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Net Neutrality and Title II of the Communications Act

By Bruce M. Owen

Summary

President Obama recently urged the Federal Communications Commission to impose common carrier regulation on the Internet access industry. The industry has been the focus of rapid technological change characterized by movement from analog to digital transmissions, from fixed to mobile service and from lower to higher speeds or bandwidths. One consequence has been to increase the number of alternative providers available to most households. While it is always possible that various threats to competition and economic efficiency may arise down the road, there is little current evidence to support a call for Title II regulation. Indeed, such regulation in the past has caused more consumer harm than good, partly by enhancing industry influence on politicians and regulators, and partly by distorting prices and discouraging investment and innovation.

President Obama, who has long supported “net neutrality,” recently made headlines by urging the Federal Communications Commission (FCC) to impose Title II (common carrier) regulation on the industry that supplies Internet access services to homes and

businesses.¹ What does this mean, and what are the economic policy issues that the President’s message addresses? Chances are that the new Republican majorities in both Houses of Congress will oppose

¹ <http://www.whitehouse.gov/net-neutrality>

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About The Author

Bruce M. Owen is the Doyle Professor of Public Policy (Emeritus) at Stanford and a SIEPR Senior Fellow. He has studied and written about telecommunications and mass media policies since 1966. He was invited to testify on net neutrality before the House Judiciary Committee in June 2014. This policy brief is based in part on that testimony.



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the President's position, putting the FCC—an “independent [of the president] regulatory agency”—in the middle of a political struggle. How will this affect the outcome of the FCC's deliberations? This policy brief provides background on the economic policy issues raised by calls for net neutrality.

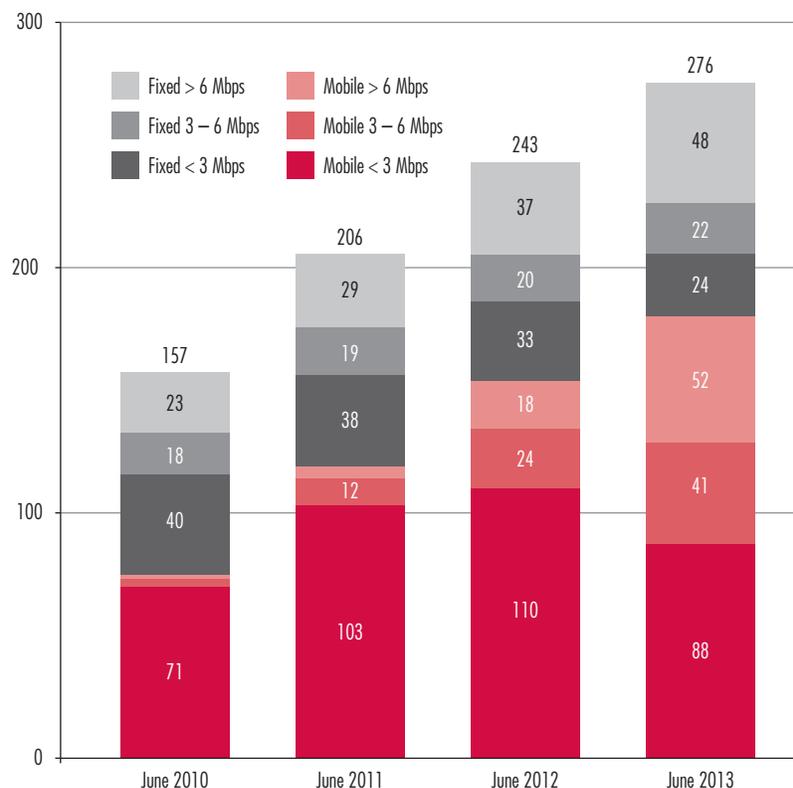
Title II of the Communications Act of 1934 (as amended) was designed to permit federal regulation of the old Bell System monopoly of long distance telephone service. It still gives the FCC the power to regulate prices and terms of service offered by telecommunication “carriers” that the Commission has decided to classify within the Title II category, although it does not compel the Commission to do so. Title II also authorizes the FCC to require carriers to offer service to all comers at published rates and to require carriers to interconnect with each other. Interconnection rates and terms are also subject to FCC regulation under Title II. Title II regulation was modeled on railroad and trucking regulations, which have since been repealed because of their anti-competitive effects. Such deregulation (which also encompassed airlines and various financial institutions) generally has

led to lower prices and increased output. The major exception is risk-taking in financial markets, where deregulation clearly was unwise.

