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ISSUES IN POST-ENTRY PERFORMANCE PLANNING FOR REGIONAL BELL OPERATING COMPANIES

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FOREWORD

The market-opening provisions of the Telecommunications Act of 1996 have forced several significant new matters to the states. Among these is the continuing regulation of the provision of wholesale services by the Incumbent Bell Operating Companies. A post entry performance plan is one method suggested by the Federal Communications Commission as a means to assure that markets remain open. This report addresses some unique issues that are presented by these plans. These issues include novel methods of regulatory review, enforcement and remedies, classic issues of performance measurement, and the need for flexibility.

Sincerely,

Raymond W. Lawton, Ph.D.
Director, NRRI
June 2001

Introduction

Performance plans in telecommunications are an emerging area of concern for all states that are served by a Regional Bell Operating Company (RBOC). As a result of a series of decisions by the Federal Communications Commission (Commission or FCC) the performance plan, while not legally required, has nonetheless become a touchstone to the Commission's approval of an application for interLATA voice and data line of business relief. The use of a performance plan and some of the other concepts inherent in the move to performance plans, however, is not unique to the RBOC efforts to lift the business restrictions. Rather, these plans are bringing to the fore some fundamental changes in way federal and state regulatory commissions address problems in the developing competitive telecommunications markets.

This report identifies some of the important issues associated with the development of these performance plans. It is not a comprehensive review of the various plans that have been developed although it relies on them for guidance. Instead, this report is a collection of short discussions of the basic questions presented by performance plans. The goal is to introduce the reader to some of the problems and concepts associated with these plans.

The central problem addressed in this report is the treatment of the RBOCs performance under the resale, unbundled network element, and interconnection requirements contained in the Telecommunications Act of 1996. All incumbent providers are required to provide these services in a non-discriminatory manner, but the RBOCs face an added requirement of a special section (Section 271) that prohibits their provision of interLATA telecommunications services until they demonstrate compliance with the market-opening requirements and further demonstrate that their applications are in the public interest. In demonstrating that an application is in the public interest, the RBOCs have relied on wholesale performance plans. Work in New York and Texas has served as a model for the kinds of plans that satisfy this public interest review. It also is evident that these models will affect a national discussion. The following essay looks at the FCC's public interest analysis and the role that the performance plans takes in that analysis.

A larger set of issues, however, underlies the use of the performance plans. In one regard, the plans mark a transition to an alternative form of regulation. The third section of this report reviews the alternative regulatory model that underlies performance plans, self-regulation, and tries to fit it into the continuum of regulatory philosophies.

The remaining sections of the report address some of the common issues inherent in a performance plan. The fourth section addresses the fundamental problem of measurement. Plans are built on the ability to measure variables that are critical to the goal of opening and sustaining markets. This section thus looks at some of the key issues in the design and application of performance measures.

The fifth section then turns to the means of encouraging the desired behavior. The basic approach of performance plans is to impose damages or fines on the incumbent for inadequate performance. This approach raises two kinds of concerns. First, the level of monetary recovery and to whom it is paid varies with the goals of the payment structure. Fines are different from damages. Second, monetary awards do not address a deeper issue of incentives: there are likely to be a variety of motivations for compliance, and monetary penalties may not be a complete approach.

The last section addresses the question of change. Performance plans must operate in a complex and changing environment. Flexibility, therefore, is an important element of an effective plan. This section thus looks at elements in the New York and Texas approaches for the explicit and implicit manner in which they deal with complexity.

It is apparent that the efforts to develop effective plans are operating outside many of the traditional structures used by commissions to regulate dominant firm behavior.

Thus, they provide an opportunity to explore the manner in which commissions are addressing important new issues as they attempt to implement the goals of the Telecommunications Act of 1996.

The Legal Genesis of Performance Plans: Section 271's Public Interest Requirement

The need for performance plans has arisen in the context of applications for relief from the interLATA restrictions on the Regional Bell Operating Companies contained in Section 271 of the Telecommunications Act of 1996. The Act itself makes no specific provision for the use of a performance plan to assure the Bell Company's continuing compliance with the requirements of Section 271. The FCC, however, has indicated through a series of decisions that such a plan is an important element in satisfying the Commission that the market will remain open.

Statutory Provisions

For an RBOC to secure relief from the interLATA restriction contained in Section 271 of the Telecommunications Act of 1996, it must satisfy three requirements. First, it must satisfy either "Track A" or "Track B" and the fourteen point competitive check list.[1] Second, it must demonstrate compliance with the separations requirements found in Section 272.[2] Third, it must demonstrate that "the requested authorization is consistent with the public interest, convenience, and necessity,"[3] the public interest requirement. As demonstrated in the Commission's decisions in applications under Section 271, the public

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[1] 47 U.S.C. § 271(d)(3)(A). Track A requires an applicant to show that it has entered one or more binding agreements to provide access and interconnection to a nonaffiliate for residential and business customers. Track B permits an applicant to satisfy the interconnection and access requirements through a statement of generally available terms if the applicant has not received a request for access and interconnection.

[2] Id. § 271(d)(3)(B).

[3] Id. § 271(d)(3)(C).

interest requirement provides the justification for some sort of post-approval performance assurance regime.

There is little in the conference report accompanying the Telecommunications Act of 1996 to explain what was intended by the public interest requirement. The relevant provisions appeared in the Senate version of the bill that went to conference, and the conference report provides a one-sentence explanation in the description of the Senate bill as to what was intended: "[T]he Senate notes that the Commission's determination of whether the provision of the requested interLATA services is consistent with the public interest, convenience, and necessity must be based on substantial evidence on the record as a whole."[4]

The underlying Senate report provides more detail on what the Senate's approach intended, but the focus related to a provision that apparently did not survive the conference process. The report noted that the intent was to rely on the traditional meaning of the public interest standard as contained in the Communications Act of 1934 and that there was no intent to change that standard.[5] It goes on to state, however, that Senate intended to require greater scrutiny of the Commission's decisions under this section by including the "substantial evidence" standard as opposed to an "arbitrary and capricious" standard.[6] The rationale for the higher standard appeared to be a distrust of agency decision making: the Senate report states that the goals were to prevent "abuse" of the standard and to "reduce litigation and intervention by the courts by requiring the FCC to clearly articulate the evidence underlying any decision to grant or deny an application."[7] Whatever the

[4] H.R. Conf. Rep. No. 104-458, 104 Cong., 2d Sess. 145 (1996).

[5] S. Rep. No. 104-230, 104th Cong., 1st Sess. 44 (1995).

[6] Id.

[7] Id.

concerns might have been, this aspect of the Senate's approach did not survive the legislative process.[8]

On the other hand, the Senate report gives a flavor of the general direction of the public interest requirement that was intended. The apparent intent was to permit the Federal Communications Commission to exercise its review authority under the broadly defined public interest standard (though apparently subject to more detailed support in the record).

Not surprisingly, the public interest requirement of Section 271 essentially leaves the agency with alternatives. There is a spectrum of possibilities for determining the public interest, convenience and necessity, and apart from the possibility of limited judicial review, the Commission fills the section with content. To that end, it is important then to assess the Commission's view of the public interest requirement.

The FCC's Interpretation of the Public Interest Requirement

The FCC's interpretation of the public interest requirement is contained in its Section 271 decisions. One decision denying relief[9] and two decisions approving requests detail findings the Commission relies upon in its evaluation of the public interest. In these decisions, the FCC focused on three factors—competition, a forward-looking

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[8] Whether the distinction was even meaningful is a separate question. "In facing the problem of whether there might be a significant difference between the arbitrary and capricious standard and the substantial evidence standard, Judge Friendly on one occasion wrote that 'the controversy is semantic in some degree, at least in the context of informal rulemaking ... [and lacks] dispositional importance. ... [T]he two criteria do tend to converge.'" Christopher F. Edley, Jr., Administrative Law: Rethinking Judicial Control of Bureaucracy 112 (1990), quoting Associated Indus v. Dept. of Labor, 487 F.2d 342, 350 (2d Cir. 1973).

[9] The second *BellSouth-Louisiana* decision also contains a brief discussion of the public interest analysis, but it is a summary of the *Ameritech Michigan* points. In the Matter of Application of BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc., for Provision of In-Region, InterLATA Services in Louisiana, Memorandum Opinion and Order CC Docket No. 98-121 (1998).

performance plan, and the lack of a pattern of discrimination—to conclude that the public interest requirement was satisfied.

Ameritech Michigan: Setting the Framework of the Public Interest Findings

In its 1997 *Ameritech Michigan* order rejecting the Bell Company's request, the FCC went to some lengths to outline the elements of a successful application. Even though the Ameritech application was deficient on the checklist items, the Commission nonetheless advised states and companies on the elements of the public interest standard.[10]

The Commission began its discussion with the philosophical structure guiding its approach. In rejecting several more narrowly defined theories offered by the parties that ranged from demonstrations of fully developed competition to the apparent effects on long distance competition,[11] it imported both its traditional approach to the public interest standard as developed by the application of other provisions in the communications statutes and the particular goals established by the 1996 Act.[12] Moreover, in rejecting the notion that checklist compliance alone would be sufficient to satisfy the Act, the Commission shifted the focus from the current condition of competition to the likelihood that markets would remain open into the future.[13] With this focus on traditional issues, the state of current competition, and the probable state of competition, the Commission then suggested several factors that it would consider relevant to the public interest analysis. It is

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[10] Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, as amended, To Provide In-Region, InterLATA Service)In Michigan, Memorandum Opinion and Order, CC Docket No. 97-137 (Fed. Comm. Comm'n Aug. 19, 1997) (hereinafter as *Ameritech Michigan*).

