Let the Experiment Run

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Six years of litigation over the Telecommunications Act of 1996 make clear one simple fact: the federal judicial system is insufficiently sensitive to the costs of uncertainty and delay. You can search the texts in vain; nowhere in cases like *Iowa Utilities Board*, *United States Telecom Association*, *Trinko*, and *Verizon* is there serious discussion of the costs associated with continued litigation. Yet in each of those cases uncertainty and delay were among the most important factors in play.

This insensitivity is particularly troubling prospectively. Bluntly, a seventh year of court review is not going to accomplish much in terms of either ensuring that the 1996 Act is implemented in a way consistent with Congressional intent or ensuring that the Act is implemented in a way that serves the public interest. The costs of delay and uncertainty, however, continue to apply full force. To me, this means that the time for litigation has passed. The smart move at this point would be to finally learn something from the 1996 Act by letting the experiment run.

In saying this, I do not mean to understate the value of judicial review nor to overstate the harms associated with uncertainty and delay. Yes, regulatory agencies do from time to time overstep proper bounds, and in those cases court oversight accomplishes important work. And yes, a few more years of delay would be only so costly; even under the current pattern of litigation, at some point things will settle down and the 1996 Act will be allowed to take meaningful effect. The point here is only that a sensible judicial system would continually weigh the benefits of further litigation against the inevitable costs, using prudential doctrines about deference, standing, immunity, and preemption to shut down litigation in instances when the costs of continued review seem likely to outweigh any plausible benefits. To varying degrees, the courts in *Iowa Utilities Board*, *United States Telecom Association*, *Trinko*, and *Verizon* failed to engage in this sort of prudential balancing.

Start with *Iowa Utilities Board*. One of the major issues raised in the case was the question of whether the Federal Communications Commission had been faithful to the 1996 Act when it promulgated regulations identifying which specific network elements have to be unbundled pursuant to section 251(c)(3). Incumbent local exchange carriers had argued that the Commission applied the wrong standard. According to the incumbents—ironically given what would ultimately be their position in the *Trinko* cert petition—the right standard would ask whether a given element was an "essential facility" as that phrase

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is used in antitrust law. The Court rejected this argument on grounds that a telecom-specific standard might better accomplish the 1996 Act's goals. But the Court did find that "the Act requires the FCC to apply *some* limiting standard"—something the Commission, in the eyes of the Court, had "simply failed to do."[1]

Pause for a moment and note both how unfair that conclusion is and how it right away puts a thumb on the scale in favor of continued judicial involvement. Could it possibly be true that the Commission had failed to apply any limiting standard when it set out to identify which network elements would be subject to unbundling? No way. As the Court itself points out, the Commission had sought to require that incumbents share only seven network elements. It might be that the Commission's limiting standard was unclearly articulated—understandably given that Congress had ordered the Commission to issue these regulations within six months of the enactment of the 1996 Act[2]—but the existence of so short a list suggests that the Commission had indeed implemented a limiting principle.

The Court's more specific criticisms centered around the Commission's interpretation of section 251(d)(2), a provision that instructs the Commission to consider two particular factors when deciding which elements to unbundle. Focus here on the first factor. That factor asks whether "access to such network elements as are proprietary in nature is necessary," a phrase that seems to establish a relatively high standard for elements that involve some form of intellectual property. According to the Court, the Commission eviscerated this standard by interpreting it "as having been met regardless of whether 'requesting carriers can obtain the requested proprietary element from a source other than the incumbent.'"[3]

Enter the second unfair thumb. Parse the pattern of the quotation marks. The quote from the Commission is made up of the words "requesting carriers can obtain the requested proprietary element from a source other than the incumbent"; the rest of the quote—in particular the troubling phrase "regardless of whether"—comes from the Court. Now, if the Commission really had said that an element can be necessary "regardless of whether" that element was available in the unregulated marketplace, then the Court would have been right to reject the Commission's interpretation as unreasonable and thereby trigger another round of procedure and debate. After all, no matter what the underlying logic of the

[1] AT&T Corporation v. Iowa Utilities Board, 525 U.S. 366, 388 (1999) (italics omitted).
[2] 47 U.S.C. §251(d)(1).
[3] 525 U.S. at 389.

unbundled network element provisions, the definition of a network element should certainly at least consider whether a given element can be obtained in the market place.