Some advocates of net neutrality argue that in the absence of FCC regulation large Internet access providers such as Comcast, Verizon, and (the new) AT&T will use market power to favor certain content suppliers, especially those in which

they have an ownership interest. The concern is that favored content suppliers will pay lower rates and/or receive preferential allocations of bandwidth (speed) compared to smaller or less favored users. If so, this would disadvantage new entrants who wish to compete with larger users. For example, Netflix—a leading supplier of popular online video content

Figure 1
Fixed and Mobile Internet Connections by Download Speed, 2010-2013 (in millions)



Source: Federal Communications Commission, “Internet Access Services: Status as of June 30, 2013,” Industry Analysis and Technology Division, Wireline Competition Bureau, June 2014. https://apps.fcc.gov/edocs_public/attachmatch/DOC-327829A1.pdf

directly to viewers—entered a deal with Comcast that removed various technical obstacles to rapid distribution of its signals. The result reduced latency for Netflix video streams and improved the quality of Netflix service to viewers. Presumably Netflix compensated Comcast for these concessions.

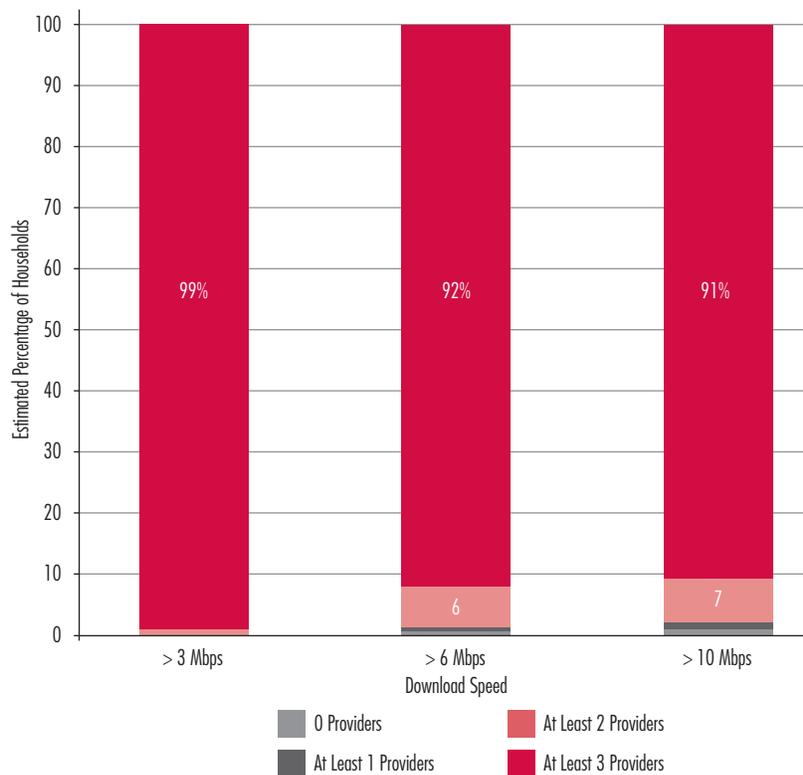
Net neutrality proponents argue that everyone should get the same

service quality, regardless of the quantity and characteristics of their transmissions. Heavy users should pay the same monthly rates as light users and every user should receive the same quality of service. Put simply, many net neutrality proponents apparently propose that it should be unlawful to pay extra for faster or heavier transmissions, even if higher service quality

costs more to provide. Of course, Internet service providers will not offer costly service improvements to anyone if they cannot recover the costs. At least on the surface, it seems that net neutrality would condemn all users to the same not terrific and slow-to-improve service.

The history of regulation provides evidence of similar calls for regulation and of the resulting impacts on consumers. Theodore Vail, an early president of the old Bell System, is said to have leveraged Bell's long distance monopoly to take over local telephone service. Multiple competing telephone companies offered local service in many cities in the late nineteenth century. Often they did not interconnect with each other. Vail hastened the trend toward consolidation of local exchanges by acquiring local telephone companies in each city and denying long distance interconnection to any competing exchanges. By the time of the 1934 Communications Act and other, earlier, federal interventions, Vail had already succeeded in monopolizing local as well as long distance service in most U.S. metropolitan areas. This pattern offers apparent support for policies akin to net neutrality.

