

TESTIMONY
OF
JEFFREY A. EISENACH, PH.D.
BEFORE THE
COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

September 17, 2014

Mr. Chairman and Members of the Committee, thank you for the opportunity to appear before you at today's hearing on "Why Net Neutrality Matters: Protecting Consumers and Competition through Meaningful Open Internet Rules."

I have had the opportunity to study communications, media and Internet policy issues over the course of many years and in several capacities, including in my current positions as Director of the American Enterprise Institute's Center for Internet, Communications and Technology Policy, Executive Editor of TechPolicyDaily.com, Co-Chair of NERA Economic Consulting's Communications, Media and Internet Practice, and adjunct professor at George Mason University Law School, where I teach the course on regulated industries. I should note that while my academic studies and my consulting practice often involve issues relating to Internet and communications policies, I am appearing today solely on my own behalf, and the views and opinions I express should not be attributed to any of the organizations with which I am affiliated.

My testimony today advances three main points. First, net neutrality regulation cannot be justified on grounds of enhancing consumer welfare or protecting the public interest. Rather, it is best understood as an effort by one set of private interests to enrich itself by using the power of the state to obtain free services from another – a classic example of what economists term "rent seeking." Second, the potential costs of net neutrality regulation are both sweeping and severe, and extend far beyond a simple transfer of wealth from one group to another. Third, legitimate policy concerns about the potential use of market power to disadvantage rivals or harm consumers can best be addressed through existing antitrust and consumer protection laws and regulations.

To begin, net neutrality regulation cannot be justified as a means of enhancing consumer welfare or advancing or protecting the public interest, and instead is best understood as a classic example of rent seeking.¹ This is particularly true of the more extreme flavors of net neutrality regulation advanced by companies like Netflix, which would ban payments from companies like Netflix to Internet Service Providers (ISPs) like AT&T.²

¹ For a general discussion of the economic theory of rent seeking, see George J. Stigler, "The Theory of Economic Regulation," *The Bell Journal of Economics and Management Science* 2;1 (Spring 1971) 3-21.

² For clarity, I will refer to this type of regulation as a "zero price rule," as distinct from the less extreme versions put forward in the FCC's Open Internet Notice of Proposed Rulemaking, which would allow such payments so long

As a general matter, government intervention in the marketplace can enhance economic welfare only in cases of market failure, which may occur under two primary sets of circumstances: (a) when a firm or group of firms can exercise monopoly power to raise prices, reduce quality or prevent entry by rivals; or (b) when markets are characterized by externalities (such as pollution) or public goods (such as national defense).³

Looking first at the monopoly power rationale for intervention, there is no basis for believing – nor does the FCC assert – that net neutrality regulation can be justified by concerns about traditional monopoly power.⁴ Indeed, the Commission’s Notice of Proposed Rulemaking waxed eloquent about the strong performance of the broadband marketplace, citing the billions of dollars invested each year and the rapid increases in performance that have come about as a result.⁵ Such performance is not consistent with the “cozy duopoly” characterizations sometimes advanced by net neutrality advocates. Nor is the structure of the broadband market a cause for concern. Indeed, the broadband market is, if anything, less concentrated than many markets that make up the Internet ecosystem: one need only think of the markets for search engines, social networks and personal computer operating systems to realize that such markets are typically served – at any given time – by a few firms rather than by the atomistic structures imagined in introductory economics texts.

To be sure, broadband ISPs, like virtually all other firms in the Internet ecosystem, do possess a certain type of market power, which is the power, derived from successful product differentiation, to charge prices above marginal costs.⁶ But the existence of such market power is hardly cause for pervasive regulation – rather, as the courts have recognized, it is both the incentive to innovate and the reward for doing so, and hence the motive force behind growth and prosperity in a modern economy.⁷ And while this sort of market power – combined with the need for firms to collaborate

as they are “non-discriminatory” or “commercially reasonable.” I refer to this milder form of proposal as a “non-discrimination rule.”

³ These are necessary conditions for government intervention to improve welfare, not sufficient ones. In addition, it must be the case that it is possible to design and implement policies that, on net, create greater benefits than costs.

⁴ See Jerry Brito, et al, “Net Neutrality: The Economic Evidence” (April 12, 2010) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1587058) (expert declaration before the FCC of 21 economists and communications policy experts).

⁵ See Federal Communications Commission, *In the Matter of Protecting and Promoting the Open Internet, Notice of Proposed Rulemaking*, GN Docket 14-28 (May 15, 2014) at ¶30.

