THE FREE STATE FOUNDATION

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

Perspectives from FSF Scholars
January 29, 2014
Vol. 9, No. 6

The Problem With Net Neutrality: Internet Regulation Is a Losing Gambit for a Fast Moving, Innovative Industry

by

Richard A. Epstein *

This past week in Verizon v. FCC, the Federal Circuit Court for the District of Columbia once again addressed the mysterious role that net neutrality plays in the Federal Communications Commission's regulatory arsenal. The simplest definition of net neutrality stresses that a telecommunications company must treat all data on the internet equally, without allowing for any prioritization by content or price differentials among customers.

The FCC sought to regulate the operations of broadband companies, like Verizon, that routinely speed large amounts of data across the Internet through high-speed technological devices such as cable modems. In order to implement its program, the FCC adopted certain anti-blocking, anti-discrimination, and disclosure rules that limit how these broadband companies can operate. The case thus raises tricky questions of law and profound issues of social policy.

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

The FCC Goes to Court

Federal Circuit Court Judge David Tatel's lengthy and meticulous decision said little or nothing about the soundness of net neutrality. But it had a great deal to say about the FCC's tangled regulatory web, especially as it relates to the elusive distinction between a "common carrier" on the one hand and an "information service provider" on the other.

First, it is widely settled that the FCC has extensive power to regulate common carriers. Just as their name implies, these companies carry things, from passengers to telephone messages to electricity. By virtue of being common, and not private, their obligation runs to all persons who request their services. Those two principles, when taken together, form the opening wedge for an extensive system of regulation, as in the present net neutrality dispute.

If a common carrier must take all comers, it cannot be given the option to turn down individual customers: hence the FCC's anti-blocking rules. And if the common carrier cannot exclude some customers, so too it cannot charge them rates so high that they amount to a de facto exclusion: hence the general injunction to charge only "just and reasonable rates." It's no surprise that affected industries often try to circumvent these regulations. Consequently, the vigilant government applies the anti-discrimination norm to all "charges, practices, classifications, regulations, facilities, or services." Disclosure obligations then enforce these basic regulations.

Information services are said to fall outside the category of common carrier obligations. But how should we distinguish between the two classes? As far back as 1980, the FCC administratively drew a distinction between 'basic' and 'enhanced' service, whereby only the former could be regulated under common carrier rules. The supposed ground of distinction is that information services do more than transmit information. They also supply content or the processes that transform information. Hence certain "edge providers" like Google, Twitter, and YouTube indisputably fall outside the common carrier rules. But it is a lot harder to see why it is that the rapid speed of broadband should somehow exempt it from common carrier regulation.

It looks, therefore, as though Verizon has to be wrong as a matter of law. But that hasty conclusion overlooks the administrative law complexities of the case. Quite simply, the FCC's own administrative rules have classified broadband as an information service. The Supreme Court's usual rules of administrative deference allow the FCC to make that decision.

But like all decisions, this one has consequences. The D.C. Circuit concluded that the FCC could not have it both ways. Judge Tatel held that once the FCC refused to classify the broadband providers as common carriers, it was expressly prohibited from treating them that way. Since its anti-blocking and anti-discrimination regulations were vintage common carrier rules, the FCC could not save its regulations by appealing to broad general statements in the FCC Act holding that "the FCC shall encourage the deployment on a reasonable and timely basis of advanced telecommunications capability to all Americans." The particular mandate trumps the general exhortation.

Regulation in Limbo

The technical peculiarities of Verizon have vast implications for the future direction of broadband services. The fuzziness of the statutory definition leaves the FCC the option of reclassifying broadband as a common carrier service. As a matter of ordinary language, that looks to be the correct call. Thus, in the future it seems highly unlikely that the District of Columbia Circuit Court would strike down any administrative decision that brought regulation into closer concordance with the statutory language.

The FCC, however, is not obliged to undertake that step, and political pressures currently are mounting on all sides of that reclassification effort. People eagerly ask whether potential losers, like Netflix, will have the power to turn things around. This unfolding spectacle is in itself a strong condemnation of the entire system of telecom regulation, which leaves too much space for destructive political manipulation. One advantage of a strong system of property rights is that the state's role is limited to enforcing the exclusivity of the property rights, so that millions of dollars are not wasted in trying to shift ceaselessly from one regime to another.

The question then arises, what kind of property regime? In this regard, it is necessary to go back to the first principles of common carrier regulation, starting with the famous work of Sir Matthew Hale, de Portis Maribus, which was incorporated into English law in Allnut v. Inglis in 1810. Under the banner of businesses "affected with the publick interest," these venerable authorities held that a requirement that a party provide services, to use the modern phrase, on reasonable and nondiscriminatory terms, worked as an offset to monopoly power that arose for some "essential facility" that has no close substitutes.

