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The Political Economy of Net Neutrality Regulation

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Abstract: On February 26, 2015, the Federal Communications Commission (FCC) proposed sweeping new regulation for broadband providers. While regulation is typically driven by a combination of economic and political considerations, this article argues that the FCC's initiative is long on politics and short on economics. For example, the FCC is not able to identify a non-transitory abuse of market power by broadband providers to justify its actions. There is no evidence of excessive returns being earned by broadband providers and the violations of net neutrality that the Commission can point to, including throttling and blocking of data, are conspicuously few in number. What is more, the FCC has yet to establish that the regulatory oversight it proposes would not stifle more investment than it stimulates. Broadband is an example of a two-sided market in which edge (content) providers represent one side of the market and consumers represent the other side of the market. Just as newspapers impose positive prices on both advertisers and subscribers, it is (quite generally) efficient in two-sided markets for both sides of the market to contribute to the total price. Two-sided markets are characterized by a seesaw principle in which a lower price on one side of the market tends to give rise to a higher price on the other side of the market. Hence, a ban on paid prioritization of traffic delivery over broadband networks essentially requires consumers to pay the full freight. The FCC is therefore in the unenviable position of having to justify a policy to regulate broadband that is distinguished by being both economically inefficient and socially inequitable. While the courts are disposed to give deference to expert federal agencies under the Chevron Doctrine, the lack of economic foundation to justify broadband regulation promises to make this tough sledding for the FCC. The strategy on the part of the broadband providers will be to run out the clock with litigation in the hope that the political winds shift in their favor post 2016.

Keywords: broadband regulation; market failure; net neutrality.

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It is widely recognized that “regulation is a political act” and no issue underscores this fact more than net neutrality (Braeutigam, 1989, p. 1299). Net neutrality is a requirement that broadband providers treat all traffic on their networks equally which means that different service tiers are not permitted.

The FCC’s proposal that broadband be reclassified as a telecommunications service rather than an information service is not benign. Regulation is like ivy in that it tends to spread and is notoriously difficult to eradicate once it takes hold. In a recent *Wired* article, FCC Chairman Tom Wheeler attempts to lessen these concerns with assurances that the FCC has no interest in imposing rate regulation on broadband providers or subjecting their last-mile facilities to unbundling obligations (i.e. requiring the individual inputs that comprise their networks to be leased to rivals at regulated prices).

This appeal to *regulation light* is illusory and the prospective problems are disconcerting. First, the FCC has a commitment problem because Mr. Wheeler cannot speak for how future FCC administrations will use these new-found regulatory powers. Second, if Mr. Wheeler is going to claim that more *heavy-handed regulation* actually encourages rather than discourages deployment and investment in broadband infrastructure, it is the capital markets that will need convincing and this is no easy sell. Third, a ban on paid prioritization (allowing broadband providers to offer different levels of service quality to content [edge] providers) is itself a form of rate regulation.

Two conditions must be satisfied to justify economic regulation. The first condition is the presence of a non-transitory market failure and the second is that the expected benefits of such regulation exceed the expected costs.

Typically, the government is able to point to the exercise of undue market power to justify market intervention in the form of economic regulation. That is not the case here, however, as Judge Silberman duly noted in his recent dissent in *Verizon v. FCC*. Market power is enhanced if it is likely to encourage one or more firms to raise price, reduce output, diminish innovation, or otherwise harm customers as a result of diminished competitive constraints or incentives (DOJ, 2010a).

It is instructive to unpack the market power question to shed light on what is driving (or more importantly what is not driving) the push for broadband regulation. In answer to the question of whether broadband prices are too high. There is no evidence of excessive earnings on the part of broadband providers (Hazlett and Weisman, 2011). In answer to the question of degradation of service quality (i.e. the throttling or blocking of data), the net neutrality violations that the FCC can cite to are conspicuously few in number and the misconduct was remedied expeditiously (Weisman and Robinson, 2009). Hence, *proportionality* suggests that whatever regulatory oversight may be warranted is of an *ex post* variety rather than the *ex ante* sort that the FCC proposes (Nuechterlein, 2009). In answer

to the question of reduced investment precipitated by the conduct of broadband providers, the FCC has yet to establish that the regulatory oversight it proposes would not stifle more investment than it stimulates.

Two types of efficiency measures come into play in crafting competition policy – static efficiency and dynamic efficiency. Static efficiency focuses on the relationship between prices and the underlying incremental cost of production at a given point in time. This is the efficiency measure that most often arises in evaluating the merits of proposed mergers. Dynamic efficiency is concerned with optimal investment in innovation over time. This is the efficiency measure that is used to rationalize intellectual property protections, such as patents and copyrights.

The Department of Justice (DOJ), in deference to the principle that dynamic efficiency takes precedence over static efficiency, particularly in technologically dynamic industries (Baxter, 1984; Gilbert, 2005), advised the FCC to refrain from regulating broadband markets even if there were a relatively few number of providers. “Although enacting some form of regulation to prevent certain providers from exercising market power may be tempting ... care must be taken to avoid stifling the infrastructure investments needed to expand broadband access (DOJ, 2010b, p. 28).

