The Free State Foundation

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Perspectives from FSF Scholars
June 9, 2010
Vol. 5, No. 16

The "Third Way" for Broadband Regulation: Goldilocks or the Big Bad Wolf?

by

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I. Introduction

The Federal Communications Commission has yet to release its Notice seeking comment on its proposed "third way" to impose net neutrality regulation on broadband Internet service providers since the federal appeals court in April called into question its attempts to do so through the exercise of *ancillary jurisdiction*.[1] All we have to go on thus far are relatively brief statements by FCC Chairman Genachowski and General Counsel Schlick.[2] Hence, out of necessity this discussion raises more questions than it answers. That said, getting the questions right is more than half the battle.

Chairman Genachowski's statement appears to say many of the "right" things. He stresses the importance of relying on the market wherever possible to foster competition, innovation and broadband deployment. He portends that the FCC has no interest in regulating the Internet *per se*, but adds that the agency must have backstop authority to protect against anticompetitive or unreasonably discriminatory behavior. The Chairman also correctly recognizes the chilling effect that regulation of broadband markets would have on infrastructure investment.

The devil is in the details, of course, and we have few of those. As the Chairman is the appointee of an Administration that could not be described as inherently marketfriendly, there is reason to be a bit suspect about what he means precisely when he invokes this *market mantra*. These observations notwithstanding, given that Chairman Genachowski has rightly emphasized the importance of crafting policy on the basis of fact-based inquiries, let's look at the facts.

II. Necessary Pre-Conditions for Government Intervention

Two necessary preconditions must be satisfied to justify market intervention in the form of economic regulation on the part of the government. The first one inquires as to whether there is a problem and the second one inquires as to whether there is a solution?[3] Only if both questions can be answered in the affirmative can such intervention be justified.

> ***Pre-Condition 1.*** Government intervention is presumptively unnecessary absent market conditions that (i) credibly establish that the abuse of market power (or threat thereof) poses a substantial, non-transitory risk to consumer welfare and/or (ii) should be expected to significantly undermine the integrity of the competitive process.

The first pre-condition simply establishes that there is a problem, or the reasonable expectation of a problem, to be addressed by regulatory intervention that is not self-correcting in nature. History tells us there is really no such thing as a little regulation – that the supply of regulation will tend to create its own demand as per *Say's Law*.[4] It is noteworthy that the appeals court voiced a similar concern when it observed that the *ancillary authority* argument that the Commission advanced would have the effect of conferring "unbounded" authority on the FCC that would "virtually free the Commission from its congressional tether."[5]

> ***Pre-Condition 2.*** No government market intervention can be justified unless the expected benefits of such intervention exceed the expected costs, appropriately defined.

The second pre-condition for government intervention may be thought of as the public policy counterpart to the *Hippocratic Oath* — "First, do no harm."[6] Simply stated, it is necessary to ensure that any regulatory intervention does not do more harm than good.

These two necessary pre-conditions are treated as axiomatic in the discussion that follows as the case for broadband regulation, light-handed or otherwise, is critically examined.

III. 'Just the Facts'

Chairman Genachowski invokes what may be termed the *Goldilocks Condition* to make the case for a "third way" in regulating broadband markets. That is to say, Title II is *too hard* and Title I is *too soft*, but the "third way" is just right. This argument presumes, of course, that an affirmative case for regulating broadband markets has been made. But these are facts not in evidence.

More than twenty-five years ago in an article entitled *The Uneasy Marriage of Regulation and Competition*, Professor Alfred Kahn observed that there is "no rational half-way house between thorough regulation and free competition."[7] Perhaps Chairman Genachowski believes that the Commission now stands at the "half-way house" of which Professor Kahn spoke. To wit, broadband is not a regulated monopoly, but perhaps, in the view of some parties, not effectively competitive in all markets either (more on this later). Professor Kahn followed this observation with another no less poignant one: "Between regulated monopoly and unregulated competition, regulated competition represents the worst of both possible worlds."[8] This begs the question as to whether the Chairman's "third way" is Goldilocks or the Big Bad Wolf?

