by cable (the broad-band connection between the customer's computer and the cable company's computer-processing facilities) is downstream from the computer-processing facilities, there is no question that it merely serves as a conduit for the information services that have already been "assembled" by the cable company in its capacity as ISP. This is relevant because of the statutory distinction between an "information service" and "telecommunications." The former involves the capability of getting, processing, and manipulating information. § 153(20). The latter, by contrast, involves no "change in the form or content of the information as sent and received." § 153(43). When cable-company-assembled information enters the cable for delivery to the subscriber, the information service is already complete. The information has been (as the statute requires) generated, acquired, stored, transformed, processed, retrieved, utilized, or made available. All that remains is for the information in its final, unaltered form, to be delivered (via telecommunications) to the subscriber.

This reveals the insubstantiality of the fear invoked by both the Commission and the Court: the fear of what will happen to ISPs that do not provide the physical pathway to Internet access, yet still use telecommunications to acquire the pieces necessary to assemble the information that they pass back to their customers. According to this *reductio*, if cable-modem-service providers are deemed to provide "telecommunications service," then so must *all* ISPs because they all "use" telecommunications in providing Internet functionality (by connecting to other parts of the Internet, including Internet backbone providers, for example). In terms of the pizzeria analogy, this is equivalent to saying that, if the pizzeria "offers" delivery, *all* restaurants "offer" delivery, because the ingredients of the food they serve their customers have come from other places; no matter how their customers get the food (whether by eating it at the restaurant, or by coming to pick it up themselves), they still consume a product for which delivery was a necessary "input." This is nonsense. Concluding that delivery of the finished pizza constitutes an "offer" of delivery does not require the conclusion that the serving of prepared food includes an "offer" of delivery. And that analogy does not even do the point justice, since "'telecommunications service'" is defined as "the offering of telecommunications for a fee *directly to the public."* 47 U.S.C. § 153(46) (emphasis added).

---

[4] The Court contends that this analogy is inapposite because one need not have a pizza delivered, whereas one must purchase the cable connection in order to use cable's ISP functions. But the ISP functions provided by the cable company *can* be used without cable delivery—by accessing them from an Internet connection other than cable. The merger of the physical connection and Internet functions in cable's offerings has nothing to do with the "'inextricably intertwined,'" nature of the two (like a car and its carpet), but is an artificial product of the cable company's marketing decision not to offer the two separately, so that the Commission could (by the *Declaratory Ruling* under review here) exempt it from common-carrier status.

The ISPs' use of telecommunications in their processing of information is not offered directly to the public.

The "regulatory history" on which the Court depends so much provides another reason why common-carrier regulation of all ISPs is not a worry. Under its *Computer Inquiry* rules, which foreshadowed the definitions of "information" and "telecommunications" services, the Commission forbore from regulating as common carriers "value-added networks"—non-facilities-based providers who leased basic services from common carriers and bundled them with enhanced services; it said that they, unlike facilities-based providers, would be deemed to provide only enhanced services. That same result can be achieved today under the Commission's statutory authority to forbear from imposing most Title II regulations. 47 U.S.C. § 160. In fact, the statutory criteria for forbearance—which include what is "just and reasonable," "necessary for the protection of consumers," and "consistent with the public interest," § § 160(a)(1), (2), (3)—correspond well with the kinds of policy reasons the Commission has invoked to justify its peculiar construction of "telecommunications service" to exclude cable-modem service.

The Commission also says its *Computer Inquiry* rules should not apply to cable because they were developed in the context of telephone lines. Brief for Federal Petitioners 35-36. But to the extent that the statute imported the *Computer Inquiry* approach, there is no basis for applying it differently to cable than to telephone lines, since the definition of "telecommunications service" applies "regardless of the facilities used." 47 U.S.C. § 153(46).

The Court also puts great stock in its conclusion that cable-modem subscribers cannot avoid using information services provided by the cable company in its ISP capacity, even when they only click-through to other ISPs. For, even if a cable-modem subscriber uses e-mail from another ISP, designates some page not provided by the cable company as his home page, and takes advantage of none of the other standard applications and functions provided by the cable company, he will still be using the cable company's Domain Name System (DNS) server and, when he goes to popular Web pages, perhaps versions of them that are stored in the cable company's cache. This argument suffers from at least two problems. First, in the context of telephone services, the Court recognizes a *de minimis* exception to contamination of a telecommunications service by an information service. A similar exception would seem to apply to the functions in question here. DNS, in particular, is scarcely more than routing information, which is expressly excluded from the definition of "information service." 47 U.S.C. § 153(20). Second, it is apparently possible to sell a telecommunications service separately from, although in conjunction with, ISP-like services; that is precisely what happens in the DSL context, and the Commission does not contest that it *could* be done in the context of cable. The only impediment appears to be the Commission's failure to require from cable companies the unbundling that it required of facilities-based providers under its *Computer Inquiry*.

Finally, I must note that, notwithstanding the Commission's self-congratulatory paean to its deregulatory largesse, *e.g.,* Brief for Federal Petitioners 29-32, it concluded the *Declaratory Ruling* by asking, as the Court paraphrases, "whether under its Title I jurisdiction [the Commission] should require cable companies to offer other ISPs access to their facilities on common-carrier terms." *Ante,* see also Reply Brief for Federal Petitioners 9; Tr. of Oral Arg. 17. In other words, what the Commission hath given,

the Commission may well take away—unless it doesn't. This is a wonderful illustration of how an experienced agency can (with some assistance from credulous courts) turn statutory constraints into bureaucratic discretions. The main source of the Commission's regulatory authority over common carriers is Title II, but the Commission has rendered that inapplicable in this instance by concluding that the definition of "telecommunications service" is ambiguous and does not (in its current view) apply to cable-modem service. It contemplates, however, altering that (unnecessary) outcome, not by changing the law (*i.e.,* its construction of the Title II definitions), but by reserving the right to change the facts. Under its undefined and sparingly used "ancillary" powers, the Commission might conclude that it can order cable companies to "unbundle" the telecommunications component of cable-modem service.[7] And presto, Title II will then apply to them, because they will finally be "offering" telecommunications service! Of course, the Commission will still have the statutory power to forbear from regulating them under § 160 (which it has already tentatively concluded it would do, *Declaratory Ruling* 4847-4848, ¶ ¶ 94-95). Such Möbius-strip reasoning mocks the principle that the statute constrains the agency in any meaningful way.

After all is said and done, after all the regulatory cant has been translated, and the smoke of agency expertise blown away, it remains perfectly clear that someone who sells cable-modem service is "offering" telecommunications. For that simple reason set forth in the statute, I would affirm the Court of Appeals. ***

[7] Under the Commission's assumption that cable-modem-service providers are not providing "telecommunications services," there is reason to doubt whether it can use its Title I powers to impose common-carrier-like requirements, since 47 U.S.C. § 153(44) specifically provides that a "telecommunications carrier shall be treated as a common carrier under this chapter *only to the extent* that it is engaged in providing telecommunications services" (emphasis added), and "this chapter" includes Titles I and II.