Response to Questions in the Third White Paper

"Competition Policy and the Role of the Federal Communications Commission"

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before the

Committee on Energy and Commerce, U.S. House of Representatives

June 13, 2014

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I. Introduction and Summary

Once more we commend the Committee for undertaking this effort to review and update the Communications Act. As we have stressed in our prior Responses to the Committee, this reassessment is necessary because the Communications Act needs updating.

We agree with the Committee's characterization in its Third White Paper that takes proper account of both the technological advances and dramatic marketplace changes. In much the same language used in the Free State Foundation's First Response to the Committee, the Third White Paper explains:

> The evolution of technology from analog to digital and narrowband to broadband has brought about the integration of voice, video, and data services across multiple platforms employing various technologies. The ongoing shift away from single-purpose technologies toward Internet Protocol packet-switching has rapidly called into question the adequacy of the current Communications Act and the

[*] While the signatories to this Response are in general agreement with the views expressed in these comments, their participation as signatories should not necessarily be taken as agreement on every aspect of the submission. The views expressed should not be attributed to the institutions with which the signatories are identified.

monopolistic assumptions on which it is based.[1]

This statement is an accurate characterization of the profound transformation that has occurred in the communications marketplace. As the White Paper states, it is against this backdrop that "an examination of competition policy and the Communications Act is warranted as part of its ongoing update efforts."[2] In order to enhance overall consumer welfare, a new Digital Age Communications Act must be crafted in a way that requires the FCC to take into account the existence of the increasing cross-platform, facilities-based intermodal competition that characterizes the digital environment. The Committee's Third White Paper presents a number of specific and overlapping questions on competition policy. The tenor of the questions makes it clear that the Committee is especially interested, as it should be, in the role that the existence of intermodal competition should play in assessing overall market competitiveness and in formulating regulatory policy.

The generalized framework presented in this response will offer a holistic response to these separate but interrelated questions. This approach fits with our central theme that facilities-based, cross-platform intermodal competition, enabled by the rise of digital and Internet Protocol-based services, has yet to be sufficiently taken into account by the FCC in its decision-making. While new technologies continue to emerge and older technologies evolve in unpredictable ways, at present the communications marketplace is impacted positively by competition among cable firms, telephone companies, satellite operators, fiber providers, and various sorts of wireless companies, each employing their own facilities. In order to encourage the further development of intermodal platform

[1] "Competition Policy and the Role of the Federal Communications Commission" ("Third White Paper"), House Commerce Committee, at 1.
[2] Third White Paper, at 2.

competition on a long-run sustainable basis, the Commission must avoid adopting policies that, in effect, seek to "manage" competition through resale and sharing mandates. What is needed in its place is a consistent, principled competition policy framework premised on facilitating free entry and exit as the basic rule, which should then be qualified by targeted *ex post* remedies rather than by prescriptive *ex ante* regulation.

Stated otherwise, a combination of rapid technological innovation, consumer choice, and disruptive changes in the communications market has altered forever the traditional competitive landscape. These profound structural and technological changes point to the need for a competition policy that leaves free from government regulation those market processes that continue to propel further innovation and competition for new services. Regulatory intervention is only warranted in instances where there is convincing evidence of a market failure that is likely to harm consumers. Absent such evidence of market failure, service and product suppliers should be free to exercise their informed business judgment in an entrepreneurial fashion. Their success will be shaped by how an ever more sophisticated generation of telecommunications consumers respond to their business offers. The interaction of both sides of the market place will outperform any effort by the FCC to chart through government design the direction of future innovations in the ever larger and more complex Internet marketplace.

To this end, under a revised Communications Act, FCC oversight of the modern communications marketplace should be conducted pursuant to a consumer welfare-based standard that relies heavily on antitrust-like microeconomic analysis. That is, the FCC's competition policy should be oriented toward the economically productive and efficient

processes by which market participants bring innovative products and services to consumers and respond to changing consumer demands, rather than to any preconceived notions by government officials concerning the shape of the market or the terms and conditions under which services may be offered. From an institutional standpoint, the FCC's competition policy should be geared much more toward *ex post* adjudications than broad *ex ante* prescriptive rulemakings.