The troubling words, however, were authored by the Court, not the Commission. Substitute the words "even if" for "regardless of whether" and all of a sudden the Commission's interpretation seems completely unobjectionable. An element indeed might be rightly unbundled *even if* that element is available in voluntary market transactions, for instance if the capital required to purchase the element would itself constitute a significant barrier to entry. Indeed, most network elements are available in the market; the typical explanation for unbundling is not that the relevant elements are unavailable, but instead that due to a natural monopoly cost structure society is better off if these elements are shared.[4]

Now, the test: the sentence that the Court quoted reads in full, "We decline to adopt the interpretation of section 251(d)(2)(A) advanced by some incumbents that incumbent [local exchange carriers] need not provide proprietary elements if requesting carriers can obtain the requested proprietary element from a source other than the incumbent." Does that mean that market availability should be ignored completely as the Court implies with its phrase "regardless of whether"? Does that mean that market availability is a factor but not a litmus test, as the phrase "even if" would suggest? Maybe there is room to disagree.

But that is the point. The Court chose to read this passage as if the Commission were acting unreasonably even though the Court could have easily adopted an equally plausible, more charitable view. The upside was that the Court's decision forced the Commission to go back and clarify the role market forces play when it comes to identifying elements for unbundling. Surprise, surprise, the Commission later announced that it would "tak[e] into consideration the availability of alternative elements outside the incumbent's network, including self-provisioning by a requesting carrier or acquiring an alternative from a third-party supplier."[5] But the downside—completely ignored by the Court—is that this micro-managing further delayed implementation of the 1996 Act. Would deference to the Commission have better served the public interest, especially given that the Commission likely was not taking the extreme position ascribed to it? The Court did not even ask.

[4] In addition to the two mentioned in the text—high costs of capital and natural monopoly properties—there are at least two other good reasons to unbundle. One is that, as applied to some network elements, the incumbents enjoy historic advantages that would unfairly skew competition in their favor. The other is that some network elements must be unbundled in order to make possible meaningful interconnection between carriers.

Costly judicial tinkering was a problem in *United States Telecom Association* as well. At issue this time were new unbundling regulations promulgated by the Commission, again designed to identify which specific network elements would be subject to mandatory unbundling. The challenged regulations articulated a national list of elements that every incumbent had to unbundle. Individual states could require that local incumbents unbundle further, but the Commission's list established a national minimum. Every incumbent in every state had to unbundle these specific elements.

The D.C. Circuit heard a challenge to these regulations—supposedly under the deferential standard of *Chevron* review—and deemed them unreasonable. That was in May 2002, so for those of you keeping track of the dates this means that the earliest the relevant regulations will go into effect is now likely some time over eight years after the Act was supposed to take effect. And what bothered the D.C. Circuit? The main concern raised in the opinion was that the Commission's list did not account for local variations such as state-by-state differences in the universal service obligation. But why should it? For one thing, the national list just establishes a baseline. These elements are to be unbundled in every market no matter what the local conditions, but the states are free to add additional elements where that might be appropriate. Was the D.C. Circuit saying that, in its view, some of the listed elements are unnecessary in certain markets? What if the Commission thinks otherwise, arguing, as the Commission apparently did, that these elements establish a core that will promote competition, investment, and innovation? And was the Commission so out of line to argue that uniform rules are desirable, too, for the simple reason that they reduce administrative complexity and market uncertainty?

As with every issue I will raise here today, the forum requires that I talk fast and thus skip over what could be a rich conversation about, for example, the pros and cons of national versus local regulation. Are there institutional differences between state and federal regulators—say, the likelihood of capture—that might recommend a system where the federal agency crafts nuanced state-specific regulations and in that way decreases the power of local regulators? Did Congress implicitly build that sort of power relationship into the 1996 Act, hiding it somehow in the several ambiguous provisions that allocate regulatory authority? Maybe. But that conversation has costs—and just as we must be sensitive to them here today, so too should the D.C. Circuit have been sensitive to them when deciding whether to tinker or defer.