[11] Id. ¶¶ 382-390.

[12] Id. ¶ 385.

[13] Id. ¶ 390.

important to note, however, that no one factor is controlling; the Bell Company's success in one area could be offset by problems in another.[14] Further, the Commission's discussion was intended to be illustrative, not determinative. The Commission left open the possibility that other issues not discussed in its advisory opinion could affect the public interest analysis.[15]

The best evidence that the public interest was being served was evidence of real competition in the market. Robust competition in both residential and business segments of the market across various platforms and geographically dispersed through large and small scale operations was the apparent ideal.[16] On the other hand, the lack of competition would not be fatal to an application if the RBOC provided the means for other companies to access Bell services by providing an open arrangement (an apparent reference to a statement of generally available terms).[17]

Second, the Commission's forward-looking emphasis was further realized in its promotion of performance monitoring. It sought to encourage two results: compliance with access and interconnection standards and benchmarking RBOC wholesale performance.[18] It also noted the importance of a self-executing mechanism for enforcement of these plans so as to avoid costly and time-consuming litigation.[19] In a similar vein, the opinion encouraged reporting requirements, detailed performance standards, as well as a self-executing enforcement plan.[20]

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[14] Id. ¶ 391.

[15] Id. ¶ 398.

[16] Id. ¶ 391.

[17] Id. ¶ 392.

[18] Id. ¶ 393.

[19] Id. ¶ 394.

[20] Id. ¶ 399.

Third, the Commission noted several factors that might affect the current or future competitive environment that might be relevant. Some of these the RBOC might have some ability to affect. For example, the company might adopt optional payment plans for non-recurring charges.[21] Alternatively, it might be adversely impacted by a showing that it engaged in a pattern of discrimination or anticompetitive behavior.[22] Other factors such as state laws or regulatory decisions could also affect adversely the competition within a state and might be used to demonstrate that the lack of competition was not the result of Bell Company activities.[23]

Although the *Ameritech Michigan* decision established a reference for the public interest analysis and provided a strong indication of the direction the Commission would like to take, it did not have real effect because it was advisory. The actual test of the approach would arise once a company had successfully navigated the shoals of Track A, the competitive checklist, and the section 272 requirements. The New York Bell Atlantic application, followed by the Texas Southwestern Bell application, provided the next extensions.

BANY and SWBT: Testing the Framework

The public interest analysis the Commission used in the *Bell Atlantic New York* (*BANY*) and *Southwestern Bell of Texas* (*SWBT*) cases focused on three factors. First, the Commission placed an emphasis on a demonstration that the market is open for competition. Second, it looked favorably on a detailed performance assurance plan. Third, it reviewed the record for a pattern of discrimination. The focus of each of these

[21] Id. ¶ 395.

[22] Id. ¶ 397.

[23] Id. ¶ 396.

inquiries was whether the Commission believed that the competitive environment will remain open to competition following Section 271 approval.

Competition: The first factor that the Commission looked at was whether the market is open to competition. Both local and long distance competition were considered.[24] The Commission rejected a market test for competition. Further, it required some showing that the lack of competition in the local market was a function of the Bell company's behavior.[25] In the long distance market, the Commission did not need a demonstration that Bell entry would produce substantial additional benefits to consumers, relying instead on the belief that additional competition would enhance benefits as long as the local market is subject to entry.[26]

Monitoring and Enforcement: FCC analysis of performance monitoring was more detailed. The Commission stated that it encourages the use of performance monitoring and post-entry enforcement plans.[27] If this approach is used, the Commission reviews the plan for five elements.[28] First, a substantial amount must be placed at risk. In both *BANY* and *SWBT*, the amounts at risk were set at 36 percent of net revenues

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[24] Application of Bell Atlantic New York for Authorization under Section 271 of the Communications Act to Provide In-Region, InterLATA Service in the State of New York, Memorandum Opinion and Order, CC Docket No. 99-295 (Fed. Comm. Comm'n 1999) at ¶¶ 427 & 328 (hereinafter as *BANY*); Application of Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance Pursuant to Section 271 of the Communications Act to Provide In-Region, InterLATA Service in the State of Texas, Memorandum Opinion and Order, CC Docket No. 00-65 (Fed. Comm. Comm'n 2000) at ¶¶ 419 (hereinafter as *SWBT*).

[25] BANY ¶ 427.

[26] Id. ¶ 428.

[27] Id. ¶¶429 & 430; SWBT ¶ 420.

[28] BANY ¶ 433.

calculated from federal filings.[29] (As detailed elsewhere, the method of determining payments differs.)

The penalties, however, were not intended as a stand-alone method of preventing economic breach[30] on the part of the Bell Company. The Commission thus looked to its own enforcement authority, interconnection agreements, and other legal actions to assure that incentives were set to promote compliance with performance standards.[31] The Commission further noted that increasing the size of the penalties in critical areas was important, especially since the total was distributed among enforcement of several measures.[32]

Second, the penalties must be tied to effective performance measures. These measures should be well-defined and comprehensive. Further, there should be an opportunity to expand the measures as needed.[33]

Third, the plan should provide a detailed structure for enforcement.

Fourth, the remedies should be self-executing. Waivers should be narrowly defined and subject to time limits to avoid extended litigation and its related costs.[34] Further there should be the possibility of revision if it appears that the dispute resolution process is being abused.[35]

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[29] Id. ¶ 436; SWBT ¶ 424. In New York, this amount was subsequently increased to account for concerns arising after the approval of the Section 271 application. In Texas, the amount may vary from year to year, but a floor of $225 million is imposed on the penalty structure.

[30] Economic breach occurs when it is more economic to breach the agreement than to comply. For a discussion of the economic breach problem in contracts, see Richard A. Posner, Economic Analysis of Law 105-08 (3d ed. 1986).

[31] BANY ¶ 435.

[32] BANY ¶ 437; SWBT ¶ 422.

[33] BANY ¶¶ 438 & 439; SWBT ¶ 425.

[34] BANY ¶ 441; SWBT ¶ 427.

[35] SWBT ¶ 427.

Fifth, the plan should provide for data validation and auditing. In addition to audits done as part of operational support testing, the Commission encouraged initial audits as done in New York,[36] annual reviews as done in New York,[37] and methods for improving the process as noted in the *Texas* opinion.[38]

Pattern of Discrimination: The final factor the Commission reviewed as part of its public interest analysis was anything that might demonstrate that the Bell company will frustrate the introduction of competition once it has Section 271 approval. In this regard the FCC focused on whether a pattern of discrimination exists.[39] Individual instances without the demonstration of a pattern would not be sufficient. Moreover, the Commission rejected competitors' arguments that the process should be used to force the Bell Company to open existing contracts to competitors through a "fresh look."[40]

Summary

The FCC's analysis of the public interest requirement has a forward-looking focus. It measures competitive impact not by existing market share, but rather by looking at the ability of a new entrant to access needed facilities without interference from the incumbent. Evidence of robust competition might be useful to the applicant, but it is not necessary. A performance assurance plan is a useful adjunct to the public interest analysis if it can provide additional support that the incumbent has the proper incentives to continue

[36] BANY ¶ 442.

[37] Id.

[38] SWBT ¶ 428.

[39] BANY ¶ 444; SWBT 431.

[40] SWBT ¶ 433.

providing opportunities for entry. Finally, the analysis of other factors focuses on whether there are indications of incumbent behavior that establish a pattern of frustrating entry.

The focus on an effective performance plan presents an interesting challenge to state commissions. First, it is clear that the FCC is relying on state enforcement.[41] More importantly, the plan, as opposed to actual competition, may be the major indicator that the market will remain open. Finally, the very structure of the approved plans is significantly different from the basic, or historic, approach to monitoring markets used by state commissions. Thus, use of performance plans presents commissions with several novel problems, some of which are discussed in the next sections of this report.

[41] In the Matter of Joint Application by SBC Communications Inc. et al. For Provision of In-Region, InterLATA Services in Kansas and Oklahoma, Memorandum and Order, CC Docket No. 00217, ¶ 269 & n.828 (Jan. 22, 2001) ("These mechanisms are generally administered by state commissions and derive from authority the states have under state law or under the federal Act.).

Regulatory Structure: Moving to Self-Enforcing Plans

An explicit factor in the FCC's treatment of performance plans in its various orders is the notion that the plans be self-effecting. For regulators (and arguably the parties themselves), this notion may be somewhat foreign. Traditionally agencies have sought to impose their public policy analysis through rules and decisions requiring some sort of enforcement action by the agency to "right the wrong" if one is committed by a regulated entity. In the performance plans, however, a different conception is used. Instead of after-the-fact intervention, the agencies have approved plans establishing agreed-to payments to competitors and, in some cases, predetermined levels of fines to be paid to the state for substandard performance. This approach is materially different from either traditional or more political conceptions of the agency's role, but it appears to be an outgrowth of attempts to reconcile competing theories of those conceptions through various forms of self-regulation. As with any policy choice, however, it is a reconciliation that comes with some concerns that may mitigate its success.