II. Competition Policy and Processes for a New Communications Act

While a new Communications Act should not direct the FCC to apply current antitrust precedents in a rigid fashion, it should require that FCC competition policy draw upon the insights of antitrust jurisprudence for purposes of analyzing what kinds of market practices poses competitive issues. As the Free State Foundation scholars stated in their First Response, adherence to these antitrust-like jurisprudential principles would properly require the FCC to engage in a rigorous economic analysis of market conduct that focuses on actual and potential competitive effects of various firm practices, technologies, and innovations. Such analysis would necessarily take into account the impact of the dynamism – and the "creative destruction"[3] – that characterizes the digital marketplace.

Regulatory prohibitions and sanctions under the new Communications Act should generally be accomplished through focused adjudicatory proceedings. The filing of individual complaints, whether by consumers or market rivals, should contain specific allegations of abuse of market power. The burden should rest on complainants to demonstrate the need for regulatory intervention by clear and convincing evidence of anticompetitive conduct and its likely resulting harm. Any regulatory intervention by the

[3] See Joseph A. Schumpeter, *Capitalism, Socialism and Democracy* 87 (3d ed. 1950).

FCC should thus normally be tied to a finding of a threat of market power abuse and a concomitant threat of consumer harm. Furthermore, due to the dynamism that characterizes the modern communications marketplace, these allegations of market failure should show more than some transitory failure that can be met by targeted responses of other market participants. Therefore, any allegations of market failure should be "non-transitory" in order to trigger a Commission response.[4]

Adoption of a competition policy based on a consumer welfare standard grounded in antitrust-like principles necessarily means discarding the indeterminate public interest standard. As already explained further in FSF's Response to Questions in the First White Paper,[5] the current public interest standard confers almost unbridled discretion on the agency without sufficient direction from Congress.[6] The public interest standard is a vestige of monopoly-era assumptions that unwisely assume regulatory intervention as the norm. As we explain below with a few specific examples, this traditional approach places high hurdles to obtaining deregulatory relief even when market conditions have introduced effective competition. Under a revised Communications Act, competition policy should place the burden on the FCC to demonstrate the necessity of regulatory intervention to address market power concerns that threaten harm to consumers. [7]

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[4] See Randolph J. May and James B. Speta, "Digital Age Communications Act," Proposal of the Regulatory framework Working Group, Progress & Freedom Foundation, June 2005.
[5] Free State Foundation Response to Questions in the First White Paper, "Modernizing the Communications Act" (January 31, 2014).
[6] Randolph J. May, *The Public Interest Standard: Is It Too Indeterminate to Be Constitutional?* 53 FED. COMM. L. J. 427 (2001).
[7] See Randolph J. May, "A Modest Proposal for FCC Regulatory Reform: Making Forbearance and Regulatory Review Decisions More Deregulatory," *Perspectives from FSF Scholars*, Vol. 6, No. 10 (April 7, 2011); Randolph J. May, "The FCC's Net Neutrality Proposal: The Wrong Way to Use Regulatory Presumptions," Free State Foundation Blog, June 4, 2014.

Application of a marketplace competition standard would make it easier for communications companies to develop ideas and bring new products to market without first having to gain government approval. An *ex ante* regulatory regime that operates mainly through rulemaking inhibits spontaneous innovation and investment by imposing heavy entry barriers on new technologies. Under such a regime, entrepreneurs may feel compelled to submit new services or products to the Commission for review or face the threat of subsequent litigation and sanctions over their lawfulness. An *ex post* process, operating under a proper competition standard, would encourage businesses to bring new services and products to the marketplace without seeking prior regulatory approval.

Establishing a regulatory construct for the FCC favoring *ex post* adjudications necessarily means transforming the FCC into more of an enforcement agency that operates much more like the Federal Trade Commission, at least with regard to competition issues. This transformation does not mean that the FCC necessarily should be precluded from adopting generic rules that define, in advance, certain specific acts or practices that constitute threats of abuse of market power because they cause consumer harm. But such rulemaking authority should be circumscribed by incorporating as a precondition for adoption of a new rule the market failure and consumer harm analysis discussed above.