⁶ Given the fundamental economic characteristics of high-tech markets in general and the markets that comprise the Internet ecosystem in particular, the only firms we observe in the marketplace are those that have successfully differentiated their products and thus have the capacity to charge prices above marginal costs; without such power, they would be unable to earn a return on the large and risky typically needed to participate. Such investments may take the form of R&D (e.g., developing software for a new application), producing content (e.g., making a movie or creating a content aggregation service), or investing in infrastructure (e.g., building a broadband distribution system). In each case, companies incur high fixed costs but, having done so, are able to produce additional units of outcome at low marginal cost. See generally Jeffrey A. Eisenach, *Broadband Competition in the Internet Ecosystem*, American Enterprise Institute (October 2012). For a layman’s explanation of the same phenomenon, see Peter Theil, “Competition is for Losers,” *Wall Street Journal* (September 13-14, 2014) at C1.

⁷ See e.g., *Novell, Inc. v. Microsoft Corp.*, 731 F.3d 1064, 1073 (10th Cir.2013) (“If the law were to make a habit of forcing monopolists to help competitors by keeping prices high, sharing their property, or declining to expand their own operations, courts would paradoxically risk encouraging collusion between rivals and dampened price competition—themselves paradigmatic antitrust wrongs, injuries to consumers and the competitive process alike. Forcing firms to help one another would also risk reducing the incentive both sides have to innovate, invest, and

with one another to create value – can create the incentive for firms to deny access to their platforms as a means of obtaining or maintaining market power (as the courts found Microsoft did in the case of Netscape and Java), such incentives are not unique to broadband markets, and thus cannot justify discriminatory regulation of ISPs.

Another variant of the market power argument suggests that while big, established edge providers might be able to fend for themselves against the ISPs, we need to look out for the little guys, the new entrants who may be strangled in the crib as a result of discriminatory access fees. What no one can explain, however, is why ISPs would want to discriminate against start-up edge providers – the very firms that create the applications and content that draw consumers to subscribe to broadband service in the first place. The reality is that to the extent ISPs engage in efficient price discrimination, basic economic theory predicts they will offer startups – those most sensitive to price – the lowest prices rather than the highest ones.⁸

Rather than being motivated by worries about market power, the FCC (like some other net neutrality advocates) justifies its proposed regulations on the existence of externalities in the Internet ecosystem.⁹ Specifically, the theory goes, innovation “at the edge” generates benefits that are not reflected in the price system, and therefore deserving of subsidization – either in the form of a zero price rule granting them free access to ISP’s services, or through a non-discrimination rule designed to shift value away from ISPs and in favor of edge providers by preventing broadband ISPs from engaging in efficient price discrimination.

Like other firms in the Internet ecosystem, broadband ISPs operate in what economists call a “two-sided market.” On one side are consumers, who value Internet access; on the other are providers of complementary products, like content, devices and applications, who value the ability to use the network to reach their ultimate customers. Such markets are not unusual: newspapers, for example, serve both advertisers and subscribers. The challenge for such firms is to set prices for each customer group in such a way as to attract the optimal mix: Newspapers need just enough advertisers to allow them to keep subscription prices low, but not so many as to annoy readers and drive down subscribership.

The FCC’s primary theory of net neutrality regulation (embraced by the DC Circuit in *Verizon v. FCC*) is that one side of the two-sided market served by ISPs (the “edge providers”) generates so

expand—again results inconsistent with the goals of antitrust. The monopolist might be deterred from investing, innovating, or expanding (or even entering a market in the first place) with the knowledge anything it creates it could be forced to share; the smaller company might be deterred, too, knowing it could just demand the right to piggyback on its larger rival.”) For a discussion, see Jeffrey A. Eisenach and Ilene Knable Gotts, “In Search of a Coetition Doctrine for Information Technology Markets: Recent Antitrust Developments in the Online Sector,” in *Communications and Competition Law: Key Issues in the Telecoms, Media and Technology Sectors* (Alphen aan den Rijn, The Netherlands: Kluwer Law International/International Bar Association series, forthcoming 2014).