The Administrative Law Problem and the Various Solutions

Expertise versus Accountability

Within the literature of administrative law, two themes have emerged to explain the agency role. One conception of the agency is that of "expert." In this role, the agency applies specialized experience and expertise to complex political problems, the solutions to which are not easily susceptible to tidy legislative solutions. The second conception is that of "political facilitator." In this role, the agency becomes a surrogate for the legislature by assuring that both the parties who are regulated and the intended beneficiaries have an open forum to express and argue their views. Inherent in administrative law is a tension between technical requirements of reasoned decision making and political demands within a democracy for participation and expression of popular will in the outcomes of that process.[42] Not surprisingly these alternative themes have strongly influenced the methods by which an agency accomplishes its tasks.

Traditional Model

The traditional model of an administrative agency focuses on its legal characteristics and its function as an expert. The traditional model resolves the tension between administrative discretion and political demands by defining the task of the agency within narrow statutory guides. Three principles are important. First, the action of the agency is benchmarked against its statutory authority, and actions outside that authority are not permissible. The statutory authorization defines the necessary accommodation. Second, the agency's procedures must be designed to assure that the agency complies with its substantive mandate. In this regard, basic due process rights assure that the agency does not interfere with personal or property rights unless supported by substantial evidence determined by an impartial factfinder, after a hearing, and based on a record. Finally, the process must afford an opportunity for judicial review as a final check on administrative discretion. Under this constrained model, the agency operates as "a mere transmission belt for implementing legislative directives in particular cases."[43]

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[42] See generally Bruce A. Ackerman et al., The Uncertain Search for Environmental Quality 1-3 (1974). Christopher Edley divides the problem into three issues: expertise, fairness, and politics. Christopher Edley, Jr., Administrative Law: Rethinking Judicial Control of Bureaucracy passim (1990).

[43] Richard B. Stewart, The Reformation of American Administrative Law, 88 Harv. L. Rev. 1667, 1675 (1975).

The policy underlying this model is the perception of the agency as an expert system.[44] As described by James Landis, the expert agency responds to a demand for institutions "to maintain a continuing concern with and control over the economic forces which affect the life of the community."[45] In place of the inexpert judge, the agency brings flexibility and expertise. The very narrowness of the assigned task assures professionalism. Indeed, this professionalism modifies and reduces the level of judicial review.[46]

This civics book explanation of agency activities retains some appeal. A recent book concerning the treatment of science by federal agencies began with a similar assertion of the agency's role as an expert in the governmental process.

> The modern administrative agency developed largely in response to the increased technological challenges posed by the twentieth century. In fact, agencies were largely created to deal with the technical details and complex technological and scientific aspects associated with the ever-expanding federal juggernaut, especially following 1932 and Franklin Roosevelt's "New Deal." They were staffed with experts who could understand the complexities necessary to the day-to-day implementation of laws that Congress did not have the expertise or institutional competence to handle.[47]

Notably, however, much of the activity that an agency must do is to meld that competence into policy, often in areas for which Congress and states have provided only the broadest

[44] Thomas K. McCraw, Prophets of Regulation 213-14 (1984).

[45] James M. Landis, The Administrative Process 8 (1938).

[46] Id. at 98-100 & 144.

[47] David L. Faigman, Legal Alchemy: The Use and Misuse of Science in the Law 153-54 (1999).

notions of guidance.[48] The alternative models of agency action make more explicit that political role.

Reform or Representational Model

An overtly political response to the traditional approach is suggested by the reform or representational model of agency action. Two important principles ground the reform representational model. First, the agency serves as a forum for affected parties to advance their views. Thus, the model assumes broad rights to initiate and intervene, to participate in hearings, and to appeal based on minimal standing requirements.[49] Second, it assumes that the agency will accommodate multiple views in its decision making process.[50] As Richard Stewart summarized the model, “[T]he problem of administrative procedure is to provide representation to all affected interests; the problem of substantive[51] policy is to reach equitable accommodations...; and the problem of judicial review is to ensure that agencies provide fair procedures for representation and reach fair accommodations.”

Counter-Reformation Model

Any good reformation foments a counter-reformation,[52] and this is true in the area of administrative law as well. The opening the administrative process in the 1960-70s

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[48] In his discussion of the complexities of policy development in several areas involving federal administrative agencies, for example, Faigman identifies the political element that often supercedes the technical one. His discussion details the conflicting roles that administrative agencies face in acting as experts and policy makers. Id. at 153-89.

[49] Stewart, supra note 43, at 1723-56.

[50] Id. at 1756-60.

[51] Id. at 1759.

[52] Jacques Barzun, From Dawn to Decadence 271-72 (2000).

provoked a response that sought to return administrative process to its "expertise" conception. Responding to perceived over-regulation and irrational policies in favor of classes of beneficiaries, the counter-reformation sought to reduce the influence of the regulated beneficiaries by closing standing requirements and to use greater judicial scrutiny to secure more reasoned decision making on the part of the agencies.[53]

The first, limits on standing before agencies, indirectly affected the influence that potential beneficiaries might have before the regulated entities.

> If one accepts the logic of the reformation, the move to restrict access to judicial review reduces the influence of regulatory beneficiaries. The reformation expanded standing to ensure that agencies paid attention to the arguments and data submitted by citizen groups. If an agency ignores this input, a judge could determine the agency had failed to take a "hard look" at the problem before it. When citizen groups can sue, they can use the threat of seeking review as leverage in bargaining with the agency (and with the regulated entities) concerning a regulatory outcome. To the extent that the courts now prevent such groups from suing, their influence is thereby diminished.[54]

The second, rationalization of decision making, is more direct. Rather than relying on the policy interpretations offered by various parties, agencies are directed to provide reasoned analysis of the benefits and risks of various policies and to do so in sufficient detail as to survive a hard look by the courts as to the fit of facts and policy choices.[55] These requirements tend to shift the focus of regulation to economists and risk analysts and increase the cost of adopting and supporting new regulations. While some have

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[53] Sidney A. Shapiro, Administrative Law after the Counter-Reformation: Restoring Faith in Pragmatic Government, 48 Kan. L. Rev. 689, 687 (2000).

[54] Id. at 720.

[55] Id. at 707-17.

sought to roll-back the counter-reformation by attacking its factual and political choices,[56] others have sought an alternative that seeks to avoid or reconcile the conflict between the choices of expertise and representation.

Reconciliation Model

The alternative of reconciliation is premised on the validity of claims from both camps in the prior struggle.

> On the one hand, [those seeking a third way] oppose a restoration because they accept many of the criticisms of regulation posed by the counter-reformation. On the other hand, they oppose the counter-reformation's procedural solutions because they recognize, along with the restoration, that these solutions can impede activist government favored by a majority of citizens.[57]

The solution then is to look outside the traditional litigation model for a model that will provide rational responses that are nonetheless responsive to political interests. The "reconciliationists" resolve this problem through various forms of cooperative efforts designed to provide rational and necessary regulation.[58] Collaborative processes, negotiated rule making, and various forms of self-regulation are the means of carrying out those goals.

Alternative Self-Governance Regimes

If one accepts the notion that self-regulation may be a potential approach to the governance question for a problem, the next issue is to determine the appropriate flavor of the approach to use. The range of choices is significant.

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[56] Id. at 721-28.

[57] Id. at 728.

[58] Id. at 731.

Using several factors to identify different approaches, Margot Priest has identified five models.[59]

> **Codes of Conduct**: Parties agree to adopt certain behaviors voluntarily and with little or no government supervision.
>
> **Statutory Self-Regulation**: Authority is delegated to the industry to develop industry regulation. The legislature often provides for some form of reporting and other forms of accountability such as public board membership.
>
> **Firm-Defined Regulation**: A firm is required by legislation or rule to adopt firm-specific procedures to regulate itself. Public involvement may vary, but government provides some monitoring of the company's efforts.
>
> **Supervised Self-Regulation**: The government establishes an oversight body that supervises self-regulation. The government body remains responsible for the supervision and provides adjudicative functions.
>
> **Regulatory Self-Management**: While the government sets the rules for the firm or industry, the latter is responsible for the implementation of the program.

As opposed to other methods of regulation, there are advantages and disadvantages to the use of self-regulation. On the one hand, it may be a practical way to extend the states' resources; politically it is attractive since it affords an opportunity to government to impose regulation with most of the costs borne by the regulated parties.[60]

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[59] Margot Priest, The Privatization of Regulation: Five Models of Self-Regulation, 29 Ottawa L. Rev. 233 (1997). Her work is summarized in Figure 1.

[60] Id. at 268-69.