To be sure, there are some specific but limited areas where the FCC may be granted express rulemaking authority. For example, the FCC should have carefully delineated authority to address interconnection practices that might pose significant consumer harm if the agency finds that marketplace competition is not adequately

protecting consumers.[8] This authority is peculiarly appropriate because hold-up problems can easily arise in complex settings that only function well when all carriers, regardless of size or content, have to gain unqualified access to all users of the Internet. Spectrum provides another example where the FCC rulemaking authority may be needed to address interference issues or other technical matters. It should be stressed, however, that the same basic consumer welfare and antitrust-like competition principles should inform the FCC's exercise of its rulemaking authority in these areas. As explained in FSF's Response to the Second White Paper,[9] spectrum policy should transition from a command-and-control model to a property rights-based approach. Consistent with this paradigm shift, FCC spectrum policy should emphasize flexibility that allows service providers to respond to marketplace changes without having to endure onerous government processes used to reallocate of spectrum across different uses.

Any FCC rules based on competition policy should sunset automatically after an appropriate period of time, say, five years. However, the FCC could be allowed to extend such rules if it affirmatively finds, based on clear and convincing evidence, that there is a market failure that necessitates continuation of the rules to prevent consumer harm.

III. Intermodal Competition: Policy and Process Implications

Under a new Communications Act, FCC competition policy and agency processes should comport with the realities of increasing facilities-based intermodal competition

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[8] See note 5 infra. Parties to an interconnection dispute should be required to engage in some form of dispute resolution process such as mediation prior to seeking FCC decisional intervention. And if it proves necessary for the Commission to intervene to resolve the dispute, the agency should avoid employing traditional administrative public utility-like proceedings in favor of more efficient processes such as baseball-style arbitration. See Randolph J. May, "Testimony of Randolph J. May, President, Free State Foundation," Hearing on "Evolution of Wired Communications Networks," Subcommittee on Communications and Technology (October 23, 2013).

[9] "Free State Foundation Response to Questions in the Second White Paper," (April 25, 2014).

across digital platforms, and they should promote the continued development of facilities-based competition. Too often in the past, for example during the Commission's years-long Unbundled Network Elements ("UNE") proceedings, the agency adopted regulations requiring various forms of network unbundling and facilities sharing. This has been done with the notion that such mandated sharing increases competition, but it generally doesn't accomplish this purpose. Instead, such policies necessitate the existence of an ongoing regulatory program in which the government sets the rates, terms, and conditions under which the unbundled and shared services must be offered. When the required unbundling is excessive, or the regulated sharing price set too low, the new entrant is able to game the system by purchasing elements at bargain rates. Yet if the rates are set too high, the new entrant can resort to market alternatives. FCC policies must guard against the creation of these free options. Yet at the same time, with respect to unique essential facilities, it is critical not to set rates in ways that block new entry.

Many of these issues surfaced in *AT&T v. Iowa Utilities Board*, where the Supreme Court reviewed the FCC's implementation of the network unbundling requirement in the Telecommunications Act of 1996.[10] In invalidating the Commission's UNE rules, the Court concluded that the agency had interpreted the statutory unbundling standard so loosely that it wrongly gave the sharing beneficiaries "blanket access" to the incumbent carriers' networks.[11] Justice Breyer's separate opinion emphasized the ultimate harm to competition caused by the FCC's rules requiring excessive sharing:

> Increased sharing does not by itself automatically mean increased competition. It is in the unshared, not the shared, portions of the enterprise that meaningful competition would likely emerge. Rules that force firms to share every resource

[10] 525 U.S. 326 (1999).
[11] Id. at 390.

> or element of a business would create not competition, but pervasive regulation, for the regulators, not the marketplace, would set the relevant terms.[12]

After the Supreme Court's rebuke in *Iowa Utilities Board*, the FCC tinkered with its network unbundling rules before the revised version came back before the D.C. Circuit for review. In *U.S. Telecom Ass'n v. FCC*,[13] the UNE rules were once again invalidated for requiring excessive sharing. As Judge Williams explained, referring to Justice Breyer's *Iowa Utilities Board* opinion, "each unbundling of an element imposes costs of its own, spreading the disincentive to invest in innovation and creating complex issues of managing shared facilities."[14]