The case for economic regulation of broadband markets is weak at best. The Commission can point to, at most, two cases where things went awry — *Madison River* and *Comcast*. *Madison River* was resolved with dispatch; and in the case of *Comcast*, the supposed cover-up was arguably worse than the alleged crime. There is no offense in reasonable network management practices designed to prevent congestion and maintain service quality. But subscribers have a right to expect full transparency with respect to how and when these practices are administered. Still, there was no evidence that Comcast engaged in these practices to disadvantage rivals. In other words, these two cases are little more than hiccups in a technologically-dynamic marketplace. It strains credulity to suggest that they somehow constitute evidence of a systemic and non-transitory market failure justifying regulatory intervention. They do not. If anything, these two cases substantiate the argument for reliance on a type of *regulatory contestability* in which the mere threat of regulatory action is sufficient to impose the requisite discipline. Whether for good or ill, the politically-charged nature of the entire net neutrality debate, at least at present, ensures that broadband providers will treat this as a credible threat.

The evidence in support of the exercise of undue market power in broadband markets would appear similarly lacking. In research recently conducted by Professor Tom Hazlett and myself, we found no evidence that the major incumbent telecommunications carriers or the cable companies were earning supra-normal returns that might be suggestive of market power.[9] In deference to *Necessary Pre-Condition 1*, the natural question to ask is "where's the beef?"

The absence of evidence to suggest that undue market power is being exercised in broadband markets belies credible complaint regarding the level of prices, but what about the structure of prices? The structure of broadband prices — how the total price is allocated between buyers and sellers or between broadband users and content providers — is a problem in the economics of two-sided markets.[10] The relevant policy conclusion regarding the structure of prices in these markets is that the price structure chosen by the monopolist may well be optimal, but when it is not, it is difficult to determine how the price structure should be changed to enhance economic welfare.[11] In other words, there can be no reasonable assurance that regulatory intervention to alter the price structure would not do more harm than good. As government intervention under these conditions violates *Necessary Pre-Condition 2*, the only prudent policy prescription is for the Commission to stand down.

Chairman Genachowski and General Counsel Schlick profess that the FCC has no interest in regulating the Internet in a heavy-handed way — prescribing broadband prices or mandating unbundling. That said, subjecting the "transmission component" of broadband to Title II (common carrier) regulation would nonetheless provide the option of prescribing prices or mandating unbundling.[12] Just as the appeals court observed in the context of actions the FCC argued were sanctioned by *ancillary authority*, under the Chairman's proposed approach, the Commission "could someday subject Comcast's Internet service to pervasive rate regulation . . ."[13]

The FCC can strongly influence, if not dictate, broadband prices through control of the pricing for the underlying transmission components of broadband. This is not direct regulation of retail broadband prices, but it might as well be. The obvious concern is that the regulation of broadband will prove difficult to contain despite the best intentions for doing so. As James Madison observed in *Federalist 51*: "In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself."

The call for non-discrimination rules is itself a non-trivial expansion of regulatory control. There are at least two problems that must be addressed. First, the FCC does not clearly differentiate between price discrimination and what is merely access-tiering, or setting different prices for different levels of service quality. Second, even in the case of actual price discrimination,[14] there is no credible basis for treating such practices as presumptively welfare-diminishing. There is now increasing recognition in the economics literature that not only are such practices consistent with competitive market behavior, but that competitive markets may actually force firms to adopt discriminatory rate structures for their own survival.[15]

Finally, there is no basis for a blanket prohibition on allowing vertically-integrated broadband providers to enter into exclusive serving arrangements with affiliated content providers.[16] Indeed, such a ban is itself discriminatory because it has the potential to preclude firms that have made large, irreversible investments in telecommunications infrastructure (and borne the significant risks associated with doing so) from differentiating their services in a manner that is likely to be welfare-enhancing. While vertical integration is not always of saintly intent, the economics literature does not support, nor has the FCC made the case, that such arrangements should be deemed presumptively anticompetitive. A more judicious approach, as others have suggested, would be to address any such questionable practices on an *ex post* basis through a formal complaint process or as an antitrust dispute.[17]

Chairman Genachowski rightly emphasizes the importance of a regulatory structure that encourages broadband deployment; such is important, not only for the vitality of the industry and the welfare of consumers, but for the economy in the aggregate. And yet a regulatory structure to encourage broadband deployment may well be a contradiction in terms. Recent empirical research reveals that the relaxation of regulation led directly to a marked increase in the rate of broadband deployment.[18]

As providing the requisite incentives for continued robust investment in broadband must take primacy, it should be recognized that Verizon's aggressive deployment of fiber optics (FiOS) would likely not have taken place absent the FCC's commitment that it would not subject FiOS to unbundling mandates. The FCC could argue (as has been argued previously in the case of local loops) that the costs of unbundling broadband networks should be minimal because those costs are now largely sunk. This is bad economics and even worse public policy — the regulatory equivalent of a *head fake* — but that alone will not deter its proponents.