The essential point is that more *light-handed regulation* is the natural path through which to encourage deployment and investment in broadband networks. With its broadband initiative, the FCC turns this principle on its head, arguing that more *heavy-handed regulation* will actually stimulate deployment and investment. In a recent interview with the *New York Times*, Professor Jean Tirole, who won the 2014 Nobel Prize in economics, was asked if he thought regulation was moving in the right direction. His response is timely and instructive.

What we have been trying to do is to get regulation which is light enough in order to let innovation happen and to promote investment by the incumbents. Bad regulation can actually reduce growth quite a lot, can create a lot of problems (Appelbaum, 2014).

A firm’s incentives for investment and innovation turn on its ability to appropriate the returns on that investment. It is therefore incumbent upon the FCC to explain how a ban on paid prioritization, which will truncate the returns on broadband investment, can be expected to strengthen incentives for investment and innovation in a manner consistent with the objective “to encourage the deployment on a reasonable and timely basis of advanced telecommunications capability to all Americans ...” called for in the 1996 Telecommunications Act.

The FCC put forward and the majority in *Verizon v. FCC* accepted the theory of a “virtuous cycle of innovation” to justify its proposal to regulate broadband. The

essence of this theory is that a ban on paid prioritization and blocking or throttling of data will encourage innovation by edge (content) providers that in turn will stimulate usage of broadband networks and ultimately increase deployment of such networks. This theory is fine and good as far as it goes – the problem is that it does not go very far. The FCC must establish that the second-order effects that it relies upon to spur investment in the form of its “virtual cycle of innovation” are not dominated by the first-order, investment-dampening effects associated with economic regulation of broadband providers. In other words, the FCC should be required to demonstrate that its proposal passes a cost-benefit test.

The FCC’s broadband initiative is driven by two principal objectives: (1) a ban on paid prioritization; and (2) a corresponding ban on blocking or throttling of data. Nowhere does the FCC acknowledge that these objectives may well be in conflict with one another. To the extent that the FCC limits the ability of broadband providers to engage in price differentiation, say, by offering higher speeds at higher prices, the stronger the incentive those providers will have to resort to non-price discrimination or sabotage (including the blocking or throttling of data) in a manner that may elude regulatory detection. This will drag the FCC into the quagmire of monitoring service quality because one form of regulation invariably leads to other forms of regulation. To wit, regulating prices without simultaneously regulating service quality is non-sensical. At a minimum it is necessary for the FCC to establish that the economic regulation it wishes to impose on broadband providers will not exacerbate the very problem it seeks to remedy.

In his *Wired* article, Chairman Wheeler observes that broadband providers should not be allowed to serve as network “gatekeepers” because their commercial interests are not always aligned with consumer interests. It is important to note that the FCC’s objection here is not to price discrimination (i.e. price differences that cannot be explained by costs differences), but to simple price differentiation or prices that vary with the level of service quality. William Baxter, the esteemed Stanford law professor and former Assistant Attorney General for Antitrust recognized long ago that consumers cannot be harmed by the introduction of new services (Baxter, 1984).

The small edge (content) providers have raised the specter that paid prioritization will confer a competitive advantage on large edge (content) providers. The *deep pockets* that these large edge (content) providers possess will enable them to partake of priority delivery of traffic that is purportedly beyond the reach of smaller rivals. The societal concern is that this will result in a loss of innovation. This begs the question of whether the government should be in the business of designing industrial policy to compensate small innovators for their inability to persuade venture capitalists of the value of their creations. It is not enough simply to build a *better mousetrap* ... investors must be convinced that you have actually done so.

Broadband is an example of a two-sided market in which edge (content) providers represent one side of the market and consumers represent the other side of the market. Just as newspapers impose positive prices on both advertisers and subscribers, it is (quite generally) efficient in two-sided markets for both sides of the market to contribute to the total price. Two-sided markets are characterized by a *seesaw principle* in which a lower price on one side of the market tends to give rise to a higher price on the other side of the market (Rochet and Tirole, 2006; Weisman, 2010; Weisman and Kulick, 2010). Hence, a ban on paid prioritization over broadband networks essentially requires consumers to pay the full freight. The FCC is therefore in the unenviable position of having to justify a policy to regulate broadband that is distinguished by being both economically inefficient and socially inequitable!

To conclude, in terms of the political economy of broadband regulation, the FCC's initiative is long on politics and short on economics (Nagesh and Mullins, 2015). While the courts are disposed to give deference to expert federal agencies under the *Chevron Doctrine*, the lack of economic foundation to justify broadband regulation (inclusive of a dearth of credible evidence of a non-transitory abuse of market power) promises to make this tough sledding for the FCC. The strategy on the part of the broadband providers will be to run out the clock with litigation in the hope that the political winds shift in their favor post 2016.

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