[5] Third Report and Order, In re Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, 15 FCC Rcd 3696 (1999).

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Turn now to the on-going *Trinko* litigation in the Second Circuit. The most important issue raised here is the question of whether an otherwise-valid antitrust claim related to local telephone service should be dismissed on grounds that allowing it to go forward would unduly interfere with the 1996 Act's regulatory scheme. The specific case under consideration was a class action lawsuit brought against an incumbent local exchange carrier by a class of customers who all purchased local telephone service from a rival firm. The customers allege that the incumbent failed to live up to various obligations owed to their telephone carrier and that those failures, in turn, injured them, its customers.

Note at the outset that there are benefits to allowing this sort of litigation to proceed. Yes, there is some duplication here given that the injured rival itself has legal remedies if it is being harmed by illegal behavior and, similarly, state regulators have the power to enforce cooperation in situations like this one. But legal rules often tolerate overlapping enforcement mechanisms, the idea being that different types of plaintiffs not only have different information but also face different incentives when it comes to suing and settling. Allowing a mix of enforcement actions thus likely produces a higher level of enforcement than would a less duplicative scheme. That might be good if we think that state regulators will enforce the law less aggressively than they should, but of course it is bad to the extent that private parties sue in their own interest even where state regulators have rightly decided to temper official enforcement efforts.

This litigation promises another possible benefit as well: as the Second Circuit points out, an antitrust action might be the only cause of action through which these customers can demand damages. That is, if these plaintiffs prove their case, they will be awarded cash—money that these customers would not necessarily have received if the legal issues had instead been raised either by their local service provider directly or through state regulatory action. Again, this is a benefit if we think that sound telecommunications policy would have cash going from misbehaving incumbents to customers who are attempting to subscribe to rival services, a reasonable position given that one of the most difficult obstacles standing in the way of competition in the local market is consumers' general reluctance to leave their familiar providers and take their chances with new entrants. These dollars go to consumers who took the risk early on and got burned, and we might think that a nice reward and a good signal to future would-be customers. Then again, this cash transfer program is not a benefit if our more pressing concern is that the possibility of large cash settlements will bring out the ambulance chasers.

All that said, my point again is that—at least in the absence of explicit instructions from Congress—it was the job of the Second Circuit to weigh with care these possible benefits against the obvious costs of

opening up an entirely new avenue for disruptive telecommunications litigation. The court had a variety of tools with which to accomplish the weighing. The analysis could have been accomplished as a question of standing, for example, or under the banner of implicit immunity—in essence an argument that the 1996 Act implicitly immunizes incumbents from certain antitrust claims, specifically those that would significantly interfere with the implementation of the Act's goals and provisions. The court could even have pursued this inquiry as a way of reconciling the specific requirements of the 1996 Act with the more general obligations of the Sherman Act. Any of these tools could have been used to accomplish this basic gate-keeping function.

But none were. Instead, the court asserted that there were no real costs associated with allowing the case to proceed because (1) damage remedies, as opposed to injunctive relief, do "not substantially interfere with the broader regulatory process"[6] and (2) antitrust law and the 1996 Act both require the same behavior and so there is no conflict.[7] The first argument is clearly incorrect. The looming threat of possible damages liability—and note that the dollar figures here could easily be in the millions—certainly would affect incumbent behavior. Incumbents would endeavor to anticipate what courts will ultimately require and act accordingly so as to minimize their legal exposure. Just like injunctive relief, then, damages liability in this setting forces incumbents to serve a second master: first the regulatory agencies wielding the 1996 Act, now the courts wielding the Sherman Act.

The Second Circuit's second argument also severely understates the costs of allowing this sort of litigation to proceed. Even if antitrust law and the 1996 Act do push incumbents toward the same behaviors—itself a tricky proposition given how ambiguous and subjective a firm's obligations are under each of the relevant statutes—a case like *Trinko* changes the size of the penalty associated with any misstep. It is thus unfair to say that there is no interference because the courts, the state public utility commissions, and the Federal Communications Commission all are looking for the same cooperative behavior. Adding in the possibility of damages (let alone treble damages) under the Sherman Act puts significantly more pressure on incumbents to shy away from possibly legal behavior. It also takes away from state and federal agencies the power to calibrate punishments in accordance with the overall regulatory scheme. Interestingly, the addition of Sherman Act penalties also skews compliance, since behaviors that can give rise to claims under both the Sherman Act and the 1996 Act will now be more

[6] Law Offices of Curtis V. Trinko v Bell Atlantic Corp., 305 F.3d 89, 113 (2002).

