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Opening the Internet to Regulation: Assessing Risks of the FCC's Failure to Limit Its New Powers

by

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The FCC grabbed front-page headlines with its recent "Open Internet" order adopting rules for regulating broadband Internet providers. In the order, the Commission purports to be acting to achieve "broad purposes," such as keeping the Internet "open" and "to encourage competition and remove impediments to infrastructure investment while protecting consumer choice, free expression, end-user control, and the ability to innovate without permission."

On the surface, these "broad purposes" sound appealing. But in practice they are so wide ranging that they invite the Commission to exercise extensive new powers to shape and dictate the future of broadband Internet practices. Through the regulatory framework set out in the order, the FCC may insert itself into the workings of the Internet value chain to pronounce regulatory blessings or curses on network management practices and cross-industry business pricing arrangements.

The FCC's new self-granted powers are also premised on an explicit rejection of any requirement for findings of anticompetitive conduct as the basis for its regulatory activity and future enforcement actions. This means that when the FCC seeks to advance its

"broad purposes" the agency will lack a sound analytical foundation for its regulatory intervention in the marketplace.

And without requiring findings of anticompetitive conduct and consumer harm as the basis for adjudicating claims that Internet provider practices should be sanctioned, the FCC's reliance on its vaguely articulated "broad purposes" could well result in arbitrary and capricious protectionist regulation for selected segments of the Internet marketplace. This is because the order contains ample seeds for differential treatment of competing marketplace rivals.

As a key example, the order adopts a set of non-exclusive categories for Internet "edge providers" and "end users." It treats so-called Internet "edge providers" differently, and more favorably, than all other "end users" for purposes of judging the lawfulness of pricing and other Internet market transactions. This analytical approach makes competitor welfare – the interests of "edge providers" – the underpinning of its no unreasonable discrimination rules. By contrast, an approach emphasizing consumer welfare – the interests of "end users" – would have made market power and consumer harm the touchstones of its framework.

Ultimately, the order provides the conceptual and precedential groundwork for competing marketplace rivals to seek out regulatory advantage through FCC enforcement proceedings. The order's procedural rules permit "any person" to file formal complaints with the Commission. This raises the real possibility that the FCC's framework will provide a new forum for tedious regulatory battles between rival companies and industry segments in the Internet ecosystem.

On the positive side, the FCC avoided the perils of imposing full-blown Title II common carrier regulation on broadband Information services. And it likewise avoided adopting an onerous set of rules to govern broadband network management practices by opting for a case-by-case approach. But by rejecting a standard of the anticompetitive abuse of market power to govern future adjudications and instead granting itself extensive powers to further "broad purposes," the FCC risks opening the Internet to extensive and arbitrary regulation.

The Commission's Regulatory Framework

The FCC's Order codifies into regulation three rules to which broadband Internet providers must adhere to. Those include: (1) Transparency; (2) No blocking; and (3) No unreasonable discrimination.¹ While appearing simple at first glance, these rules are actually complex collections of more detailed requirements and carve-outs. For instance, the "no blocking rule" doesn't apply to transmission of unlawful conduct. And it "bars broadband providers from impairing or degrading particular content, applications, services, or non-harmful devices so as to render them effectively unusable (subject to reasonable network management.)"²

Those more detailed requirements are by no means precise in each instance. In many instances they require judgments based on a balancing of competing interests. The "no unreasonable discrimination" rule, for example, supposedly "strikes an appropriate balance between restricting harmful conduct and permitting beneficial forms of differential treatment," that considers maximization of the value of "end user control" as well as conformity with best practices and technical standards adopted in the Internet engineering community.³

Also, in many instances the rules establish standards expressed in general terms rather than specific requirements. For example, the Commission defines "reasonable network management" as conduct "appropriate and tailored to achieving a legitimate network management purpose, taking into account the particular network architecture and technology of the broadband Internet access service."⁴ The scope of such conduct will be further developed "on a case-by-case basis, as complaints about broadband providers' actual practices arise."⁵

Both the rules themselves and their application will also vary according to whether or not the broadband Internet provider delivers wireline or wireless services. And the FCC will also render its decisions by taking into account the particulars of how respective technologies are used by different broadband Internet providers in different contexts.

