



THE FREE STATE FOUNDATION

A Free Market Think Tank for Maryland.....Because Ideas Matter

Perspectives from FSF Scholars
February 20, 2015
Vol. 10, No. 10

Regulation Won't Preserve a Dynamic and "Open" Internet

by

Robert W. Crandall *

One might reasonably ask why anyone would expect that the FCC's impending decision to regulate broadband providers by extending Title II regulation in the name of preserving "network neutrality" would benefit consumers. The principal justification for this striking reversal of several decades of telecom *deregulation* is that it will prevent the Internet service distributors – local telecom providers and cable companies – from exercising their power to discriminate against nascent upstream innovators, thereby protecting the "Open Internet." But for more than three decades, innovation and entry in this sector has occurred because the FCC has been forced to relinquish its regulatory grip on the sector.

A little history is important. Four decades ago, no one could have foreseen that most of today's consumers would have access to video and data from a variety of carriers at speeds approaching 100 Mbps. The reason was simple: The FCC, acting pursuant to its vague "public interest" delegation of authority, had routinely moved to block entry into telecommunications markets and severely limited what cable television companies could offer their subscribers, thereby creating or fortifying the market power of AT&T and the television broadcasters. Few at that time would have expected that a dynamic, competitive communications market place was even a possibility.

The FCC had repeatedly attempted to block entry into AT&T's markets. It stymied entry into terminal equipment in earlier years until overruled by the federal courts. When competition in long-distance services emerged from MCI and others, the Commission moved to block it without

The Free State Foundation
P.O. Box 60680, Potomac, MD 20859
info@freestatefoundation.org
www.freestatefoundation.org

ever analyzing whether such entry would be economically feasible or welfare-enhancing. This protectionism finally ended when MCI won a court battle against the FCC and the Justice Department broke up AT&T after a decade of litigation.

A similar story unfolded in video distribution. In the 1950s, the FCC allocated broadcast spectrum in a manner that ensured that no more than three national television networks could survive even though less restrictive policies were available. When competition sprang up in the form of cable television, the FCC moved to protect the television broadcasters' market power (that it had created) by prohibiting cable operators from offering live sporting events, most motion pictures, and television series reruns. This protectionism ended in the late 1970s when the federal courts ruled against most of these "pay TV" restrictions. Cable television then flourished for more than a decade until Congress enacted cable rate regulation in 1992, an exercise that failed badly, leading to essentially cable rate deregulation in 1996.

Perhaps the most relevant precedent in the history of regulatory protectionism for the current discussion surrounding the proposed net neutrality rules was the FCC's decision to constrain the allegedly-monoposonistic television program procurement practices in the 1970s. After creating the protected three-network broadcast oligopoly through its spectrum allocation policies and then its constraints on cable television, the Commission bowed to pressure from Hollywood in 1970 to block the networks from allegedly exercising their market power by acquiring the rights to revenues from subsequent reruns of their network programs – programs procured mainly from the large Hollywood studios. These "financial interest and syndication" rules thus prevented the networks from sharing in the risk of new program series by investing in the subsequent distribution of these programs, making it difficult for small producers not affiliated with a Hollywood studio to compete for network contracts. The result was an increase in the concentration of program supply in the hands of the Hollywood studios, and a loss of potentially innovative programming for viewers. Regulating the "powerful" television networks that the FCC had created in turn increased upstream market power – a result we should wish to reflect upon as the FCC moves to regulate broadband distributors' arrangement with upstream media companies.

Ironically, the FCC is now being egged on in its new regulatory pursuit by those who view regulation as necessary to maintain an "open" Internet through which innovative start-ups can gain access to the public and by a variety of large Silicon Valley firms. At the center of the debate has been the potential practice of "paid prioritization" of network traffic, which now is close to non-existent. This refers to agreements between content suppliers and distributors for high-speed access lanes to their subscribers that the advocates of regulation see as a violation of network neutrality and large content providers view as damaging to their bottom line.

As many have noted, the FCC is about to adopt its new net neutrality rules without any evidence that there is a problem to address. Proponents of strict net neutrality regulation respond that this new FCC foray is required because even in the rivalrous broadband market of today, distributors have the ability and the incentive to quash or discourage entry into upstream media ventures through discriminatory practices as gatekeepers of broadband content. This discrimination has not yet developed to any extent, but the Netflix carriage agreements with Comcast and Verizon last year has led many to believe that the Internet service providers are now launching a major campaign of such discrimination.

The regulation of these large incumbent broadband distributors, with a combined enterprise value approaching \$1 trillion, was strongly supported last year by a consortium that included Amazon, eBay, Facebook, Google, Microsoft, Netflix, Twitter, and Yahoo, whose market value far exceeds \$1 trillion. Given the history of telecom and video regulation, it is difficult to believe that the FCC's decision to mediate disputes among these communications giants will ultimately result in more market entry and innovative new communications and media ventures down the road than would occur in an unregulated marketplace.

Are the proponents of regulation truly seeking to increase competition in their markets for the benefit of consumers, or are they simply trying to shift more of the economic cost of distribution of their media products onto these consumers? Has the political environment in which regulators operate changed so dramatically in the past few years that the "independent" regulator, the FCC, is now less subject to political pressure from these powerful interest groups than in earlier years? Surely, such a notion is at odds with Chairman Wheeler's recent capitulation to the political pressure brought on this issue by the Obama White House late last year.

Moreover, the marketplace suggests very strongly that discrimination is hardly imminent and may not even be profitable for the broadband Internet service providers. If the "paid prioritization" of the Netflix agreements is a form of profitable discrimination by the providers, why did its emergence not lead to a surge in the stock prices of the telecom and cable companies? And if such discrimination were profitable, why has there not been a trend of vertical integration between media companies and distributors?

Years ago, Time Warner spun off its cable television operations. Disney, the world's largest traditional media company, has not shown any interest in buying cable or telecom carriers. Comcast's acquisition of NBC has not had a noticeable effect on Comcast's economic performance or its stock price. AT&T and Verizon have entered the video distribution business, but there is no evidence that they are about launch major acquisitions of content suppliers, even as these media companies begin to offer their content "over the top." (They may reconsider if the FCC's forthcoming net neutrality rules prevent them from negotiating efficient carriage agreements with media companies!)

The absence of such vertical integration suggests that the broadband Internet providers do not think that there are substantial joint economies from owning content and that they cannot profitably discriminate in favor of their own content. The history of FCC regulation demonstrates convincingly that the agency should wait until marketplace evidence provides a different conclusion. It could be a long wait.

* Robert W. Crandall, a member of the Free State Foundation's Board of Academic Advisors, is a Nonresident Senior Fellow at The Brookings Institution and the Technology Policy Institute.

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