



# Net Neutrality Is Bad Broadband Regulation

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America needs jobs, and Obama is facing a serious problem of how to get them. Private-sector job creation in 2010 has been a paltry 100,000 per month. At that pace, it would take over three years to restore just the nearly four million private-sector jobs lost in the first six months of

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2009, let alone absorb new and discouraged workers coming into the labor force.

Jobs require private investment. After all, there is little appetite in Washington or among the public generally for additional federal stimulus. Moreover, there are few, if any, macroeconomic “bullets” left at the Federal Reserve, which already has greatly expanded the money supply and reduced short-term interest rates to near zero.

However, private capital is waiting on the sidelines. America's 500 largest nonfinancial companies have stashed away nearly \$1.8 trillion of cash on their balance sheets according to Federal Reserve statistics.<sup>1</sup> If the administration could get these funds to flow into the economy, the recovery would ramp up into high gear.

Why the trepidation among investors? The overriding reason is weak consumer demand and fears that this will continue. A contributing factor, however, is that businesses are uncertain about the government's appetite for further regulation. Experience shows that in order to preserve private-sector incentives to invest, especially in a capital-intensive industry like telecom, policymakers should intervene only to correct a market failure. Even then, policymakers should weigh the benefits and costs of new regulation on consumer welfare (a short-run concern) and on investment incentives (a long-run concern).

## NET NEUTRALITY AND INVESTMENT INCENTIVES

The Administration's evolving policies in the telecom arena do not meet these

criteria. The FCC has set in motion a rule-making proceeding designed to make “net neutrality” a permanent part of the regulatory landscape. To do so, the FCC is seeking to reclassify Internet service providers (“ISPs”)—from a light-touch “Title I” to a heavy-handed “Title II” designation.

Title II rules were designed to reign in monopoly telephone carriers of the 20th century, which could not be counted on to price their services at competitive levels. But are such rules needed for broadband? Except in the most remote areas consumers have a choice of at least three types of broadband providers: cable, DSL, and wireless. No monopoly here.

Recognizing that there is no broadband monopoly and that heavy-handed regulation could freeze broadband investment in its tracks, the FCC is promising that the current and future FCC would refrain from invoking the more draconian levers available under Title II, including price regulation. But can telecoms rely on this promise?

The verdict from the markets is “no.” Investment analysts, for example, have noted that the major telecom carriers are already paying significant dividends—even more than

tobacco companies—suggesting that they are too worried about future regulation to invest this money. One economic study by the Phoenix Center estimates that the May 6, 2010 announcement of the FCC’s plans to reclassify Internet service shaved ten percent from the value of stocks of cable companies that also would be subject to the FCC’s proposed new Title II regulatory regime (controlling for movements in the broader stock index), but had no effect on the stock prices of direct broadcast satellite providers that would not be subject to the proposed reclassification. In short, the markets are telling policymakers that the proposed regulatory shift is already adversely affecting investment prospects in the telecoms sector and blocking the jobs that such investment could generate.

To understand why the telecoms and their current and future shareholders are spooked, one must understand the meaning of net neutrality. Net neutrality has come to mean that all content providers pay the same price and have the same access to final consumers. Advocates have the understandable goal of ensuring that Internet Service Providers (ISPs) do not advantage one content provider over

another. But instead of the widely accepted and proven non-discrimination provisions in other areas of communications (such as cable programming), which provide independent programmers a forum to adjudicate their “program carriage” complaints, the FCC has crafted a brand new concept of non-discrimination solely for the Internet that can only harm future investment and reduce consumer welfare. As laid out by the Commission, non-discrimination (i.e., “net neutrality”) under the FCC’s proposal means that ISPs cannot offer enhanced services to content providers at any price except zero. That some content providers may not afford priority service at a positive price does not constitute discrimination; there are many upgrades in life—from navigation systems on cars to private lounges in airports—that are not free.

Why do we worry about this policy? Enhanced connectivity would enable real-time applications to operate free of jitter and perform at higher levels. And, competitive pressure would force ISPs to use at least some of the money raised from these enhancements to lower the price of broadband access to end users. Unfortunately, so long as ISPs are barred

from charging for enhanced services, they won't offer them.

There is no getting around the fact that telling a firm that it can't charge for a service is price regulation, notwithstanding the Commission's claims to the contrary. Like with any regulation, if the regulator sets the wrong price, problems emerge. Setting a price of zero for valuable enhancements is quite simply the wrong price.

#### LESSONS FROM TWO-SIDED MARKETS

The prospect of future price regulation of ISPs is of more than academic interest. It is well established that price regulation often truncates the returns on an investment in a regulated industry, and thereby decreases investment. Likewise, net neutrality would reduce the profitability of broadband networks, and thus discourage network investment by ISPs.