IV. Conclusion

In a market economy, the policy default is not economic regulation, but rather reliance upon the market for providing the requisite competitive discipline. Regulatory intervention is warranted only in the case of a non-transitory market failure and then only when the expected benefits of regulation exceed the costs. In the case of broadband regulation, neither of these two preconditions has been met.

At the outset of this discussion, I posed the question as to whether Chairman Genachowski's "third way" is Goldilocks or the Big Bad Wolf? To be fair, it is too early to tell with certainty. But in the final analysis this may well be a distinction without a difference because, in this instance, even Goldilocks would appear to have some very big teeth!

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[1] Comcast Corporation v. Federal Communications Commission, Case No. 08-1291, D.C. Cir., April 6, 2010 (hereafter *Comcast v. FCC*).

[2] Julius Genachowski, "The Third Way: A Narrowly Tailored Broadband Framework." Federal Communications Commission, May 6, 2010. Austin Schlick, "A Third-Way Legal Framework for Addressing the *Comcast* Dilemma." Federal Communications Commission, May 6, 2010.

[3] This discussion is based, in part, on Dennis L. Weisman, "A 'Principled' Approach to the Design of Telecommunications Policy," *Journal of Competition Law & Economics*, 2010 (available at http://jcle.oxfordjournals.org/cgi/content/full/nhq004?ijkey=md5trWh820QSofr&keytype=ref.)

[4] In addition, regulators tend to emphasize short-term static efficiency over long-term dynamic efficiency when consumers would be better served by a reversal in emphasis. See Glen O. Robinson and Dennis L. Weisman, "Designing Competition Policy for Telecommunications," *The Review of Network Economics*, Vol. 7(4), December 2008, pp. 509-546.

[5] *Comcast v. FCC*, p. 23.

[6] See 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.

[7] Alfred E. Kahn, "The Uneasy Marriage of Regulation and Competition," *Telematics*, Volume 1(5), 1984, p. 8.

[8] Id., p. 2.

[9] Thomas W. Hazlett and Dennis L. Weisman, "Market Power in U.S. Broadband Services," December 2009. (Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1525568).

[10] See, for example, Jean-Charles Rochet and Jean Tirole, "Two-Sided Markets: A Progress Report," *Rand Journal of Economics*, Vol. 37(3), Autumn 2006, pp. 645-667.

[11]Glen E. Weyl, "The Price Theory of Two-Sided Markets," March 2009, p. 6. (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1324317).

[12] On this point, it important to note that the FCC has previously recognized that network "unbundling is one of the most intrusive forms of economic regulation – and one of the most difficult to administer . . ." (The fourteen years that have passed since the 1996 Telecommunications Act was signed into law have served only to validate this observation time and again.) See Federal Communications Commission, *In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, CC Docket No. 01-338, Report and Order and Order On Remand and Further Notice of Proposed Rulemaking, Released August 21, 2003, ¶ 141.

[13] *Comcast v. FCC*, p. 23.

[14] For our purposes, price discrimination may be defined as selling the same service at different prices.

[15] See, for example, William J. Baumol, Regulation Misled by Misread Theory: Perfect Competition and Competition-Imposed Price Discrimination, AEI-Brookings Joint Center, 2005; and Michael E. Levine, "Price Discrimination Without Market Power," *Yale Journal on Regulation*, Volume 1, pp. 1-36, 2002.

[16] For a discussion of this issue and its economic implications, see Reply Comments of Thomas W. Hazlett, *In the Matter of Preserving the Open Internet Broadband Industry Practices*, GN Docket No. 09-191, WC Docket No. 07-52, April 23, 2010, ¶¶ 28-42; and Dennis L. Weisman and Robert B. Kulick, "Price Discrimination, Two-Sided Markets and Net Neutrality Regulation," (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1582972).

[17] Jonathan E. Nuechterlein, "Antitrust Oversight of an Antitrust Dispute," *Journal of Telecommunications and High Technology Law*, Volume 7, 2008, pp. 19-66; and Alfred E. Kahn, "Network Neutrality," AEI-Brookings Joint Center for Regulatory Studies, Working Paper RP-07-05, March 2007.

[18] Thomas Hazlett and Anil Caliskan, "Natural Experiments in U.S. Broadband Regulation," *The Review of Network Economics*, Volume 7(4), December 2008, pp. 460-480.