Figure 2
Percent of Households Located in Census Tracts Where Providers Report Residential Fixed Connections or Mobile Availability at Various Download Speeds June 30, 2013



Source: Federal Communications Commission, "Internet Access Services: Status as of June 30, 2013," Industry Analysis and Technology Division, Wireline Competition Bureau, June 2014. https://apps.fcc.gov/edocs_public/attachmatch/DOC-327829A1.pdf

Other net neutrality proponents put the argument in terms of price discrimination. The earliest federal regulatory statute, enacted in 1887, provided for regulation of railroads. One of the complaints that led to the Act to Regulate Commerce was the railroads' practice of offering lower prices per ton-mile to large shippers located in urban centers than to rural shippers. At the time, rural shippers were farmers who generally had no alternative to using the nearest railroad. Urban manufacturers in contrast often had a choice of several rail routes to other urban destinations. Competition among railroads led to lower rates for urban shippers than for farmers, who faced monopoly railroads. Agrarian lobbies and progressive reformers favored railroad regulation in order to limit such demand-elasticity-based price discrimination. Although the 1887 Act did not deal with railroad price discrimination, a later amendment gave the Interstate Commerce Commission (ICC) the power to limit "unreasonable" discrimination. Nevertheless, both railroads and interstate trucking companies under ICC jurisdiction eventually developed elaborate

elasticity-based discriminatory rates, with the ICC's blessing. Cost-based price differentials were also permitted, although the allocation of fixed and common costs has always been contentious.

Regulation of the Bell System under Title II was almost unique in the federal regulatory arena because, unlike banks, trucks, railroads, stock exchanges, and airlines, Bell really was a monopoly. Indeed, the FCC believed that monopoly in this industry was useful and necessary, and for decades protected the Bell System from any attempt by others to enter the business. Most other federal regulators dealt with industries that were at least partially competitive. In general, these regulators also tended to restrict competition and entry, often on the basis that "too many" competitors would impair the ability of incumbents to provide service to the public. The experience of deflation during the Great Depression—blamed on excessive competition—reinforced these attitudes.

By the end of the 20th Century a broad consensus developed among economists that price regulation, even of monopolists, and certainly of industries with multiple competing suppliers, is unlikely

in practice to improve consumer welfare.² Maintaining efficient prices and providing incentives for progressive management of regulated firms rarely works. This is partly because the political economy of regulatory interventions tends to favor producers, not consumers. Using Title II of the Communications Act to reach the goals of net neutrality (non-discrimination) requires price regulation of competing suppliers of Internet services.

The claim that Internet access service is offered by competing suppliers may sound surprising. Many people think of cable television companies, and perhaps telephone companies, as the only such providers, and two suppliers is not very many. (Of course, if the concern is with video services specifically, then satellite companies like DirecTV and DISH would also need to be counted as competitors.) But a focus on cable television companies as potential threats to Internet freedom is misplaced. The next generation of Internet access service has already arrived, in the form of broadband mobile providers.

² See William J. Baumol, et al., "Economists' Statement on Net Neutrality," AEI-Brookings Joint Center for Regulatory Studies (2007), available at <http://ssrn.com/abstract=976889>

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The FCC surveyed Internet access services in June 2013 and issued a report one year later. Tables 1 and 2 highlight some of the Commission's findings. According to the Commission, of 276 million U.S. Internet connections, 52 million were mobile connections with download speeds greater than 6 Mbps, compared to only 48 million traditional fixed connections offering such speeds. Fixed connections use wires or coaxial cables; mobile connections use the same frequencies set aside for cell phones. In other words, mobile devices such as smart phones and tablets provide many consumers with access to the Internet at speeds

comparable to those offered by cable companies. Further, the trend is for video content viewers to “cut the cable” by turning to online video providers such as Netflix.

The situation today, as it is relevant to policies intended to guide future events, is not accurately captured by the picture of large cable TV companies dominating both local video and also local Internet access service. Even traditional TV and cable channels are available to the vast majority of households from at least three suppliers—one cable company and two satellite suppliers. But the movement to online video content and the development of broadband

mobile service means that access to Internet content, including video, is available increasingly, at least in urban areas, from three or four additional suppliers, namely cell phone companies. To its credit, the FCC has been trying to support increased competition by reallocating spectrum from broadcast television to mobile services. An industry with this many competitors is likely to behave competitively, responding to consumer needs and investing in new technologies that improve and expand service. An industry with this many competitors is unlikely to have its performance improved by regulatory interventions of the types associated with Title II regulation.

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Stanford University
366 Galvez Street
Stanford, CA 94305
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