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**Regulating Under the Influence:
The FCC's Title II Initiative for Broadband**

by

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FCC Chairman Tom Wheeler is in a tough position. Notwithstanding the fact that the FCC is an independent federal agency, when the President weighs in on a policy matter – as is the case with net neutrality – it is difficult for the Chairman to say “thank you for your input Mr. President, but we are going to go in a different direction.” It is widely recognized that “regulation is a political act” and no extant issue attests to this fact more than net neutrality.¹ Mr. Wheeler’s claim, therefore, that economics (“long-standing regulatory principles”) carries the day on net neutrality regulation is more than a bit disingenuous. Indeed, as I argue below, the “economic fig leaf” that the FCC dons to rationalize its actions with respect to Title II regulation for broadband is particularly ill fitting – Mr. Wheeler’s wardrobe malfunction *du jour*.

The FCC’s Title II initiative reclassifies broadband as a telecommunications service rather than an information service and broadband providers would become common carriers with all of the myriad obligations this entails. Mr. Wheeler attempts in a recent *Wired* article to soften the blow by claiming that the FCC has no interest in imposing rate regulation on broadband providers or

¹ Ronald R. Braeutigam, “Optimal Policies for Natural Monopolies” in HANDBOOK OF INDUSTRIAL ORGANIZATION, ed. by Richard Schmalensee and Robert Willig, Amsterdam: North-Holland, Vol. 2, Chapter 23 1989, p. 1299.

subjecting their last-mile facilities to unbundling obligations.² This defense has a certain Clintonesque quality to it – “Yes, but I did not inhale.” The problem here is three-fold. First, Mr. Wheeler has a commitment problem of sorts because he cannot speak for future FCC administrations. There is no such thing as a little regulation; it is invariably subject to regulatory creep, as the venerable Professor Alfred Kahn astutely recognized when he turned off the lights at the Civil Aeronautics Board.³ Second, if Mr. Wheeler is going to make the case that more *heavy-handed regulation* encourages deployment and investment in broadband infrastructure, it is the capital markets that he will have to convince and this is likely to be a tough sell. Third, a ban on paid prioritization is itself a form of rate regulation and this means that the FCC is going to be dragged into seemingly endless disputes over compliance with its rules.

There is a two-part standard to justify economic regulation.⁴ The first part is that governmental intervention is presumptively unnecessary absent market conditions that (1) credibly establish that the abuse of market power poses a substantial, non-transitory risk to economic welfare; and (2) should be expected to significantly undermine the integrity of the competitive process.⁵ The second part is that no governmental intervention can be justified unless the expected benefits of such intervention exceed the expected costs, appropriately defined. The fact that the FCC failed to ground its Title II initiative in any formal market power analysis resonated with Judge Silberman in his dissent in *Verizon v. FCC*.⁶

Two additional observations are noteworthy. First, the FCC cannot point to any non-transitory abuse of market power. The net neutrality violations that it can cite are preciously few in number and the misconduct was remedied expeditiously.⁷ Hence, whatever regulatory oversight is called for is most assuredly of an *ex post* variety rather than the intrusive, *ex ante* sort that the FCC now contemplates.⁸ Second, the FCC cannot point to any systemic pattern of consumer harm stemming from these transitory violations of net neutrality principles to justify its approach because no such evidence exists.

In his *Wired* article, Mr. Wheeler makes the unexceptionable point that commercial interests are not always aligned with consumer interests. This is a fair point, but seemingly works at cross purposes with his proposal to ban paid prioritization. According to the Chairman, society is

² “FCC Chairman Tom Wheeler: This Is How We Will Ensure Net Neutrality,” *Wired*, February 4, 2015, available at <http://www.wired.com/2015/02/fcc-chairman-wheeler-net-neutrality/>

³ Glen O. Robinson and Dennis L. Weisman, “Designing Competition Policy for Telecommunications,” *The Review of Network Economics*, Vol. 7(4), December 2008, pp. 534-540.

⁴ Dennis L. Weisman, “A ‘Principled’ Approach to the Design of Telecommunications Policy,” *Journal of Competition Law and Economics*, Vol. 6(4), 2010, pp. 927-956.

⁵ 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. See the U.S. Department of Justice Horizontal Merger Guidelines available at <http://www.justice.gov/atr/public/guidelines/hmg-2010.html>

⁶ *Verizon v. FCC*, 740 F.3d 623 (D.C. Cir. January 14, 2014).