[7] *Id.* at 111.

important to incumbents than behaviors required under the 1996 Act but for one reason or another beyond the reach of the Sherman Act.

Again, my purpose here is not to delve into the details, but instead to point out yet another instance where the possible benefits of further litigation were not fairly weighed against the costs. Evenly framed, the prudential questions raised by *Trinko* are difficult ones. Allowing the Sherman Act to be used as a tool for collateral attacks on the regulatory regime does mean that the regulatory regime will be disrupted. That said, allowing the Sherman Act claim does ensure that telephone customers are accorded a remedy that they might otherwise have difficulty attaining and does likely increase compliance with the law. This is the balance that the court should have addressed under the various prudential doctrines available. To assert instead that there were no costs to balance is to duck this obligation and possibly to allow litigation to proceed despite the public interest.

The last case to consider here is *Verizon*, and once again my basic claim is that the Supreme Court was insufficiently sensitive to the costs of uncertainty and delay. The bulk of *Verizon* is from my perspective completely unobjectionable. The case was a challenge to the Commission's methodology for pricing access to network elements, and the Court understandably found that the Commission had acted well within the bounds of *Chevron* deference. The 1996 Act says very little about how these prices should be calculated, after all, explicitly requiring only that the prices be "based on ... cost," that they be "nondiscriminatory," and that they "may include a reasonable profit."[8] The Commission had adopted a methodology that fits those parameters, and the Court reasonably so found.

Where I take issue, however, is with the Court's handling of the incumbents' claim under the Takings Clause. The incumbents had argued that the Commission's pricing methodology will result in regulated prices so low as to constitute a taking of the incumbents' property without just compensation, a possible violation of the Fifth and/or Fourteenth Amendments. The Court acknowledged that this might be true, but ruled that the claim was not yet ripe. According to the Court, the Commission's pricing methodology is so flexible that, even knowing what it is, it is still almost impossible to guess whether the resulting prices will be high or low, let alone so unconstitutionally low as to set up a possible takings argument. The Court thus deferred the issue, noting that its "general rule" is that it does not consider "a

[8] 47 U.S.C. §251(d)(1).

taking challenge on ratesetting methodology without being presented with specific rate orders alleged to be confiscatory."[9]

There is some truth to that and I do not want to be too critical. It did make sense to delay adjudication on the takings claim until actual numbers were in place, precisely because the pricing methodology might end up yielding perfectly reasonable prices. That said, however, the Court could have said more about how the analysis might ultimately run. For example, will a takings be recognized only if the loss to the firm is sufficient to push it to the edge of bankruptcy? Earlier Court opinions might be read to imply just that, concerned as they are with the question of whether a given government regulation has "denied all economically beneficial or productive use" of an asset.[10] Does that same standard apply here? Even in dicta, the Court could have significantly reduced uncertainty by arming both policymakers and incumbents with a better sense of how any takings claim might work.

This is not much ado about nothing. The Takings Clause is primed to play a central and beneficial role in the implementation of the unbundled network elements regime, but it can do so only if both the Commission and the incumbents can have confidence today that there will be a takings remedy available tomorrow. Think of it this way: if the takings claim looks implausible, the Commission will have to set prices with an eye toward balancing several competing factors. Specifically, the price will have to attempt to achieve efficient use of network elements in the short run; promote efficient investment in research and development by the incumbents for the long-run; similarly promote efficient investment in research and development by new entrants for the long-run; and on top of that address the distributional implications that are the core of the takings claim. This is hard to accomplish, both because the analysis becomes complicated with all these factors in play and because these factors often push in opposite directions. For instance, to maximize short-run efficiency, the Commission should set prices at the level of marginal cost, but to address the distributional issue prices will certainly have to be far above marginal cost.