Ultimately, how the new rules will apply – how the FCC will parse out the details, balance the interests, and define the scope of reasonable conduct – will be determined in future proceedings on a case-by-case basis.

Regulation Without (Anticompetitive) Limits?

In laying out the requirements and standards that make up its new broadband Internet regulatory framework, the FCC also rejects limits on the scope of its rules that were urged in public comments. As an initial matter, the order makes no finding and cites no evidence that broadband Internet providers currently possess market power and harm consumers. Thus, the FCC implicitly rejects the existence or likelihood of anti-competitive conduct as the basis for its new broadband Internet regulatory framework.

The FCC also explicitly rejects anti-competitive conduct as the basis of its future enforcement of the new rules. In a recent blog post, Free State Foundation President Randolph May highlights paragraph 78 in the FCC's order, which rejects the proposition that any FCC exercise of regulatory authority over broadband Internet providers regarding network management must be predicated on agency findings of market power or consumer harm.⁶ According to paragraph 78 of the order:

We also reject the argument that only "anticompetitive" discrimination yielding "substantial consumer harm" should be prohibited by our rules. We are persuaded those proposed limiting terms are unduly narrow and could allow discriminatory conduct that is contrary to the public interest. The broad purposes of this rule—to encourage competition and remove

impediments to infrastructure investment while protecting consumer choice, free expression, end-user control, and the ability to innovate without permission—cannot be achieved by preventing only those practices that are demonstrably anticompetitive or harmful to consumers. Rather, the rule rests on the general proposition that broadband providers should not pick winners and losers on the Internet—even for reasons that may be independent of providers' competitive interests or that may not immediately or demonstrably cause substantial consumer harm.⁷

As FSF President May responds in his recent blog post: "by disclaiming reliance only on anticompetitive injury and consumer harm (generally present only when an Internet provider possesses market power)," the Commission "is leaving itself with nearly unbridled discretion in deciding which Internet provider practices will be permitted and which will not."⁸ May also points out that by not requiring any showing of anti-competitiveness or consumer harm the FCC actually assumes for itself the power to pick such winners and losers. In other words, if FCC regulatory intervention into broadband Internet network practices is based on what regulators believe will generate better overall outcomes that satisfy its "broad purposes," then it will be easy for the Commission to justify a broad variety and extensive amount of Internet regulatory mandates. And following such a regulation-friendly, "broad purposes" approach to tackling complex and contentious Internet marketplace issues will also make it difficult to stave off regulation that favors one industry segment over another.

A Framework for Obtaining Regulatory Favoritism?

Unfortunately, some measure of industry favoritism already appears to be written in to the FCC's regulatory framework. In the order the FCC confers special status on what it calls "edge providers" ("content, application, service, and device providers") over what it calls mere "end users" ("any individual or entity that uses a broadband Internet access service").⁹ In fact, the FCC also gives edge providers certain advantages in the market when engaged in dealings with broadband Internet providers.

Significantly, the order states that it does not prohibit broadband Internet providers from offering end users metered or tiered pricing options.¹⁰ Whereas flat-rate pricing for all end users on the same terms results in light-use subscribers subsidizing heavy-use subscribers, metered pricing allows light-use subscribers to pay only for the length of time they spend online or the amount of data traffic they send and receive. Metered pricing also means certain heavy-use subscribers pay extra for service.