	Example	Govt Involvmnt	Source of Power	Public Involvmt	Account-ability to Govt	Rule Making	Adjudicatn	Sanctions	Offenses	Coverage	Judicial Review
Codes of Conduct	GAP Sourcing Guidelines	None	Contract	Low	Usually none	Consensual	Usually none	None	None	Voluntary	No
Statutory Self-Reg	Bar Associatn	Govt creation	Legislative delegation	Varies	Annual reports	Internal	Internal	Fines	Usually internal	May be compulsory	Yes
Firm-Defined Reg	Clean Water Act	Govt creation	Legislation and employee contracts	Limited	Govt and firm monitoring	Firm level rules	Made at the firm level	May escalate to fines	Legal	Legislation defines; Rules tailored to firm	Yes
Supervised Self-Reg	Stock Exchange Broker Rules	Govt creation	Oversight body	Public member-ship	Annual report and monitoring	Internal	Through agency to courts	May escalate to fines	Internal and legal	Company and Regulatory	Yes
Regulatory Self-Mgmt	Canadian Auto Dealer Rules	Govt creation	Legislative delegation	None	Govt monitors performance and conduct	Govt initiated	Internal dispute resolution	Internal	Govt states; org. may enforce	Covered companies	No

Figure 1. Alternative models of self regulation. (Source: Margot Priest, "The Privatization of Regulation: Five Models of Self-Regulation," 29 Ottawa L. Rev. 233 (1997).

Further it allows greater flexibility and avoids the potentially slower political processes.[61] On the other hand, these approaches are susceptible to challenges that they constitute a facade of regulation and are prone to cronyism.[62] These claims in turn could lead to charges of under-regulation and reduced accountability.[63] Point of view thus becomes critical.

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[61] Id. at 269.

[62] Id. at 271-72.

[63] Id. at 272-73.

> Take a factor such as costs. The reduced cost to government of self-regulation may be an advantage to politicians and general taxpayers; it may not be an advantage to bureaucrats who wish to increase their ambit of influence. Reducing government costs may increase costs to industry and may disproportionately affect a segment of the industry based on size, product, region or other factors. The cost of regulation may be passed on to consumers, which may also disproportionally affect certain classes of consumers.[64]

Whose ox is getting gored obviously will be important.

Priest also notes the importance of related factors to the success of a self-government effort. She notes that changes in liability rules, the imposition of duties of care to conform to rules, peer pressure, rewards, and a wide range of sanctions can serve to enhance the effectiveness of self-regulation.[65] Notably, most of these require some sort of legislative or judicial assistance. That assistance ironically appears inconsistent with the intention of all companies to self enforce.

Self Regulation

As Priest has noted, there are a variety of models of self- or limited regulation from which to choose. They range from a completely voluntary model represented by codes of conduct to the significantly defined models of regulatory self management. The approaches taken by both New York and Texas to performance plans for their incumbent Bell Companies fall basically into the model of self-regulation set out by Ayers and Braithwaite.[66]

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[64] Id. at 274.

[65] Id. at 293-95.

[66] Ian Ayers and John Braithwaite, Responsive Regulation (1992). See Appendices 1 and 2 for versions of the New York and Texas plans. Due to the dynamic nature of these plans, some features may

(continued...)

First, the plans rely on *company-specific rules*. Rather than industry wide rules, the approach is to devise rules specific to the individual company.

Second, there is *government approval of the company specific rules*. Each state went through an extended process of collaboration followed by state commission endorsement of the rules operating within the plans.

Third, *enforcement costs are internalized*. In each situation, the company is responsible for monitoring and distributing the results of the monitoring. Further, the plans are self-executing; thus, each company is responsible for reviewing and enforcing its own plan.

Fourth, *the plans contain provisions for outside observation*. In each case, the incumbent must make the data available to its wholesale customers and to the regulator.

Fifth, *there is a process for auditing the results*. In New York, for example, this process was further enhanced by replication of the data by the state regulator.

Finally, there are provisions for *enforceable sanctions*. Indeed, the whole plan in each state is built around the notion that there are predictable sanctions for less than acceptable performance. Moreover, the FCC retained the authority to challenge the ability of the companies to use the relief from the interLATA restriction if performance deteriorated to unacceptable levels.

Strengths and Weaknesses of Supervised Self-Regulation

As with any policy approach, there are debatable strengths and weaknesses to the move toward supervised self-regulation. Strengths arise out of the match of facts and incentives. Weaknesses are apparent in the potential for capture and evasion. Together they make a case for careful study as these practical policy experiments move forward.

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[66] (...continued)
have changed since the author received these versions.

In the view of Ayers and Braithwaite, the strengths of self-regulation are derived from its flexibility and alignment of goals and incentives. Rules are designed for the company, and the plans can be designed to be flexible and responsive to changes in the business environment. Likewise, the plans can be made comprehensive with respect to the particular companies to which they are addressed. Incentives are improved since the company must internalize enforcement and monitoring costs, and the regulated entity may set as its goal the successful implementation and performance of the plan (in lieu of its evasion of governmentally-imposed requirements).

That said, the approach is not a panacea for all that ails the traditional regulatory approach. First, it results in an increased number of regulatory "rules." Each company has its own set, and different interpretations may develop. The efficiency of monitoring is likely affected as well since the data collection and interpretation are made more remote. Of more general concern is the possibility of co-optation and evasion. With greater day-to-day cooperation expected, there is likely to be at least the perception that the regulated entity has too much control over the information and processes, a perception that will be shared by competitors and the public under the right conditions. Further, other similarly situated companies that are faced with different rules are likely to complain that enforcement standards that are relatively weaker or stronger lead to favoritism toward the company facing the less stringent requirements. While there are methods to mitigate these concerns, none is likely to be totally successful in removing all perceptions of problems.

At a more basic level, there are also concerns with jurisdictional authority to use an approach based on self-regulation. These problems arise in a couple of ways. First, there are procedural constraints that may prove problematic. For example, the process for negotiating an agreement and enforcing it may give rise to ex parte concerns as staff and commissioners are called upon to negotiate and agree to the appropriate standards in a non-traditional process.[67] Second, there may be significant enforcement problems as commissions may not have the basic subject matter and monetary authority to enforce the resulting plans. As long as the plans remain voluntary, this latter problem is mitigated, but a challenge might prove fatal.

Finally, there is the question of incentives. Ayers and Braithwaite provide a sobering critique of their invention:

> A voluntary program will stop many violations that cost the company money and others that are cost neutral; it will even halt some violations that benefit the company financially in the short term, for the sake of the long-term benefit of fostering employee commitment to compliance. Recommendations that involve consequences beyond the cost neutral or short-term, however, commonly will be ignored.[68]

The role of proper design and implementation, the continuing role of government involvement, and the ability to revert to traditional forms of regulation thus all become relevant inquiries.

Looking Forward

There is increasing pressure from many quarters for state commissions to devise more effective regulatory approaches to market activities. Some is driven from the federal reliance on the states to assure that the implementation of the Act is effective. Some of this pressure results from the regulated companies, and particularly the competitors which face the need for more timely responses to critical problems. Whether the self-regulation approaches devised to address these concerns will be successful is an empirical and policy question that only time will answer.

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[67] Some states have concluded that state section 271 reviews are not contested proceedings subject to *ex parte* rules. U S WEST Comm. v Montana Dept. of Pub. Serv. Regulation, Case No. BVD 99-12 (Mt. 1st Jud. Dist. Ct. Mar. 12, 1999).

[68] Ayers and Braithwaite, supra note 66, at 106.

Performance Measurements

Performance measurements are at the center of any effective performance plan used to govern the behavior of the dominant carrier. The measurements serve as the metric for assuring that the incumbent provides wholesale service to the new entrants under sections 251 and 252 of the Act in a non-discriminatory manner. In this aspect, the measures take on the nature of service quality measures; thus, the literature on service quality is helpful in that it points to traditional factors that are important to the party that takes the service. Getting to an effective set of measures, however, requires more than an understanding of the end user's needs. Additionally, care must be taken to describe, implement, and update those measures.[69] Thus, the necessary use of performance measures implies a significant regulatory commitment until such time as the performance plan becomes unnecessary.

The Objectives of Performance Measurements

In the context of the post-section 271 performance plans, the effort is to assess the continuing compliance of the incumbent with the requirements of sections 251 and 252 for the provision of services to the entrants. Under those sections, the incumbent is required to provide non-discriminatory service. As the FCC has detailed this requirement, the incumbent must provide service either in parity with the same services that the incumbent provides to itself or in such a manner as to provide a competitor a meaningful opportunity to compete in those instances in which the provision of the service to the entrant does not

[69] A separate and very important issue is the statistical approach to measuring non-discrimination. For purposes of this report, however, it is assumed that the parties have a method for effectively making that determination.

have an analogue in the retail service.[70] Although the FCC has provided substantial input on what these performance standards should consider,[71] it left to the states the critical role of determining performance measure definitions and expectations as to parity requirements or benchmarks for those measures for which parity was not appropriate. These efforts appear to require the states to address several issues: scope and definition; data collection; and data assessment.

Scope and Definition

Performance measurements in the context of performance plans focus on the needs of the end user. In this sense they are similar to the quality of service requirements commissions are familiar with in the retail area. "Quality of service measurements help the telecommunications service or network provider to gauge customers' perceptions of service."[72] In the retail area, the goal is to identify those areas of customer concerns and determine whether the monopoly provider is serving those interests appropriately.[73] Because there is no market check on the provision of service by a monopoly provider to its wholesale customers, clearly there is an incentive to degrade the wholesale provision of service since degradation increases the costs of the retail competitor.[74] The competitors

[70] Frank P. Darr, Third Party Testing of Operational Support Systems: Background and Related Materials 3-8 (1999).