⁸ Indeed, small/start-up edge providers – who have not yet achieved the scale necessary to justify building their own content delivery systems – are most likely to benefit from the ability to purchase high quality delivery services from ISPs. On the economic basis for – and beneficial effects of – competitive price discrimination, see e.g., David B. Audretsch, William J. Baumol and Andrew E. Burke, “Competition Policy in Dynamic Markets,” *International Journal of Industrial Organization* 19 (2001) 613-634 and Jonathan B. Baker, “Competitive Price Discrimination: The Exercise of Market Power without Anticompetitive Effects (Comment on Klein and Wiley),” *Antitrust Law Journal* 70 (2003), 643-654.

⁹ See NRPM at ¶43.

much innovation and other “external” benefits that it should be subsidized by the other side (that is, by consumers) through a rule that forces consumers to pay 100 percent of the costs of the network while edge providers pay zero. This is a fine theory – but there is not a scintilla of empirical evidence to support it. Indeed, a strong argument can be – and often is – made that the external benefits generated by investment in broadband infrastructures are at least as great as if not greater than the benefits associated with innovation at the edge.¹⁰ In short, the edge-provider-innovation-externality rationale for net neutrality regulation is a naked emperor of an argument if ever there was one.

Finally, some argue net neutrality regulation is needed to protect freedom of speech – that without it, “alternative, non-profit and dissenting voices” will be consigned to “Internet slow lanes.”¹¹ There are at least three problems with this theory. First, there is virtually no evidence that ISPs have (or have incentives) to stifle dissenting or alternative views; indeed, as explained above, the availability of diverse content on the Internet is what makes it valuable and causes people to want to pay ISPs for broadband access in the first place. Second, to the extent “censorship” is an issue, it implicates other types of Internet firms at least as much as (and likely more than) ISPs. Third, and finally, it is simply not apparent that giving Netflix free use of Comcast’s network has anything to do with protecting political speech.

When these rationales are stripped away, what is left is the obvious: Edge providers, big and small, and those who fund them and profit from their success, have a powerful economic interest in getting the government to guarantee them free access to the ISPs’ networks. Occam’s Razor applies: when it doubt, the simplest explanation tends to be the correct one, and net neutrality is no exception.

At this point in my testimony, I want to be emphatically clear that, in suggesting that net neutrality is a battle over the allocation of economic rents, I am not impugning the integrity of anyone involved in the process. Government intervention in markets – whether justified or otherwise – invariably results in the redistribution of wealth, and the affected parties have every right – even, arguably, an obligation – to look out for their own interests.¹² That is the way our democracy works and, to paraphrase Churchill, it is a terrible system...except when compared to the

¹⁰ This point is acknowledged even by the strongest supporters of net neutrality regulation. See e.g., Robin S. Lee and Tim Wu, “Subsidizing Creativity through Network Design: Zero-Pricing and Net Neutrality,” *Journal of Economic Perspectives* 23;3 (Summer 2009) 61–76 at 67 (“Of course, for a given price level, subsidizing content comes at the expense of not subsidizing users, and subsidizing users could also lead to greater consumer adoption of broadband. *It is an open question whether, in subsidizing content, the welfare gains from the invention of the next killer app or the addition of new content offset the price reductions consumers might otherwise enjoy or the benefit of expanding service to new users.*”)(emphasis added). For a summary of more recent research indicating that net neutrality regulation is likely to harm consumer welfare, see Comments of Justin (Gus) Hurwitz, Assistant Professor of Law, University of Nebraska College of Law, GN Docket 14-28 (

¹¹ See e.g., Testimony of Michael Copps Before the Committee on the Judiciary, July 1, 2014 at 12.

¹² Nobel Prize winner Ronald Coase described the political dynamics of regulatory intervention in the market in his famous 1959 article on the FCC’s approach to the allocation of broadcast licenses. See R.H. Coase, “The Federal Communications Commission,” *Journal of Law and Economics* 2 (October 1959) 1-40 at 35-36 (“That [efforts to exercise political influence over licensing decisions] should be happening is hardly surprising. When rights, worth millions of dollars, are awarded to one businessman and denied to others, it is no wonder if some applicants become overanxious and attempt to use whatever influence they have (political and otherwise), particularly as they can never be sure what pressure the other applicants may be exerting.”).

alternatives. Nor do I mean any disrespect to the heartfelt views of those across the political spectrum who worry about the need to protect free speech on the Internet and elsewhere. I share their ultimate goals and objectives, even though I may not fully share their assessment of the nature of the challenge, or the appropriate response.