At the same time, however, the order does prohibit broadband Internet providers from actively seeking certain pricing options with edge providers – many of whom may also be heavy users of broadband Internet service. In the order, the FCC states that "[a] commercial arrangement between a broadband provider and a third party to directly or indirectly favor some traffic over other traffic in the broadband Internet access service connection to a subscriber of the broadband provider (*i.e.*, "pay for priority") would raise significant cause for concern."¹¹ And the FCC goes on to declare that "as a general

matter, it is unlikely that pay for priority would satisfy the 'no unreasonable discrimination' standard."¹²

Conversely, the order allows edge providers to charge broadband Internet providers fees for allowing end user subscribers access or prioritized access to edge providers' content. This means that an edge provider can require a broadband Internet provider to pay fees in order to allow its end user subscribers to stream or download certain edge provider content. The FCC maintains this differential treatment by expressly limiting the reach of its rules to broadband Internet providers, rejecting application of its neutrality rules to edge provider activities.¹³

One-Sided Regulation of Two-Sided Markets?

The order thereby limits the ability of broadband Internet providers to bargain with edge providers in one respect while giving bargaining leverage to edge providers in another respect. So the larger question raised by the order's differential treatment of priority access fees and edge provider-imposed fees is whether analytical justification exists for such differential treatment. What is the basis for the FCC interposing itself into the Internet value chain, according bargaining and pricing flexibility to certain players in certain circumstances but not to others?

Demonstrated existence of anticompetitive conduct in the broadband Internet market might justify differing regulatory treatment for edge providers. But as already indicated, the FCC makes no anticompetitive conduct findings and rejects any rationale tied directly to market power and consumer harm. The FCC relies instead on predictive judgments and conclusory assertions about economic incentives.

The FCC justifies its one-sided restriction on certain two-sided market transactions between broadband Internet providers and edge providers by relying on its self-styled mission to further "broad purposes." It insists that if broadband Internet providers could charge access or priority access fees to edge providers, then such transactions would be a departure from historical norms, could create transaction costs and impose barriers to entry, could harm non-commercial users who make heavy use of video, and could give broadband Internet providers incentive to limit the quality of non-prioritized traffic – all of which would reduce innovation on the Internet.¹⁴

The Commission's conclusions are also propped up by its insistence that "broadband providers have the ability to act as gatekeepers" or "terminating monopolist[s]."¹⁵ But "gatekeeper" status remains a somewhat hazy concept since the Commission defines the concept divorced from any market power considerations. As it contends in the order: "[t]hese threats to Internet-enabled innovation, growth, and competition do not depend upon broadband providers having market power with respect to end users."¹⁶ The FCC even goes so far to insist that "[a] broadband provider can act as a gatekeeper even if some edge providers would have bargaining power in negotiations with broadband providers over access or prioritization fees."¹⁷ In this instance, the use of labels tied to

activities the Commission deems less beneficial provides a regulatory rationale in place of a more discernable and rigorous standard such as consumer harm.

Moreover, the FCC dismisses any concerns that its "broad purposes" of reducing impediments to infrastructure investment would be adversely impacted by granting edge providers protection from having to bargain for access or priority access pricing while ensuring edge providers have the ability to charge Internet broadband providers for edge provider content. In so doing, the FCC declines to take seriously the idea that the same sort of pricing flexibility that could benefit light-use Internet subscribers through tiered pricing could also allow a broader range of end users to benefit from a similar pricing flexibility resulting in bargains between broadband Internet providers and edge providers concerning prioritized content.

Unfortunately, by taking the analytical approach set out in the order, the FCC makes competitor welfare – the interests of "edge providers" – the underpinning of its no unreasonable discrimination rules. An approach emphasizing consumer welfare – the interests of "end users" – by contrast, would have made market power and anticompetitive conduct the touchstones of its framework.

None of this is necessarily to assume or suggest that it is somehow desirable or beneficial for broadband Internet providers to charge edge providers priority access fees. Depending on the situation, it may or may not be. It is easy to imagine end user subscribers responding negatively to any broadband Internet provider practices that limit access to or diminish the quality of content that end users want. Rather, what is important is the concern over disparate treatment of business dealings that from an end user's standpoint lead to the same result. Regardless of whether it is the broadband Internet provider or the edge provider that is demanding fees for access to content, in both instances the experience of the end user in being ultimately unable to access content is functionally the same. A consumer welfare approach to broadband Internet and access to content would emphasize end user experience and focus on whether any lack of access to content stems from market power and anticompetitive conditions.