[71] The FCC Notice of Proposed Rulemaking provided some guidance on the various factors that the Commission thought were important, but the proceeding ultimately did not result in rules. In the Matter of Perfomrance Measurements and Reporting Requirements for Operations Support Systems, Interconnection and Operator Services and Directory Services, Notice of Proposed Rulemaking, CC Docket No. 98-56 (Apr. 17, 1998). The FCC has detailed the requirements further in the various section 271 orders.

[72] Martin P. Clark, Networks and Telecommunications 636 (2d ed. 1997).

[73] See Vivian Witkind Davis et al., Telecommunications Service Quality (1996).

[74] Cite to NRRI report; my dominance report. Peter Drucker makes a similar point on the need for performance measurement within the organization as a basis for checking behavior in situations in which

(continued...)

themselves have tried to capture this relationship between quality of service and the user experience in the preamble to their proposal for performance standards:

> A measurement plan, capable of monitoring for discriminatory behavior, must incorporate at least the following characteristics: 1) it permits direct comparisons of the CLEC [Competitive Local Exchange Company] and CLEC industry experience to data of the ILEC [Incumbent Local Exchange Company] through recognized statistical procedures; 2) it accounts for potential performance variations due to differences in service and activity mix; 3) it measures not only retail services but experiences with UNEs and OSS interfaces; and 4) it produces results which demonstrate that non-discriminatory access to OSS functionality is being delivered across all interfaces in a broad range of resold services, unbundled elements and interconnection capabilities.[75]

This statement seems to be largely consistent with the notion that it is the quality of service provided to the end user that the performance measures are intended to address.

In general, three aspects of the customer experience are important: speed of response; accuracy of response; and dependability.[76] These elements then must be applied to the various components of the wholesale experience.

- Customer service focuses on the helpfulness of the incumbent's staff in providing timely and accurate responses.

- Service availability focuses on access to critical systems such as gateway availability.

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[74] (...continued)
market sanctions do not work. Peter F. Drucker, Management: Tasks, Responsibilities, Practices 158 (1973).

[75] Local Competition Users Group, Service Quality Measurements (ver. 7.0) 3-4 (Aug. 28, 1998).

[76] Katherine Brown, Performance Measurements: Improving a Valuable Tool, Speech to Qwest Regional Oversight Committee (Apr. 3, 2000) at 3-4; Clark, supra note 72, at 640.

- Measures concerning the provisioning and alteration of service focus on the incumbent's timely response to orders.
- Service reliability focuses on the availability of services once they are installed.
- Other quality measures focus on the availability and quality of the services provided and the timeliness and accuracy of billing.[77]

The goal is to focus on the end user's desired outcomes.[78]

These measures do not dictate to the incumbent how the measures are to be met. In this regard, performance measures are not internal controls. An internal control system, as its name suggests, identifies those factors that are important to the company in defining its effort at providing service. In this sense, internal controls provide internal focus, direction, and common understanding.[79] Internal controls obviously share some common features with performance plans, however, and thus may be useful as an analogy. For example, both are forms of bureaucratic rather than market control.[80] Similarly, they both rely on defined measuring processes, detailed collection of information, reporting, and accountability.[81] Two distinctions are important. First, performance measures look at the customer experience compared to that provided by the incumbent to itself; internal controls are self-imposed. Second, they are artifacts created because the law requires non-discriminatory service; internal controls reflect business needs of the company to satisfy its various political and economic constituencies.

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[77] Id. at 642-46.

[78] Harry P. Hatry, Performance Measurement 17-18 (1999). Hatry states, "Quality indicates how well a service was delivered, based on characteristics important to customers." Id. at 17. He identifies a similar set of actors: timeliness, convenience, accuracy, condition and safety of facilities, customer satisfaction with a particular item, customer satisfaction with overall service. Id.

[79] Richard Y. Chang and Paul DeYoung, Measuring Organizational Improvement 6-7 (1995).

[80] Charles W. L. Hill and Gareth R. Jones, Strategic Management 357 (2d ed. 1992).

[81] Chang and DeYoung, supra note 79, at 8-11.

Design and Selection of Measures

The design of performance measures occurs within the context of a particular system. Thus, the starting point requires a review of inputs, outputs, desired outcomes, and overall productivity.[82] One method of identifying the various elements is to prepare a causal model.[83] From this model, the evaluator will determine the relevant criteria for measurement. These criteria might include relevance to objectives, importance, simplicity, ability and cost to collect the relevant data, uniqueness of indicator, and comprehensiveness.[84]

In selecting particular indicators, several concepts are important. First, "[o]utcomes are not the same as indicators. Each outcome to be tracked must be translated into one or more outcome indicators."[85] Second, care must be taken in providing specific wording; reliance on area experts is often necessary.[86] Third, the data may define what can be measured, and the measure therefore should properly reflect that limitation.[87] Fourth, data should be collected at an appropriate level of disaggregation.[88] This idea is particularly important in the area of telecommunications if the delivery of multiple products might obscure differences among those products. Fifth, measurements need not be quantitative. Some aspects of the business may not be susceptible to measurement. In those cases,

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[82] Hatry, supra note 78, Ch. 2.

[83] Id. at 23.

[84] Id. at 58.

[85] Id. at 56. For example, the desired outcome may be timely provisioning of order confirmations. Indicators might include a statement of the acceptable interval in terms of minutes, hours, or days.

[86] Id.

[87] Id.

[88] Id. at 103-04.

some effort should be made to consider qualitative factors.[89] Finally, the measures need to focus on what is really important.

> A major potential criticism of performance measurement systems is that they focus attention on the indicators being measured. If important outcome characteristics are neglected, this can lead to misallocation of a program's resources and effort. The system needs to include a comprehensive set of indicators. This includes indicators that track undesirable outcomes.[90]

The old saying that managers manage what is measured brings out the essence of this concern and applies equally well in the regulatory context.

The translation of these criteria results in a comprehensive set of measures that address availability, timeliness, and quality of the wholesale transaction. The breadth of these factors is demonstrated in the various approaches such as those suggested by the FCC,[91] and those that have been tested or implemented.[92]

Assessing the Results of Performance Measurement[93]

The Department of Justice in its section 271 reviews has set out three basic and understandable criteria for assessing the results of performance measurement. First, the

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[89] Id. at 65-69. In those cases in which quantitative data are not available, it may be appropriate to substitute qualitative reports. "Programs should provide as much evidence as possible to backup qualitative statements." Id. at 69-70.

[90] Id. at 57.

[91] Notice of Proposed Rulemaking, supra note 71.

[92] The Appendix contains performance measures adopted in New York, Texas, and the Qwest region.

[93] For a more general discussion that expands on the criteria suggested by the Department of Justice in section 271 cases, see Hatry, supra note 78, at 223.

results should be meaningful.[94] This criterion is logically related to the suggestion above that the results should reflect what is important to the objective.

Second, the measurements should be accurate.[95] This notion may seem obvious, but it is important to remember that the collection of this information presents some significant problems for the incumbent. Apart from the incentives to overstate the success of competitors' experiences, there is the very real physical problem of converting systems to do things they were not designed to do. Audits of the performance measures, therefore, are appropriate.[96]

Third, the results should be reproducible. "Such controls permit ongoing audits and data reconciliation between the BOC and the CLEC [competitive local exchange company] and other appropriate parties, which is a critical check on the entire performance measures process."[97] As noted in a following part of this report, a performance plan might provide for just such auditing and data replication.[98] These checks are necessary to assure the continued integrity of the data and the collection process.[99] This assessment will not and should not be an attempt to assure perfection in the system. "It is important for the assessment process to respect the fact that no performance measurement system is–or ever will be– perfect. The most important question is whether the performance data are sufficiently complete, accurate, and

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[94] Brown, supra note 76, at 4-7.

[95] Id. at 8.

[96] In a related context, Hatry has suggested that care should be taken in the use of new measures in setting benchmarks for performance. Hatry, supra note 78, at 128. Competitors may raise a similar concern: to the extent that the information being collected is new to all parties, setting performance benchmarks without some experience may be risky. The benchmark may be set too low, slowing entry, or too high, generating unwarranted payments.

[97] Brown, supra note 76, at 9.

[98] See text accompanying notes 133-143 infra.

[99] Hatry, supra note 78, at 226.

consistent to document performance and support decision-making at various organizational levels. If the answer to this is positive, the system can be considered adequate."[100]

[100] Id. at 228.

Damages and Fines for Discriminatory Performance

As noted above, embedded in the performance plans are performance expectations in the form of performance measures. If the goals are not met, both the public and the wholesale customers fail to receive the expected benefits. Thus, the performance plan should provide incentives and disincentives designed to encourage the fulfilment of customer and public expectations. Policy implementation, however, can take many paths.

Damages and penalties fall into a broad category of concerns raised by policy implementation. Damages remedies traditionally have sought to compensate the injured party. Penalties, on the other hand, may have several goals including overall justice and deterrence. A deeper view of the regulatory goals, however, is needed to understand how damages and penalties can be used as part of a more complicated structure to encourage and support the goals of a performance plan.