But while there is nothing illegal or even immoral about private entities seeking to advance their interests through the use of state power, the results can prove highly damaging, and ultimately can be far more harmful than a simple transfer of wealth from one group to another. In the case of net neutrality, the risk is that the intensely dynamic, pragmatic, business-and-engineering-driven approach to building and running the most important “general purpose” technology in history – the approach that has facilitated the remarkable growth of the Internet over the past two decades – could be replaced by a static, bureaucratic, politicized regulatory regime, not only in the U.S. but around the world.

There is no economic basis for a general rule forcing one side of the market, consumers, to bear 100 percent of network costs while the other side, the firms that benefit from the ability to deliver content over the network, pay zero. Indeed, as the types and volumes of traffic carried over the web change, one would expect pricing structures and other contractual terms to adjust accordingly – as has been the case with peering and transit arrangements, which have adjusted dynamically to the explosive growth of the Internet without regulatory intervention for nearly two decades. Net neutrality regulation would at best inhibit, or at worst prohibit altogether, the market’s ability to achieve such adjustments.

The costs of net neutrality regulation are directly related to the substantive standards imposed, the extent of their application, and the means by which they are enacted and enforced. For example, a rule that presumptively bans all forms of differentiated service offers could literally cripple the ability of the Internet to adjust to the continued growth in the amount and types of traffic, especially if it were extended to wireless ISP services, where differentiation is especially important due to inherent limitations on bandwidth and other engineering concerns.

The specter of common carriage regulation is of particular concern. As others have noted, Title II regulation would not ban price discrimination by ISPs. To the contrary, Title II specifically envisions that prices should vary across different types of services and different types of customers, just as – for example – postal rates do today. It may seem difficult to imagine imposing on the Internet a public-utility-style rate setting process akin the Postal Regulatory Commission; but can anyone doubt that if broadband were declared a Title II service, it would not be long before the Commission would take comments on whether some types of services should bear more of the costs of the network than others, leading inevitably to something closely resembling the perennial scrum between first, second and third class mailers over who will pay how much for junk mail, magazines, and so forth?

Even less intrusive approaches could have serious costs. Consider, for example, the comments filed with the FCC by startup firm Syntonic, which develops innovative technologies that allow content providers to make their content available to consumers over mobile networks without charge. Such “sponsored data” plans shift the cost of bandwidth from consumers – especially those less able to afford high-end data plans – to mobile wireless carriers and content providers,

and are increasingly popular in both the U.S. and, to an even greater extent, in developing countries.¹³ As Syntonic explains in its comments, “despite the fact that these alternative business models increase consumer choice and help bring consumers the content they desire more efficiently ... opponents can use stringent net neutrality rules to impose homogeneity on broadband markets and destroy even the most consumer-friendly alternatives to the status quo ... [showing] the danger of structural rules designed to protect edge providers rather than consumers.”¹⁴

Adopting net neutrality regulation would also harm the cause of Internet freedom worldwide. The Internet the most powerful and disruptive force for freedom in the world, threatening the power of the state and setting literally billions of people free to learn, think, and decide for themselves. It represents a fundamental threat to repressive, authoritarian regimes from Moscow to Tehran, from Beijing to Caracas. By embracing the idea of state control of the Internet – both economic and political – the adoption of net neutrality regulation by the U.S. would legitimize the efforts of tyrants everywhere to impose far more repressive forms of statist intervention.

My last point, which I will make briefly because it has been so thoroughly addressed elsewhere, is that legitimate concerns about the exercise of market power by ISPs (and other firms in the Internet ecosystem) can readily be addressed through existing laws, including specifically the Sherman Act, the Clayton Act and the Federal Trade Commission Act.¹⁵ These laws have protected competition and consumers for well over a century, and have developed into a dynamic and sophisticated body of economic doctrine and legal jurisprudence that is fully capable of addressing the threat that Internet firms, whether ISPs or others, will use the market power signified by their persistence in the marketplace for harmful purposes. Antitrust is not perfect, but it is by far the best approach to addressing concerns about the business practices of broadband ISPs.

* * *

Mr. Chairman and Members of the Committee, this completes my testimony. I look forward to answering any questions you may have.

¹³ See Roslyn Layton, “IGF Highlights How Developing Countries Use Zero Rating Programs to Drive Internet Adoption,” *TechPolicyDaily.com* (September 4, 2014) (available at <http://www.techpolicydaily.com/communications/igf-zero-rating-programs/>)

¹⁴ See Reply Comments of Syntonic, Inc., GN Docket No. 14-28 (September 3, 2014) at 12-13.

¹⁵ See for a discussion see e.g., Brito *et al* and Eisenach and Gotts.