Utilizing Regulatory Definitions to Gain a Competitive Edge?

The privileged treatment accorded edge users in the order becomes more apparent in light of the FCC's murky distinction between "end users" and "edge providers." Given the criteria set out in the order, it is difficult to tell what distinguishes those categories. A media company offering video content online through its high-traffic website fits within the definition of "edge provider," but what about a blogger running a popular website that features frequent high-definition video entries and generates profits through blog ads? Might the former not also be a large subscriber to broadband Internet service – and therefore an "end user"? And might the latter "end user" also be a small "edge provider"? While a major online retail outlet offering digital downloads and non-digital products via direct mail suffices as an "edge provider," wouldn't the same be said for a broadband Internet subscriber who posts its own product storefront on a the online retailers site? Or consider a subscriber who runs a small, mom-and-pop retail store that

it complements with a low-traffic website to sell its respective goods online.

In fact, the order acknowledges that the regulatory definitions of "end user" and "edge provider" are "not mutually exclusive."¹⁸ This gives rise to the implication that "edge providers" are treated as a special, privileged kind of end user without clear justification. It is uncertain how the FCC will treat parties in future proceedings given its non-exclusive definitions of "edge providers" and "end users." But the order creates the precedent for the agency inserting itself into the market's value chain, deciding where pricing freedom exists and for whom. All of this raises the possibility that future attempts by the FCC to demarcate "edge users" from mere "end users" will become fertile ground for special interest pleading and lobbying.

The FCC's "end user"/"edge provider" analytical approach might well open the door to disputes similar to intercarrier compensation disputes raised at the Commission where significant benefits were accorded to parties depending upon whether they were designated as carriers or customers. Problems of this kind arose, for instance, when competitive local exchange carriers formed for the purpose of terminating and ending ISP-bound traffic, generating substantial revenues by collecting access charges from long-distance carriers. As FSF Academic Board Advisor Professor Gerald Brock has written, "[i]n the late 1990s, companies attempted to transform themselves from customers into LEC," the reason being that "[i]f a dial-up ISP could create a CLEC 'front' so that the traffic coming to it was treated as incoming reciprocal compensation traffic, then the ILEC would make net payments to the ISP instead of the ISP paying the ILEC."¹⁹

In short, the FCC's intercarrier compensation regulatory scheme conferred significant benefits on carriers as opposed to regular customers. Today, however, the ambiguity of the FCC's non-exclusive definitions for "edge providers" and "end users" could create incentives for lawyers and lobbyists to pressure the Commission to decide one way or another in future enforcement proceedings.

The Commission's Open Complaint Standards

The FCC's regulatory framework could create just such opportunities for a variety of complicated disputes about the definitional boundaries and intricacies of "edge providers" versus "end users." Or it could create opportunities for disputes over a number of other aspects of the rules that were discussed earlier. The procedural component to the rules permits such a scenario.

The rules state that "[a]ny person may file a formal complaint alleging a violation of the rules."²⁰ Larry Downes recently pointed out that the FCC's order sets out "procedures for filing complaints, answers and replies, conducting discovery, developing and supporting legal arguments, verifying facts and documents submitted, and the like."²¹ As Downes describes it: "These sections are in fact far longer and more detailed than the rules themselves, and in essence create a system of adjudication that is similar to the most complex cases brought in federal court."²² Thus the FCC's new regulatory

framework provides plenty of avenues for special interest or industry rivals to lodge complaints that frame alleged violations in a manner calculated to extend special protections to themselves under the new rules.

Conclusion

The FCC's recent decision to grant itself extensive powers to regulate network management practices and cross-industry business dealings is sure to invite requests that the Commission make aggressive use of those powers, even in matters of a complicated and technical nature. Future enforcement will likely be based on FCC interpretations of its claimed "broad purposes," and could thereby extend into the minute details of engineering and businesses decisions that until now have been left up to the competitors themselves in the free marketplace.