Plan Penalty Structures[101]

The complexity of the narrower question of identifying appropriate remedies is suggested by a review of the New York and Texas performance plans. While they both contemplate payments to injured competitors, Texas also recognizes payments to the states for aggravated situations. Further, they take different approaches in developing payments to the competitors. These approaches begin to highlight the differences in outcomes generated by plan elements based on damages versus those using a more punitive approach to checking sub-standard performance.

[101] The New York Plan is attached as Appendix 1. The Texas Plan is attached as Appendix 2.

New York Plan

The New York plan provides predefined remedies addressing several different concerns. These include methods of entry remedies to address problems that occur across an entry approach, critical measures which apply specific penalties to identified measures thought particularly important to competition, and several specialized remedies to deal with particular interests.

The method of entry remedies identify four typical entry strategies and provide for penalties if the weighted quality of service is substandard. The categories are unbundled network elements, resale, interconnection, and collocation. An annual cap of $75 million in bill credits is provided. The cap is divided among the four categories based on relative importance, and up to one-twelfth of each portion is payable each month.

To determine if payment is due, a complicated process is used. First, each measure in a particular method of entry is assigned a value of 0, -1, or -2. The values are assigned by either looking at the deviation from parity, using a calculation of permutation values that are converted to equivalents for Z scores, or through either absolute values or a table for absolute standards when the number of observations is less than 20. Scores for each measure are then weighted for relative importance. The weighted average of these scores within a method of entry is then compared against a table that contains a minimum and maximum value and the allocation of the amount assigned to the method of entry is determined. CLECs receive credits based on relative purchase share (market share) of various components of the entry strategies.

Twelve critical measures receive special treatment under the plan because of their importance to competitors. Up to $75 million is allocated for these critical measures. Measuring substandard performance is done the same way as that provided for methods of entry measures. If more than one measure is included then the submeasures are weighted using the weights from the methods of entry. Payments can occur in two situations. First, those CLECs receiving substandard performance receive bill credits if the aggregate score is -1 or lower for a measure. Second, if a CLEC receives substandard performance for two months, the CLEC receives a credit even if the aggregate score for the measure is greater than -1.

The plan contains several measures that are described called Special Provisions. These are all relatively straightforward and deal with remedies for failures in flow through performance, non-flow through performance, hot cuts, and order management. The plan allocates $58 million for these measures.

Texas Plan

The Texas plan provides for two different types of payments. Tier 1 damages are paid to individual CLECs receiving substandard performance. Tier 2 assessments are payments to the state for continued poor performance. Each measure within a tier is assigned a relative level of importance and is treated as a high, medium or low violation, and a penalty is calculated on that basis.

Damages are paid on an occurrence basis. The number of occurrences are adjusted to balance Type 1 statistical errors. A table sets out the amount of damages to be assigned for per occurrence and per measure.

Tier 1*:* Several steps are used to calculate a CLECs damages. An appropriate statistical test (Z, modified Z, permutation or benchmark) is used to determine the out of compliance data points. The performance measures that are not in compliance are ranked by high, medium, and low importance, and within each grouping by the number of data points. Then a table is used to remove items, starting with the low importance items. (This step is used to limit the effect of Type 1 statistical errors.) The remaining items are multiplied by the damage amount.

Tier 2*:* Assessments are calculated in basically the same manner as is used for Tier 1 but are based on three consecutive months of data that show non-compliance. Payments are set by a second table and are paid to the state.

For a couple of items there is a general assessment to which the cap does not apply. These are for late and incomplete reports. Additionally late payments to the CLECs carry interest at the state's highest legal rate.

The plan contains some amendments that permit a damages calculation without reductions for randomness. These calculations are applied to unbundled network elements, digital subscriber line, collocation, and trunk blockage and installation.

The Texas plan also makes clear that the provisions paid to the CLECs are intended as liquidated damages. By its terms, the plan provides that the payments are to be treated as liquidated damages because the amounts of actual damages are difficult of calculation.

Alternative Rationales for Remedies

The plans' penalty provisions demonstrate alternative goals. On the one hand, the Tier 1 payments in Texas and the base structure of New York (which makes all payments to the CLECs) suggest that the plans have a compensatory goal. To the extent that CLECs are damaged by substandard performance by the ILEC, the incumbent will pay compensation in the form of liquidated damages. On the other hand, there appears to be a more punitive aspect of the performance plans as well. In particular, the Tier 2 remedy in Texas (which provides for payments to the state) indicates an attempt at punishment rather than compensation. It is the public that recovers. The designs of the two plans suggest more complexity than the simple formula suggested by the FCC's threshold for approving the plans that stresses deterrence. Thus, a better understanding of these plans is tied to the policies underlying compensation and damages as means to secure desired outcomes.

Private Remedies: Damages

As a general statement, the goal of damages is compensation. "The stated goal of the damages remedy is compensation of the plaintiff for legally recognized losses."[102] Compensation seeks to place the injured party in a position it would have been in but for the injury. Particularly in the case of contracts, the goal is to allow the injured party to recover its expected benefit of the bargain. This benefit may be measured in several ways such as the difference in what is promised and what is received, the value of the product not received, or the lost profits.[103]

The parties may also set the expectations for damages as a part of their agreement. This agreement can include a determination of the amount of damages that might be paid. Referred to as liquidated damages, this provision may be either a set figure for a breach or a formula.[104] Often (as suggested by the Texas' plan's provision for damages), the parties agree that the amount of damages is difficult to determine and use liquidated damages as a means to reduce the transactions costs of establishing the actual loss.[105] On the other hand, a liquidated damages remedy need not be exclusive.[106]

One critical limitation constrains the potentially oppressive use of liquidated damages. Given the relative bargaining power of parties in nearly any transaction, it is likely that a strong buyer or seller could insert a liquidated damages provision that exceeds

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[102] Dan B. Dobbs, Law of Remedies 210 (2d ed. 1993). Similarly, Fischer states, "The common practice is to award a sum of money to compensate the plaintiff for the 'damages' sustained." James M. Fischer, Understanding Remedies 5 (1999).

[103] The Uniform Commercial Code contains an organized discussion of remedies that reflects these concepts. See UCC §§ 2-703 to 2-718. The courts are directed to use the remedy that best matches the situation so as to satisfy the expectations of the injured party. UCC § 2-703, comment 1. Nearly all states have adopted these provisions to govern contracts for the sale of goods.

[104] Dobbs, supra note 102, at 812.

[105] Id. at 812-13.

[106] Fischer, supra note 102, at 758-59.

the expected loss from non-performance. The courts in their application of contract remedies, however, have long sought to avoid the assessment of penalties; the modern economic rationale for this approach is to avoid wasteful investment in attempts to avoid breach.[107] This policy of avoiding penalties has carried into the assessment of liquidated damages provisions.[108]

Private Remedies: Punitive Damages

The suggestion of penalties raises the possibility of punitive damages as a constraint on behavior as well. Punitive damages are awarded to an injured party if the conduct of the injuring party exhibited serious misconduct, malice, or reckless disregard of the interests of others.[109] Unlike compensatory damages, punitive damages when awarded to a private plaintiff seek to further an alternative goal such as punishment or deterrence.[110] For example, a court may issue a punitive damages award as a means of exacting justice in a particular case.[111] Alternatively, the goal may be to deter behavior by eliminating all profit from the activity. In an individual tort case involving a defective product, for example, a court may award punitive damages to extract the profits that would otherwise be earned because only a fraction of similarly injured parties seeks recovery.[112]

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[107] Id. at 752.

[108] Id.; Dobbs, supra note 102, at 812.

[109] Dobbs, supra note 102, at 311-12. See, generally, Fischer, supra note 102, at 694-718.

[110] Dobbs, supra note 102, at 311-12.

[111] Id. at 318-22.

[112] Id. at 322-24.

Recent Supreme Court decisions provide a constitutional check on punitive damages. In assessing punitive damages, courts and juries must be guided by stated criteria. Thus, the assessment must include a review of the defendant's conduct, the ratio of the compensatory damages to the punitive damages, and the difference between the damages and comparable civil penalties. Failure to satisfy these requirements may violate due process rights.[113]

Public Remedies: Fines and Other Sanctions

An alternative to private remedies is a public check on behavior in the form of incentives or fines or other civil or criminal sanctions. Although government may seek to provide incentives for behavior that it would like to encourage, it is likely to fine that behavior it seeks to limit. When government does seek to penalize behavior, two issues are likely to arise.[114] First, government needs to determine if the penalty is effective in producing the desired results. Second, it must determine if the penalty is just or fair. Proper remedies need to satisfy both criteria.

Government works through more than sanctions to achieve publicly desired outcomes. Information, facilitation through the removal of barriers, incentives, and penalties all play a role in government's attempts to direct private behavior.[115] When government attempts to constrain behavior, moreover, it may either set a price for

[113] BMW of North America v. Gore, 517 U.S. 559 (1996). The Court anticipated the result in *Gore* in Pacific Mutual Life Ins. Co. v. Haslip, 499 U.S. 1 (1991).

[114] John Brigham and Don W. Brown, Introduction, in Policy Implementation: Penalties or Incentives 9 (John Brigham and Don W. Brown, eds. 1980).