All too often, the FCC has failed to grasp this fundamental point. When revising the Communications Act, the goal, as Justice Breyer put it, must be to foster "meaningful competition," not to unwisely maintain "pervasive regulation." And this requires observance of a proper competition standard, such as we have suggested, that favors investment in new facilities over mandated sharing of existing facilities. Under such a proper standard, older technologies can be adapted to new purchases. It was commonly thought as late as 1996 with the passage of Telecommunications Act that local exchange carriers would be able to maintain a bottleneck position for the foreseeable future. Within a few years, it became clear that cellphone technology, VoIP, and the Internet could provide viable alternatives. Regulatory policy will always go down the wrong path if it

[12] Id. at 428 – 429.
[13] 290 F. 3d 415 (D.C. Cir. 2002).
[14] Id. at 427.

ignores the dynamic forces that constantly undercut the creation and maintenance of services monopolies.[15]

Still tied to the silo structure mindset that subjects various services to disparate regulatory requirements, the FCC to date has shown too little interest in evaluating intermodal competition. This lack of interest is perhaps most pronounced when it comes to the substitutability of wireless services for wireline in relation to the overall competitive dynamics of cross-platform rivalry. The FCC has declined to undertake any meaningful analysis of intermodal competition between wireless service and wireline in its *Wireless Competition Reports*.[16] Its *Qwest-Phoenix MSA Order* (2010) and subsequent forbearance orders effectively have rejected cross-platform competition from wireless voice services by imposing a heavy presumption against the substitutability of wireless for wireline.[17] This despite the significant and predictable observable losses in wireline market share to wireless. It is striking that during the first half of 2013, 39.4% of households did not have a landline telephone but did have at least one wireless phone.[18] Just 17 years after passage of the 1996 Telecommunications Act, the FCC's *Local Telephone Competition Report* states that, as of December 2013, the number of wireless

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[15] See, for an early statement of this position, Harold Demsetz, *Why Regulate Utilities?*, 11 J.L. Econ. 55 (1968); Richard A. Posner, *Natural Monopoly and Its Regulation*, 21 STAN. L. REV. 548 (1999).

[16] See Seth L. Cooper "Convergent Market Calls for Serious Intermodal Competition Assessments," *Perspectives from FSF Scholars*, Vol. 8, No. 12 (May 2, 2013). The FCC has

[17] See Memorandum Opinion and Order, *In the Matter of Petition of Qwest Corporation for Forbearance Pursuant to 47 U.S.C. § 160c) in the Phoenix, Arizona Metropolitan Statistical Area*, WC Docket No. 09-135 (June 22, 2010). See also note 3, infra.

[18] See Stephen J. Blumberg, Ph.D., and Julian V. Luke, "Wireless Substitution: Early Release of Estimates From the National Health Interview Survey, January-June 2013," Division of Health Interview Statistics, National Center for Health Statistics, Centers for Disease Control and Prevention (released December, 2013).

subscriptions – 305 million – is now *more than three times* the number of wireline access lines – 96 million.[19]

Similarly, in its *Video Competition Reports* the FCC continues to disregard online video as a cross-platform competitive substitute for multi-channel video programming distributor (MVPD) services – even as Netflix has mushroomed into the nation's largest distributor of video program with over 33 million U.S. subscribers, more subscribers than than Comcast and the two satellite TV distributors have.[20] Indeed, almost 50% of U.S. households now subscribe to Netflix or one of the other leading online video distributors, such as Hulu Plus or Amazon Prime.[21] This discounting of the rapidly growing online video distributor market segment in competitive assessments is unwise. It comes on top of the FCC's continued indifference to intermodal competition from direct broadcast satellite (DBS) providers and telephone company entrants into the MVPD services market. All told, such multiplatform competition has reduced cable providers' share of the multi-channel video market to 55.7% by the end of 2012, down from approximately 60% in 2010.[22] Yet, the video regulations of the early 1990's were all wrongly premised on the faulty assumption that the market power of cable operators could be maintained for the indefinite future. One consequence of this unsound assumption was a raft of