⁷ Dennis L. Weisman and Glen O. Robinson, “Lessons for Modern Regulators from Hippocrates, Schumpeter and Kahn,” in *NEW DIRECTIONS IN COMMUNICATIONS POLICY*, ed. by Randolph J. May, Durham NC: Carolina Academic Press, 2009, pp. 3–37.

⁸ See, for example, Jonathan E. Nuechterlein, “Antitrust Oversight of an Antitrust Dispute: An Institutional Perspective on the Net Neutrality Debate,” *Journal on Telecommunications & High Technology Law*, Vol. 7(1), Winter 2009, pp. 19-66.

better off when the government forces everyone to fly coach and partake of parcel post. Really? Bill Baxter, the esteemed Stanford law professor and architect of the AT&T divestiture accord, recognized long ago that consumers cannot be harmed by the introduction of new services.

Finally, it should be noted that, if there is a tomorrow's product, it cannot be monopolized to the extent that we would be worse off than if we did not have that tomorrow's product. Tomorrow's product is, at any finite price, a net gain. Today's products remain available to compete with it.⁹

Mr. Wheeler would appear to see it differently, but as a matter of economics he would be wrong. Of course, there is the oft-stated concern that paid prioritization will favor large (edge) providers over small innovators toiling away in their garages. This is a vacuous argument – the FCC should not be in the business of designing industrial policy to compensate for the failure on the part of small innovators to convince venture capitalists of the value of their creations. Lest we forget that Apple, Google, and Microsoft were all yesteryear's garage innovators that somehow managed to develop *better mousetraps* without industrial policy being hijacked to handicap the race.

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. A ban on paid prioritization over broadband networks essentially requires consumers to pay the full freight.¹⁰ To paraphrase the late Judge Robert Bork, one often hears of the baseball player who, although a weak hitter, was also a poor fielder.¹¹ Mr. Wheeler's ban on paid prioritization is a little like that. Although it is socially inequitable, at least it is economically inefficient.

The FCC's invocation of Section 706 of the 1996 Telecommunications Act to justify its Title II initiative for broadband is particularly curious. This section of the Act calls for the Commission "to encourage the deployment on a reasonable and timely basis of advanced telecommunications capability to all Americans . . . by utilizing price cap regulation, regulatory forbearance measures that promote competition in the local telecommunications market, or other regulating methods that remove barriers to infrastructure investment." The FCC previously invoked this section of the Act to justify its decision not to require incumbent providers to unbundle their fiber networks.¹² In addition, the Department of Justice, in deference to the principle that dynamic

⁹ William F. Baxter, "The Definition and Measurement of Market Power in Industries Characterized by Rapidly Developing and Changing Technologies," *Antitrust Law Journal*, October, Vol. 53, October, 1984, p. 724.

¹⁰ Two-sided markets are characterized by a *seesaw principle* in that a lower price on one side of the market tends to give rise to a higher price on the other side of the market. See, for example, Jean-Charles Rochet and Jean Tirole, "Two-Sided Markets: A Progress Report," *Rand Journal of Economics*, Vol. 37, 2006, pp. 645-667.

¹¹ Robert H. Bork, *THE ANTITRUST PARADOX*, New York: The Free Press, 1978, p. 382.

¹² *In the Matter of Unbundled Access to Network Elements, Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, WC Docket No. 04-313, CC Docket No. 01-338, Report and Order and Order On Remand and Further Notice of Proposed Rulemaking, released August 21, 2003, ¶ 173.

efficiency trumps static efficiency,¹³ advised the Commission to refrain from invoking economic regulation for broadband services even if there were a paucity of providers.

The Department recommends that the Commission monitor carefully those areas in which only a single provider offers – or even two providers offer – broadband service. Although enacting some form of regulation to prevent certain providers from exercising market power may be tempting with regard to such areas, care must be taken to avoid stifling the infrastructure investments needed to expand broadband access. In particular, price regulation would be appropriate only where necessary to protect consumers from the exercise of monopoly power and where such regulation would not stifle incentives to invest in infrastructure deployment.¹⁴

The key point is that more *light-handed regulation* is the avenue through which to encourage deployment and investment in broadband networks. With its Title II initiative, the FCC seeks to turn this principle on its head, arguing that more *heavy-handed regulation* will actually encourage the desired deployment and investment, but the Commission cannot have it both ways. Professor Jean Tirole, the winner of the 2014 Nobel Prize in economics, was asked by the *New York Times* whether he thought regulation was moving in the right direction. Mr. Wheeler would be wise to reflect upon his response.