[115] George I. Balch, The Stick, the Carrot, and other Strategies, in Policy Implementation: Penalties or Incentives 44-46 (John Brigham and Don W. Brown, eds. 1980).

undertaking that behavior (e.g., the purchase of pollution credits) or sanction it more directly through fines, the loss of benefits, or imprisonment.[116]

The complexity of the existing plans thus reflect the differences in goals. Private remedies such as damages seek to right the relationship or expectations between the affected parties. Penalties, either public or private, seek to express community opinions about the behavior and to constrain it through removing the benefit of the non-compliant behavior. There is no economic breach if the awards are set properly.

Remedy Plans as One Element of a Larger Solution for Performance

The use of damages or penalties, however, must be considered as part of a larger picture. The issues of effectiveness and fairness themselves present a question about both the damages and penalties in a narrow context and how they fit into the set of commission activities that might be used to direct the incumbent's behavior.

The narrow question raises the issue of effectiveness and fairness of the remedies themselves. Whether a performance plan's provisions for fines are effective might first be assessed from an economic perspective. This relatively narrow approach would measure if the fines are set at sufficiently high level so that the gains from improper behavior are removed. In such an approach, one would attempt to measure the potential gains and set the fine so that the fine is greater than the expected benefits from the malfeasance.[117] The fine would be set so that it captured the costs of the criminal act and the probability of punishment. Thus, if the expected benefit of a violation were $5 and the probability of

[116] Robert Cooter, Prices and Sanctions, 84 Colum. L. Rev. 1523 (1984).

[117] Richard Posner, The Economic Analysis of the Law 205-206 (1986).

enforcement near one hundred percent, a fine of $5 should deter the behavior. As the probability of detection and punishment decreased, the necessary fine would increase.[118]

This economic model is subject to several limitations. First, it may be nearly impossible to assess the level of benefits caused by illegal behavior. In the context of telecommunications, for example, failure to maintain systems as required by the Act might result in both immediate and significantly delayed injuries such as customer reluctance due to neighbors' poor experiences. The delayed injuries, remote in time, may nonetheless, delay the entry benefits sought through the Act.

Second, the model suggests a nearly infinite level of penalties for violations that are difficult to detect. Practically, setting fines too high may result in wasteful efforts directed at either avoiding the possibility of a large fine or hiding the behavior.[119]

Third, the real question may not be the effectiveness of the particular measure, but its relative effectiveness when compared to alternative approaches. Government may adopt alternative regulatory strategies that are tied to the type of problem.[120] For example, government might provide tax breaks and research and development support for infrastructure to CLECs as an alternative to opening the incumbent's systems through the carrots and sticks of the Act. The choice between the two regulatory approaches would present a more accurate determination of effectiveness than simply assessing whether the threat of a fine or other sanction motivated the desired behavior.

Fourth, the use of the model fails to account for the common understanding that more than fines direct behavior. Company managers are sensitive to their good reputations. Many are sensitive to their social responsibility. Thus, the rule itself may lead

[118] Id. at 207.

[119] Id. for a similar argument. See, also, Ayers and Braithwaite, supra note 66, at 25.

[120] Balch, supra note 115, at 44-46.

to the desired behavior.[121] As a former Internal Revenue Service commissioner noted, "If a person is an economic being and figures the odds, then there is every incentive to cheat. That is, of course, putting aside honor, duty and patriotism."[122]

This notion of alternative rationales for compliance fits nicely with the second issue of whether the penalty is fair. The economic assessment questions only effectiveness: too small a fine and it is ineffective in deterring the undesired conduct; too high a fine and it provokes wasteful behavior in either compliance costs or costs of evasion. A political assessment must also be made, one that is not encompassed in the economic one. That assessment rests on a determination that the behavior sought to be restrained is deserving of punishment, that it is wrong or unjust.[123] "[V]iewing coercion versus noncoercion as only alternative techniques obscures the moral and ethical dimension of human affairs and the role of rule making and punishment as important sources of a moral consciousness, something that the 'ethics' of economic transactions cannot provide."[124] In making that assessment, then, government is making a moral judgment. Punishment is social restitution.[125]

The Larger Enforcement Issue and a Tiered Approach to Enforcement

The broader question, however, is whether the use of damages and penalties is a complete solution in itself. From the perspective of policy development, a range of tools is available. Incentives to encourage desired behavior and disincentives to discourage

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[121] Ayers and Braithwaite, supra note 66, at 22.

[122] Wall St. J., Apr. 10, 1984.

[123] Max Neiman, The Virtues of Heavy-Handedness in Government, in Policy Implementation: Penalties or Incentives 26 (John Brigham and Don W. Brown, eds. 1980).

[124] Id. at 33.

[125] Brigham and Brown, supra note 114, at 13.

certain behavior are both relevant. Moreover, they may be in keeping with the more complicated motivations of the corporate actors than is suggested by a model built only on disincentives.

In section 271 and its implementation, examples of both the carrot and the stick are evident. On the one hand, section 271 is a form of carrot: an RBOC is permitted to enter the interLATA business if it demonstrates compliance with the section's requirements to make its infrastructure available to competitors, to establish sufficient separations between competitive and non-competitive businesses, and to demonstrate compliance with the public interest. The stick, on the other hand, is contained both in section 271's explicit terms that permit a termination of the section 271 approval if the requirements are violated and the lesser threats contained in the performance plans such as that of Texas that provides for fines paid to the state treasury if the company grossly misses performance requirements.

In their study of self-regulation, Ayers and Braithwaite also suggest the need to look beyond economic rationality to better understand the approaches regulators can use to encourage desired results. Economic rationality can explain some behavior, but it is incomplete in measuring the motivations of various actors subject to regulation.[126] Based on fieldwork and other efforts that Ayers and Braithwaite summarize, they believe that there is also a strong element of social responsibility guiding corporate actors that operates in parallel with strong economic motivations.[127] As a result, a mixed set of regulatory strategies is needed.

> [B]usiness actors exploit a strategy of persuasion and self-regulation when they are motivated by economic rationality. But a strategy

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[126] Posner and other law and economics scholars have argued that the measure of a theory is not necessarily the realism of its assumptions but rather its ability to explain or predict outcomes. Posner, supra note 117, at 206. Presumably, if the realism of its assumptions is improved, the predictive power of the theory should, although not necessarily, improve as well.

[127] Ayers and Braithwaite, supra note 66, at 24.

> based mostly on punishment will undermine the good will of actors when they are motivated by a sense of responsibility. This will be true of any version of responsibility that is construed by actors as a more noble calling than making money. When actors see themselves as pursuing a higher calling, to treat them as driven by what they see as baser motivation insults them, demotivates them[.][128]

The authors go on to note that the danger of a purely punitive approach is that it frustrates the attempt to use self-regulation. "When punishment rather than dialogue is in the foreground of regulatory encounters, it is basic to human psychology that people will find this humiliating, will resent and resist in ways that include abandoning self-regulation."[129] Policy is thus frustrated by poorly designed plans.

The solution to the problem of balancing the competing motivations is in developing a variety of tools to seek the desired outcomes. In particular, persuasion may be used to legitimize later regulatory action. "By cooperating with firms until they cheat, regulators avert the counter productivity of undermining the good faith of socially responsible actors. By getting tough with cheaters, actors are made to suffer when they are motivated by money alone; they are given reason to favor their socially responsible, law-abiding selves over their venal selves. In short, they are given reason to reform[.]"[130]

In a tiered approach, the remedy plan is only one part of a regulatory strategy. Ayers and Braithwaite, for example, describe an enforcement pyramid by which the regulator begins with attempts at moral suasion, moves to warning, and brings out penalties, suspensions, and revocation for persistent levels of non-compliance.[131] In general the regulator will seek to use persuasion to set the regulatory table. If the company

[128] Id. at 24-25.

[129] Id. at 25.

[130] Id. at 27.

[131] Id. at 35-51.

comes into compliance, persuasion has worked. Failure to comply, however, may lead to warnings, low level penalties, suspension, and ultimately revocation. Tied to an attitude that demonstrates that the agency is willing to use the tools available to it, the agency can then create an environment in which the value of cooperation returns better results for the regulated firm than the alternatives.[132]

The implications of this approach are both profound and straight-forward. Securing effective regulation requires a range of credible tools, but the use of the more punitive should be tempered. Penalty provisions should seek to deter behavior, but should be used only when real digressions from the regulatory mandate are detected. This approach is especially important when the whole program is premised on self-regulation since self-regulation relies on the cooperative attitude of the regulated company. By the same reasoning, self-regulation does not become a rationale for the regulator's abandoning the field. Cooperation is a product of moral suasion and the appeal to higher motives, but it may be frustrated by economic calculations leading to non-compliance. Graduated and probable retaliation makes the cooperative response more compelling to the regulated company.

In practice, the beginnings of such an approach are reflected in the current practice in telecommunications regulation under the performance plans. The plans themselves set some expectations for behavior. The reporting mechanisms create an early warning system identifying when compliance is not being achieved. Actual penalties, either in increased damages paid to competitors under a New York-style plan or fines paid to the state under a Texas-style plan, occur only after a higher level of failures occurs. Moreover, the FCC has noted that the plans are part of a larger enforcement structure that carries the ultimate sanction of section 271 revocation. Thus, the basic structure is in place for a graduated approach.

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[132] Id. at 44-47.