Note this profound reversal. In competitive markets, a refusal to deal is what makes the economy work, because it prevents any forced interactions that could prove disastrous for one side or the other—hence the sensible rule that the customer who was refused service from one merchant could just do business with another. But in the monopoly setting, there is no other rival merchant next door; rate regulation was intended to reduce monopoly rates to competitive levels. This enterprise of rate regulations poses serious compensation risks, so that the American cases have, for close to 125 years, imposed judicial review to see that the rates imposed allow the firm in question to make a reasonable return on invested capital.

Of course, the entire regulatory process is fraught with abuses that in individual cases could leave the established rates either too high or too low. It follows therefore that with the first whiff of competition a strong case arises for dispensing with the rate regulation process altogether. In the short run, this might lead to higher rates, but, in the long-run, innovation from new entrants will tend to drive rates down to a competitive level that is likely unattainable under sclerotic rate regulation systems.

So in the end, the key substantive decision should not turn on whether broadband providers transmit or create information. It should turn on whether or not they can exert any form of monopoly power in some relevant market. As a general matter, the faster the technological transformation, the less desirable the monopoly regulation. Firms like AOL and Blackberry, once thought to possess monopoly power are now footnotes in modern policy debates. The great danger of regulation is that those intended to foster competition will further entrench the position of incumbent players.

A Defense of Net Neutrality?

Many proponents of net neutrality argue that the power to exclude is fraught with the risk of abuse. Writing on Slate, Marvin Ammori raises this concern to a fever pitch, by insisting that only net neutrality prevents Comcast from blocking Facebook or Bing, or Verizon from offering better terms of service to the Huffington Post than Slate. One purported consequence of this high-handed action is that the delay could "stifle innovation." What is striking about this one-sided account is that it does not address any possible efficiency advantages from rejecting net neutrality.

The first of these efficiency considerations is that it is a lot cheaper to operate a system that makes no pretense of putting in place the elaborate scheme of regulation that now applies to common carriers. Second, we have already had extensive experience with systems, like the internet and cell phone networks, that are not subject to direct rate regulation and we have not seen any of the odious practices that Ammori predicts.

Most importantly, however, he does not attribute any social gains to the ability of carriers to prioritize and price information as they choose. But that cannot be right in light of how firms operate in competitive industries.

Federal Express does not have a monopoly in the shipping business. In order to bolster its service, it engages in extensive forms of price discrimination. It lets its customers decide whether they want same-day, one-day, or two-day delivery, and then charges them in accordance with their preferences, with rate differentials that it sets for itself. The upshot is a wide array of services that is only possible when government does not stand between the conception and execution of a planned program. Product and price differentiation improve consumer welfare.

Similar practices have driven success in hotels and airlines. Indeed, the forces of innovation are so great, that it may well be the case that it is better, especially in rapidly evolving industries, to forget the idea of rate regulation altogether, given that future competitors, sensing opportunity, will attack first those market niches where monopoly power still exists.

Ammori does note, correctly, that there are certain markets in which some service providers may well possess monopoly power. But for those incursions, net neutrality is still not the answer. Even in the short run, rival plays will seek to steal market share from the monopolist. In the long run, the rapid movement of technology has already left us with a new and vibrant landscape that is light years removed from a generation ago when the major premise of the Telecommunications Act of 1996 was that landlines would continue to hold a monopoly position for years to come—about two years, in fact. That false premise led to extensive regulatory battles over all the interchange relations between local exchange carriers and long line carriers. But the rise of cell phones and VoIP technology changed all that, so that the regulation did much to hamper innovation, but virtually nothing to protect consumers.

The lessons apply here. It is always a desperate mistake to allow hypothetical horror stories to set the intellectual stage for evaluating regulatory proposals. Quite simply, Slate will be able to access all major networks because no broadband carrier wants to face the consumer wrath and defections that would surely accompany high-handed and intrusive interventions.

The correct approach therefore is to do nothing. The FCC need not implement any regulations. For now, it should sit back and relax. If some crisis occurs that merits new forms of internet regulations, we can address that situation when it comes. But for the moment, innovation on the internet is doing great. Let's keep it that way.

* Richard A. Epstein, Free State Foundation Distinguished Adjunct Senior Scholar, is the Peter and Kirsten Bedford Senior Fellow at the Hoover Institution, and the Laurence A. Tisch Professor of Law at New York University. *The Problem With Net Neutrality – Internet Regulation Is a Losing Gambit for a Fast Moving, Innovative Industry* first appeared in the *Hoover Institution Journal* on January 20, 2014 and is republished here with permission.

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