[19] See FCC, *Local Telephone Competition Report* (2013).
[20] See Seth L. Cooper, "FCC's Video Report Reveals Disconnect Between Market's Effective Competition and Outdated Regulation," *Perspectives from FSF Scholars*, Vol. 7, No. 25 (September 12, 2012).
[21] Janko Roettgers, "Close to Half of All U.S. Households Subscriber to Netflix, Amazon Prime or Hulu Plus, GIGAOM, June 6, 2014, at: http://gigaom.com/2014/06/06/close-to-half-of-all-u-s-households-subscribe-to-netflix-amazon-prime-or-hulu-plus/
[22] See FCC, *Fifteenth Video Competition Report*, (2013). See also Seth L. Cooper, "FCC Report Reconfirms the Reality of the Video Market's Competitiveness," *Free State Foundation Blog* (July 25, 2013).

must-carry regulations, program carriage regulations, and video device regulations, all of which impose serious threats to operators' First Amendment rights.

Any new Communications Act should place intermodal competition at the center of the FCC's analysis of market competition. The explanatory power of static market indicators such as market concentration or market share is severely limited when dynamic markets characterized by innovation and disruption are under review.[23] Convergence of services and the emergence of new services resulting from the digital transition are testaments to the persistence of market dynamism. Competition between different communications platforms must inform the product and service market definitions to be used by the FCC as part of its analyses of market power and potential consumer harm, including, of course, the Commission's evaluation of the competitive impacts of mergers and other transactions that require agency approval.[24] And these intermodal competition considerations should be brought to bear in periodic reports on competition in the communications market – presumably through a reconstituted FCC report that combines its annual wireless, video, and other reports.[25]

Our central point is that the rise of intermodal competition dismantles the analytical underpinnings of the FCC's silo approach to communications services as a whole. As more fully explained in FSF's Response to Questions in the First White Paper,

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[23] See Dennis L. Weisman, "On Market Power and the Power of Markets: A Schumpeterian View of Dynamic Industries," *Perspectives from FSF Scholars*, Vol. 3, No. 5 (2008).

[24] There is an extensive literature on the need for reform of the FCC's transaction review process. And many scholars have suggested that, in light of the competition reviews undertaken by the Department of Justice or the Federal Trade Commission, the FCC's role should be limited to ensuring that the proposed transaction complies with all existing agency rules. This would eliminate the substantial duplication of effort that currently occurs when a proposed transaction is reviewed by both the FCC and the antitrust authorities.

[25] See Randolph J. May, "Testimony of Randolph J. May, President, Free State Foundation," Hearing on "Evolution of Wired Communications Networks," Subcommittee on Communications and Technology (October 23, 2013).

the various silos – whether denominated "telecommunications," "information services," "cable service," "mobile service," or so on – are primarily based on "techno-functional" constructs that do not comport with the realities of digital age technologies and service offerings and the way in which consumers perceive the choices available to them in the marketplace.[26] Technological transitions to all-digital and to all-IP services have furthered the integration and interchangeability of voice, video, and data services regarded as discrete and separate. Consumer expectations for a consistent interface and end-user experience across multiple platforms dictate the end of the prevailing "silo" approach.[27]

Convergence in spectrum applications, described in FSF's Response to Questions in the Second White Paper, offers yet another instance in which the silos created by Communications Act's Titles II, III, and VI have become increasingly obsolete. Promoting intermodal competition among different spectrum-based applications requires a reoriented analysis that is cut free from the legacy definitional constructs. A revised Communications Act should facilitate a vigorous competition policy that fosters entrepreneurialism by facilitating a flexible use, market-oriented regime. This market-based spectrum regime will allow spectrum resources to move easily to their highest and most valuable use, while simultaneously encouraging the development of new services and products.

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[26] See note 5 infra.

[27] As briefly summarized in the above section and addressed more fully in the Response to the First Paper, because consumer protection issues such as privacy and data security are form part of the FTC's institutional expertise, the FCC should surrender its jurisdiction over such issues to the FTC. See Randolph J. May and Seth L. Cooper, "Any New Privacy Regime Should Mean An End To FCC Privacy Powers," *Perspectives from FSF Scholars*, Vol. 7, No. 9 (April 5, 2012).

IV. Conclusion

As the Committee moves forward with its review and update process, including the evaluation of competition policy, we urge it to carefully consider and implement the views expressed in this Response.