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.¹⁵

Finally, 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 investment, can be expected to strengthen incentives for investment and innovation in a manner consistent with Section 706 of the 1996 Act.

The FCC put forward and the majority in *Verizon v. FCC* accepted the theory of a “virtuous cycle of innovation” to rationalize its Title II initiative.¹⁶ The basic idea 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. Of course, a theory is only as good as its empirical validity and

¹³ Richard J. Gilbert, “New Antitrust Laws for the ‘New Economy,’” Testimony Before the Antitrust Modernization Commission, Washington D.C., 2005.

¹⁴ *Ex Parte* Submission of the United States Department of Justice, Before the Federal Communications Commission, *In the Matter of Economic Issues in Broadband Competition: A National Broadband Plan for Our Future*, GN Docket No. 09-51, January 4, 2010, p. 28.

¹⁵ Binyamin Appelbaum, “Q. and A. with Jean Tirole, Economics Nobel Winner,” *New York Times*, 15 November 2014, available at http://www.nytimes.com/2014/10/15/upshot/q-and-a-with-jean-tirole-nobel-prize-winner.html?_r=1&abt=0002&abg=0

¹⁶ The majority in *Verizon v. FCC* derides Verizon for its characterization of this theory as a “triple cushion shot.” The majority observes that in pool “a triple-cushion shot, although perhaps more difficult to complete, counts the same as any other shot.” This observation misses the point. The objective, of course, is not to make a single shot, but to win the game. The “triple cushion shot” is of limited value if the other balls displaced in the course of making the shot render subsequent shots more difficult.

this one smacks of the very same smoke and mirrors that the FCC once embraced in the form of the now discredited *stepping-stone hypothesis* to justify pervasive unbundling of incumbent providers' networks at artificially low prices.¹⁷ At a minimum, it is necessary for the FCC to establish that the second-order effects that it relies upon in the form of its "virtual cycle of innovation" to spur investment are not dominated by the first-order, investment-repressing effects associated with common carrier regulation of broadband providers. That is to say, the FCC should be required to demonstrate that its proposal passes a cost-benefit test, a point not lost on Judge Silberman in his dissent in *Verizon*.

The FCC's Title II initiative is driven by two principal objectives, a ban on paid prioritization and a corresponding ban on blocking or throttling of data. Nowhere does the FCC seem to appreciate the fact that these objectives are potentially in conflict with one another. To the extent that the FCC limits the ability of broadband providers to engage in price differentiation,¹⁸ say, by offering different speeds at different prices, the greater the incentive those providers will have to engage in non-price discrimination (including the blocking or throttling of data) in a manner that may not be directly observable by regulators. This will drag the FCC into the abyss of monitoring service quality and reliability because one form of regulation invariably begets other forms of regulation. Hence, at a minimum it is incumbent upon the FCC to establish that the economic regulation it seeks to impose through its Title II initiative will not aggravate the very problem it seeks to remedy.

To conclude, if Mr. Wheeler wants to move forward with Title II regulation of broadband, he should concede that this is largely a political issue and not ask economics to do his bidding for him. It is not uncommon for public policy decisions to be made predominantly on the basis of politics. The hopelessly inefficient, long-standing practice of regulators setting artificially high long-distance rates and correspondingly low local service rates is a case in point.¹⁹ That said, in hanging his hat on economics to rationalize Title II regulation for broadband, Mr. Wheeler has embarked upon a fool's errand because *that dog won't hunt*.

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The Free State Foundation is an independent, nonpartisan free market-oriented think tank located in Rockville, Maryland.

¹⁷ See, for example, Glen O. Robinson and Dennis L. Weisman, "Designing Competition Policy for Telecommunications," *The Review of Network Economics*, Vol. 7(4), December 2008, pp. 534-540.

¹⁸ Price differentiation typically refers to any deviation from a uniform price. Conversely, price discrimination refers to price differences that cannot be explained by cost differences. For example, "the sale of two or more similar goods at prices which are in different ratios to marginal cost" would constitute price discrimination. See George J. Stigler, *THE THEORY OF PRICE*, New York: Macmillan Publishing, 1966, p. 209.

¹⁹ Robert W. Crandall and Leonard Waverman, *WHO PAYS FOR UNIVERSAL SERVICE?*, Washington D.C.: Brookings, 2000.