The other component of this strategy is the application of graduated and credible responses. When faced with minor or significant deviations, commissions will have to shape their responses to the problem. The credible response may fall at different points on the pyramid. The point is that the response must be perceived by the parties as consistent with the competing goals of cooperation and constraint. This political role is not new for commissions, and when relying on increased of self-regulation it may grow in importance.

Plan Flexibility

Importance of Flexibility

Reliance on self-enforcing mechanisms for post-271 performance or compliance more generally with the requirements of section 251 also must address the question of change. Computer systems, in particular, are subject to upgrades, while the various services that are being monitored are subject to change as well. A requirement and a strength of performance plans is that they be able to adapt to new systems, new requirements, and better understanding.

In its review of performance plans in section 271 reviews, the FCC has indicated its view that self-enforcing plans adapt. In the *Oklahoma/Kansas* decision, the FCC noted the importance of review and revision of the plans so that they "provide a meaningful incentive to provide nondiscriminatory performance in the future."[133] Thus, the plans approved in the section 271 context contain elements for modification the FCC feels are important to their effectiveness.

The ability to adjust to new circumstances may also be one of the strengths of a self-regulation approach. First, individualistic plans can be adjusted quickly and more frequently. "Consensus can be reached more quickly within one firm than it can across all the firms in an industry."[134] Also supporting the ability to change quickly is that the approach is not necessarily tied to strong precedent. Neither the existing rules' effects on the plan's subject-firm or the rules' effects on other similarly situated companies would be

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[133] In re Joint Application by SBC Communications Inc. et al for Provision of In-Region InterLATA Services in Kansas and Oklahoma, Memorandum and Opinion, FCC No. 01-29 (released Jan. 22, 2001).

[134] Ayers and Braithwaite, supra note 66, at 111.

of much significance.[135] Second, change management affords an opportunity for innovation.[136] This benefit is likely to be important in telecommunications markets in which product change and regulatory requirements are in flux.

Thus, the FCC has indicated the importance of change management in its review of state public interest reviews under section 271, and one of the benefits of self regulation is that it affords the opportunity for flexible and innovative responses.

Elements for Modifying Plans

In practice, performance plans implement change management in several predictable ways. The New York and Texas approaches to change management contain some explicit and important supporting provisions. The more predictable method is the periodic review. Other provisions, however, may have the effect of introducing changes into the plans. Among these are provisions for audits, waivers and exceptions, and show cause proceedings. Together, these provisions provide a framework for adjusting the plans to new circumstances.

Periodic Reviews: One of the more obvious ways in which a commission might adjust a plan is through periodic reviews. Both the Texas and New York plans provide for conforming the plan to practice over time.

As approved by the New York commission, the New York plan provides for annual reviews. These reviews cover measures and the weights assigned them under the plan's formulas, the distribution of dollars, the possibility of geographically deaveraging the plan's measures, data clustering, small sample size procedures, and bill credit calculations.

[135] Id. One important caveat should be noted. If similar terms are adopted by different companies, a common understanding may develop around the common language of these plans and the manner in which they are implemented. Parties looking to pre-existing plans for language may want to address explicitly the effect of changes in other regions on their own agreements.

[136] Id. at 111-12.

Despite this laundry list of potential topics, however, the plan also states that any relevant topic concerning the plan can be addressed in a review. The review commences six months before an anniversary of section 271 approval. Any changes occur with commission pre-approval.[137]

The Texas performance plan provides for six month reviews. During these reviews, the parties are tasked to discuss additions, deletions, or modifications of measures, modification of standards, and the revision of penalties. The stated goal of the reviews is two-fold: first, to capture intended performance and avoid duplicative measures; second, to reduce the total number of measures by fifty percent. The first review was scheduled to commence six months after the plan was adopted by a CLEC and approved by the Texas commission. Any changes to the plan are adopted by agreement or through an arbitration award.[138]

Audits: An audit is a second way that the implementation of the plan may change. Through an audit, the incumbent carrier may determine that the processes it is using are inaccurate. As a result, there may be changes in performance measure design, data collection, data reporting, or other matters relating to the implementation of the performance plan.[139]

The New York plan provides for annual audits for selected portions of the plan. It also provides two other checks on data production. First, the New York staff committed to replicate the performance results provided by Bell Atlantic for six months and retained the

[137] New York Performance Assurance Plan at 19-20.

[138] Texas 271 Agreement, Attachment 17, sections 6.4 & 6.5.

[139] The author's work on the Qwest OSS test is relevant to this assertion. One of the important features of that test is the detailed audit of the performance measures. The auditors have identified several concerns with the measures that have been translated into substantive changes in the procedures and reporting performed by Qwest. See http://www.nrri.ohio-state.edu/oss/exceptions.htm. Similar changes could be expected as a result of the periodic audits of performance measures and their implementation in performance plans.

option to recommend that replication continue. Second, the CLECs retained a right to challenge the performance results provided by Bell Atlantic. If a CLEC made such a challenge, Bell Atlantic was required to hire an independent auditor. Final responsibility for the costs of the audit fell to Bell Atlantic if the auditor found material errors; otherwise, the CLEC paid.

The Texas performance plan provides for more limited auditing. It states that the ILEC and CLEC will attempt to resolve a problem with data through negotiation and failing that, after forty-five days, the CLEC may seek an independent audit at the CLECs expense. The ILEC will reimburse the CLEC if the auditor identifies a problem. The CLEC, however, may assert this right to an audit only once a year.

Exceptions, Waivers, and Show Cause Proceedings: While broad classes of problems are likely, there may also be instances that are not anticipated. For example, performance may be excused due to some form of impossibility of performance such as flood or fire that is not the result of the fault of the party seeking the excuse. Similarly, the performance plans provide for the treatment of unforeseen circumstances due to several classes of problems.

The New York plan provides that Bell Atlantic may petition for an exception or waiver in three situations. First, it allows waivers if data cluster in defined ways. For example, this waiver is permitted to avoid tripping a measure repeatedly due to the loss of a single facility. Second, it allows exceptions if the payment is the result of CLEC behavior. Third, a waiver is possible if the incumbent shows that it failed to perform measures subject to benchmark standards if the failure was due to an act of God.[140]

The Texas plan also provides for several exclusions. It contains four circumstances that may result in suspending penalties: Acts of God; CLEC behavior that is contrary to the agreement or state law; conflicts with CLEC equipment that could not be avoided by the

[140] New York Performance Assurance Plan at 17-19.

incumbent (this exception may be used only three times a year by the incumbent); and a demonstration of CLEC bad faith such as dumping orders on the incumbent.[141]

The Texas plan also contains an additional feature, a petition to show cause, that might limit or increase the amount the incumbent pays a CLEC. The incumbent may file to limit payments exceeding $3 million in a month if it can demonstrate that payment in such a case would be unjust and if it has escrowed the amount in excess of $3 million cap. The CLEC may file to increase the payment if the incumbent misses 20 percent of the measures reported to the CLEC for three consecutive months but penalties are less than $1 million if it can demonstrate that the results of the plan are unjust.[142]

Fast Track Changes: The New York plan also provides that the New York commission can make changes in the distribution of penalties on a fifteen-day notice. This provision was important in the first quarter of 2000 when Bell Atlantic apparently was losing orders submitted by CLECs. Pursuant to the notice procedure, the New York commission reassigned amounts for some of the key measures affected by lost orders.[143]

Summary

An inherent problem in any enforcement scheme is its ability to adjust to changed circumstances. A common complaint about telephone regulation in particular is that it fails to meet the changing needs of a dynamic market. One solution to that problem is to make the regulatory process more responsive to the contractual needs of the parties. As seen in the performance plans, the parties and state commissions have sought to provide some flexibility to deal with the more traditional problems that might affect enforcement such as

[141] Texas 271 Agreement, Attachment 17, sections 7.1 and 7.2.

[142] Id., section 7.3.1.

[143] New York Performance Assurance Plan at 5.

acts of God, but have also gone beyond that to address the modification of the plans themselves. While there is some danger that the parties may seek to tie each other up in exceptions, this approach appears logical as a starting point in these dynamic markets.

Conclusions

A performance plan designed to assure continuing compliance with the requirements of Section 271 presents several serious questions for commissions. On a basic level, a state commission will be concerned with the continuing vitality of the commitments an incumbent made so that it can enter the interLATA market. In that regard, the commission will be making reasoned assessments of the appropriate regulatory tools such as investigations, audits, and penalties to pursue that outcome.

On a broader level, this research suggests that performance plans are part of a larger transitional process in the way regulation is approached. The competition between expertise and democratic values that has so bedeviled the debate about regulation does not necessarily disappear, but it is significantly reformed when commissions pursue models based on collaboration with the regulated industry, notice to the intended beneficiaries, preset standards and penalties, and defined change processes.

At this broader level, this research suggests that commissions should consider the alternative regulatory tools available to them. The notion that behavior is motivated by non-economic factors carries with it the seeds of a broader set of tools such as moral suasion. Processes are then designed to create common understandings and goals. It is in this way that effective regulation takes place. Moreover, these processes may have broader application. As various parts of the network industries become more subject to competitive pressures, the models found in performance plans and their economic and political rationales may emerge over other industries. Performance plans in telecommunications thus may provide a preview of changes in other industries.

APPENDIX 1

NEW YORK PLAN

APPENDIX 2

TEXAS PLAN