To see why, consider two regulatory regimes: one in which an ISP may charge content providers for enhanced services, and another in which such charges are prohibited (net neutrality regulation). Even according to a theoretical model championed by net neutrality proponents, end users are unequivocally worse

off under net neutrality regulation, as the end-user price of broadband access is always higher when ISPs are barred from raising revenues from content providers. This is the seesaw principle in action—placing downward pressure on price on one side of the market (for content providers) leads to upward pressure on price on the other side of the market (for end users), as described by economists Jean-Charles Rochet and Jean Tirole.

For those who are skeptical about this result, think what would happen if newspapers, another two-sided platform, were suddenly restrained from charging advertisers for ads. The daily price of a newspaper would rise.

Because end users are more sensitive to price increases than are content providers, the incremental revenues raised on end users under a net neutrality regime cannot compensate ISPs for the forgone revenues on content providers; that means that the profitability of the broadband network will decline under a price-regulated net neutrality regime. Lower profitability means lower returns, which in turn means less investment.

To be sure, some content providers that would otherwise pay ISPs for enhanced

services might benefit from net neutrality rules, which is no doubt the main reason they vigorously advocate such rules. But the absence of net neutrality regulation won't necessarily reduce investment by content providers, and it might even increase their investment.

Suppose, for example, that an ISP offered special handling of a content provider's data packets for \$1,000 per month. Content providers with no need for such enhancements would simply decline the offer. No investment risk there. Now consider content providers who can make use of the enhanced services. Those content providers might invest more (relative to a net neutrality regime) in developing applications that take advantage of the new feature.

Setting aside the welfare of end users (which is always lower under net neutrality rules), policymakers must balance the investment risk faced by ISPs in the presence of net neutrality rules against the (however implausible) investment risk faced by content providers in the absence of net neutrality rules. ISPs are set to invest \$30 billion annually over the next five years to blanket the country with next-generation broadband networks, nearly half of which (\$14 billion per year) will

support wireless networks, according to Robert Atkinson and Ivy Schultz of the Columbia Institute of Tele-Information. That's a lot of investment at risk.

It is difficult to estimate with precision what portion of the \$30 billion would be eliminated in the presence of net neutrality rules, but the direction of the impact—negative—is clear. One paper by Cambridge Strategic Management Group estimates that the FCC's planned reclassification of ISPs would cause 47 percent fewer households to financially justify fiber-to-the-home investment, impacting some 29 million homes nationwide. Noted telecom analyst Craig Moffett of Bernstein Research opines that, with the imposition of net neutrality rules and Title II reclassification, Verizon FiOS “would be stopped in its tracks,” AT&T's U-Verse “deployments would slow,” and Clearwire's investment in wireless 4G service might be scaled back. Bank of America/Merrill Lynch and Standard and Poor's reached similar conclusions regarding adverse investment effects.<sup>2</sup>

And on the other side of the ledger? Crickets.

We are not aware of any study that purports to estimate the aggregate investment by

content providers over the coming years or the alleged increase in aggregate investment by content providers owing to net neutrality regulation. Absent such data, it is irresponsible for government policymakers to move forward with the proposed system of net neutrality regulation.

Because content providers are agitating for government intervention, they should bear the burden of demonstrating that aggregate investment across the “edge” and “core” of the network would not decline under their exotic strand of nondiscrimination. In other words, they must show that the increase in content provider investment under a net neutrality regime will more than offset the decrease in ISP investment. Today there is no such proof, and we doubt they can make the case.

#### A BETTER WAY FORWARD

So if net neutrality regulation is bad policy, what should the Commission be doing to encourage investment by both Internet providers and content providers?

We concede that independent content providers need assurance that they will not be discriminated against when it comes to accessing

broadband subscribers or buying enhanced quality of service from ISPs (this is a very different thing from paying nothing for enhanced service under net neutrality). The best way to do this is to “use the basic principles animating antitrust law to fill in the content of the case-by-case analysis,” as explained by Professor Christopher Yoo of Pennsylvania Law School.

In fact, the FCC already uses a case-by-case process to adjudicate discrimination complaints brought by independent cable networks against vertically integrated cable operators. Why should the FCC use one process to adjudicate discrimination claims in the Internet space and a different process in the cable programming space? The recent WealthTV and NFL Network court cases made clear that the process is not stacked in favor of complainants, but the process does properly place the burden squarely on the complainant to prove that (1) it has been discriminated against on the basis of affiliation and (2) as a result of that discrimination, the complainant has been materially impaired in its ability to compete against the affiliated provider. Importing that framework here, a disgruntled content provider should be required to make the same showing to the FCC.

Such a process would leave ISPs free to contract—at a positive price—with content providers for enhanced services offerings. Although the importation of the current dispute-resolution process from the cable programming space to the Internet space might require new legislation, that is not a bad thing; the regulatory agenda should flow from Congress to the Commission.

These two policies—assurance that ISPs' investments will not be appropriated and that independent content providers will not be anticompetitively discriminated against—would create an ideal investment climate for ISPs and for content providers. Such an outcome is critical because it can help boost the economy in general by opening the door to telecommunications investment and job creation.

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#### NOTES

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