But now consider how things change if the Commission and the incumbents believe that a takings claim will ultimately be successful. Under this scenario, the Commission can ignore the distributional issue when setting access prices, focusing exclusively on the various incentive effects outlined above and knowing all the while that any distributional issue will be fairly addressed separately. Incumbents would be precluded from arguing against the Commission's prices on distribution grounds, in that way perhaps

[9] Verizon Communications v. FCC, 122 S. Ct. 1646, 1679 (2002).
[10] See, e.g., Lucas v. South Carolina Coastal Council, 112 S. Ct. 2886, 1015 (1992).

narrowing the grounds for disagreement and maybe even dampening their incentive to litigate and delay implementation of the Act. And the Commission would likely be able to set prices that better serve the public interest, because under this approach the Commission can establish one price that sensibly balances all the various incentives and then, through takings litigation, establish a second number that fairly compensates the incumbents for their losses.[11]

Again, all this is possible only possible if the Commission can tell incumbents with confidence that the distributional issue will ultimately be addressed. The *Verizon* Court did nothing in support of that aim. The net result is that the Court will have better information to work with when it finally does evaluate the takings claim, but the bulk of the value of allowing the claim will have already been sacrificed to uncertainty and delay.

Conclusion

My argument here today boils down to a call for increased deference, both to the Commission and to the state regulatory agencies that are working with the Commission to implement the 1996 Act. As a legal category, deference is not always the issue technically in play; in *Trinko*, for instance, the district court would have played this conversation out under the banner of standing doctrine while the Second Circuit would have framed it as a question of implicit immunity. But if I am right as a descriptive matter that in these cases the federal courts have been insufficiently sensitive to the costs of uncertainty and delay, then—whatever the specific legal category—the cure will mean less aggressive judicial involvement and hence more power in the hands of the original decision-making agencies. That is deference, albeit in an unconventional form.

[11] Another virtue to the takings approach is that it separates in time the decision to regulate from the decision over fair compensation. Consider in this light the recent anthrax scare and the ensuing debate over whether the government should regulate or otherwise influence the price of Bayer's patented antibiotic, ciprofloxacin (Cipro). When federal officials believed that the country would need a large and cheap supply of this drug, Secretary of Health and Human Services Tommy Thompson entered into a frenzied negotiation with Bayer. In the background was the threat that the government would invalidate the patent if negotiations broke down. A deal was ultimately struck—but a better approach would likely have had the government just cancel the patent and encourage Bayer to sue for its injuries. After all, at the time of the perceived crisis, the important thing was to get Cipro produced and available at marginal cost. Invalidating the patent would have accomplished that goal as dozens of firms would have begun to produce and distribute the drug. And deferring to litigation the debate over fair compensation would have allowed those calculations to take place under calmer, more thoughtful circumstances. The result would likely have been a net payment to Bayer that more appropriately rewarded the firm for its efforts at research and development.

This sort of prudential deference is important in all cases, whether telecom-related or no. At every step, courts should be sensitive to the costs of uncertainty and delay and should use whatever prudential doctrines available to cut short litigation that is likely to do more harm than good. But the concern is particularly sharp here, where the 1996 Act is at issue. The reason: the 1996 Act is an experiment. The old regulatory regime had imagined regulation as a substitute for competition; the new one dares to think of regulation as a tool through which to promote competition. In the context of an experiment, the costs of delay and uncertainty are significantly amplified. Intuitively—as Randy Picker and I have said elsewhere—experiments just don't do well with the equipment flickering on and off. Yet that is exactly what the courts are doing and threatening to do in the cases canvassed here.

It would make sense to allow uncertainty and delay to muck up the experiment if the expected benefits of continued court review were high. But in this instance that is hard to believe. The underlying economics at issue here suggest that even unbiased minds can disagree with respect to the details of implementing the unbundling, interconnection, and resale provisions of the Act. And the 1996 Act itself is ambiguously written and thus subject to many reasonable interpretations. Given all that, there is no point in delaying any further. I said it at the start and I will say here again: at this point, the smart move would be to finally learn something from the 1996 Act by letting the experiment run.