The FCC's "broad purposes," in turn, likely will be fleshed out in light of the regulatory framework's competitor welfare-based protections for "edge providers." Unfortunately, by rejecting the requirements for anticompetitive conduct as a trigger to regulatory intervention and the basis for adjudicating future complaints, the FCC leaves itself without a surer analytical footing concluding that any benefits to regulatory intrusion outweigh the costs to end user consumers. And without standards for anticompetitive conduct to guide its future enforcement, the Commission also leaves itself without a surer basis for avoiding protectionist results in future enforcement proceedings.

By replacing the free market with regulatory requirements and agency enforcement proceedings, the FCC now asserts itself as the powerful institution for resolving competing interests on the Internet. And so the order could usher in a new front for competitors seeking regulatory advantage over one another. This means that the Commission has now put itself into a position that will require significant discipline in order to resist the pro-regulatory bias typical of regulatory institutions as well as pressures from competing interests to impose intrusive or protectionist Internet regulation. Having rejected market power and consumer harm considerations as the basis for its regulatory framework, whether the FCC has the disposition or analytical resources to defensibly resist such undesirable regulation of the Internet remains an open question.

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¹ Federal Communications Commission, Report and Order (Order), *In the Matter of Preserving the Open Internet*, GN Docket No. 09-91, WC Docket No. 07-52 (December 23, 2010), at 1, para. 1 (Appendix A: Substantive Rules), available at: http://www.fcc.gov/Daily_Releases/Daily_Business/2010/db1223/FCC-10-201A1.pdf.

² *Id.* at 39, para. 66.

³ *Id.* at 40, para. 69; *id.* at 40-41; para. 71.

⁴ *Id.* at 48, para. 82.

⁵ *Id.* at 48, para. 83.

⁶ Randolph J. May, "Infamous No. 78 (of the Net Neutrality Order)," *FSF Blog* (January 5, 2011), available at: <http://freestatefoundation.blogspot.com/2011/01/infamous-no-78-of-net-neutrality-order.html>. See also Comments of the Free State Foundation, *In the Matter of Framework for Broadband Internet Services*, GN Docket No. 10-127 (July 15, 2010), available at:

http://www.freestatefoundation.org/images/Framework_for_Broadband_Internet_Service_-_Initial_Comments_071510.pdf.

⁷ Order, at 45-46, para. 78.

⁸ May, "Infamous No. 78," *FSF Blog*.

⁹ Order, at 3, para. 4, fn. 2. See also *id.* at 11, para. 20 (describing "three types of Internet activities").

¹⁰ *Id.* at 41, para. 72.

¹¹ *Id.* at 43, para. 76.

¹² *Id.* at 43, para. 76.

¹³ *Id.* at 30, para. 50.

¹⁴ *Id.* at 43, para. 76.

¹⁵ *Id.* at 15, para. 24; *id.* at fn.66.

¹⁶ *Id.* at 19, para 32.

¹⁷ *Id.* at 15, para. 24, fn. 66.

¹⁸ *Id.* at 3, para. 4, fn 2.

¹⁹ Gerald Brock, "Unifying the Inter-carrier Compensation Regime," at 125, (published in Randolph J. May (ed.), *NEW DIRECTIONS IN COMMUNICATIONS POLICY* (2008)).

²⁰ Order, at 90 (Appendix B: Procedural Rules, § 8.12).

²¹ Larry Downes, "A Hundred Years of Coase: Reading the Net Neutrality Order (Part II)" *Tech Liberation Front* blog (January 3, 2011) (referencing (§§ 8.13-8.17)), available at:

<http://techliberation.com/2011/01/03/a-hundred-years-of-coase-reading-the-net-neutrality-order-part-ii/>.

²² Downes, "A Hundred Years of Coase," *TLF* blog.