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PHOENIX CENTER FOR ADVANCED LEGAL & ECONOMIC PUBLIC POLICY STUDIES

Non-Discrimination or Just Non-Sense: A Law and Economics Review of the FCC's New Net Neutrality Principle

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Introduction

Last October, the Federal Communications Commission "FCC" launched a Notice of Proposed Rulemaking for the ostensible purpose of preserving the "Open Internet."[1] Perhaps the most contentious element of this proceeding is the FCC's proposal to implement a new, bright-line "non-discrimination" rule. As explained below, the FCC's proposed new definition of "non-discrimination" is plainly incompatible with the concepts of discrimination in both the economic literature and established communications jurisprudence.[2] As a result, the Commission's flawed standard is likely to create numerous unintended consequences that are antithetical to economic welfare and the stated goals of the Commission in promulgating the rules in the first instance.

If the Commission deems that a bright-line non-discrimination rule is necessary, then the agency should adhere to well-recognized definitions and conceptualizations of discrimination in its formulation of price regulation for broadband service providers. Indeed, the agency must return to first principles and both clearly specify the problem the rule is intended to solve, as well as lay out explicitly why the benefits of such a rule are likely to exceed the cost. While we agree that setting up clear rules of the road to preserve an "open" Internet is an important policy priority in concept, failing to respect economic principles and established jurisprudence when promulgating those rules hardly serves the public interest.

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Defining Non-Discrimination

An essential first step in reviewing (or drafting for that matter) a "non-discrimination" rule is to define "discrimination." Discrimination is not a new concept in communications law or in economic science. The definitions of discrimination in economics and communications law are largely consistent, and we take each in turn.

In economics, discrimination occurs when different prices are charged different customers for the *same* commodity.[3] Formally, with customers A and B, price discrimination exists if $(P_A/P_B) \neq (C_A/C_B)$, where P is price and C is marginal cost for the same good.[4] This definition also reveals that price discrimination occurs when the same price is charged to customers where the cost of supply is different (i.e., the same P but different C). For example, cost differences may arise for the same good due to transportation costs.

Typically, those referencing discrimination in communications law are referring to the provisions contained in Section 202 of the Communications Act, which states:

> It shall be unlawful for any common carrier to make any unjust or unreasonable discrimination in charges, practices, classifications, regulations, facilities, or services for or in connection with like communication service, directly or indirectly, by any means or device, or to make or give any undue or unreasonable preference or advantage to any particular person, class of persons, or locality, or to subject any particular person, class of persons, or locality to any undue or unreasonable prejudice or disadvantage.[5]

There are two key elements of the statutory language relevant here:

First, it is important to note the qualifying adjectives before the concepts of discrimination and preferences—i.e., discrimination and preferences must be "unjust", "unreasonable" or "undue." By definition, therefore, Section 202 is not a bright-line rule.

Second, the legal standard for discrimination under Section 202 is nearly identical to the economic definition. According to well-established case law, a charge that a carrier has unduly discriminated in violation of Section 202 entails a three-step inquiry (in the sequence): (1) whether the services are "like"; (2) if they are "like," whether there is a price difference; and (3) if there is a difference, whether it is reasonable.[6] If the services are not "like," or not "functionally equivalent" in the legal parlance, then discrimination is not an issue and the investigation ends. There is no discrimination claim for *different* prices or price-cost ratios for *different* goods.

Notably, a determination of whether services are "like" is based upon neither cost differences nor competitive necessity. Cost differentials are excluded from the likeness determination and introduced only to determine "whether the discrimination is unreasonable or unjust." Likeness is based solely on functional equivalence.[7]

If the services are determined to be "like" or "functionally equivalent," then the carrier offering them has the burden of justifying any price disparity as reasonable, such as a difference in cost.[8] If a price difference is not justified, then the price difference is deemed unlawful.

It is easy to see that the legal definition of discrimination under Section 202 is mostly consistent with its meaning in economics. First, in both economics and law the goods must be "like" or the "same physical good." Second, discrimination occurs when price differences are not cost based.[9]

The FCC's New Definition of "Non-Discrimination"

In the FCC's "Open Internet" NPRM, the Commission radically departs from the legal precedent and economic literature and instead attempts to reinvent the concept of discrimination. According to the Commission,

> Subject to reasonable network management, a provider of broadband Internet access service must treat lawful content, applications, and

> services in a nondiscriminatory manner (¶104).

Moreover, by non-discrimination, the FCC means

> … that a broadband Internet access service provider may not charge a content, application, or service provider for enhanced or prioritized access to the subscribers of the broadband Internet access service provider (¶106).

The FCC's proposal is plainly inconsistent with standard legal and economic definitions of discrimination for at least three reasons.

First, the FCC's proposed rule states that BSPs "may not charge a content … provider for enhanced or prioritized access." However, standard services and enhanced/prioritized services are, by definition, not functionally equivalent and thus not "like," so a different price for these different services is certainly not discrimination under communications law (as set forth in Section 202).[10] If a higher price for enhanced services was reviewed under standard procedure, then the question of discrimination does not proceed beyond the first stage of legal review. Since the services are not "like", the investigation ends. Economics likewise requires the goods to be "identical," so different prices for standard service versus enhanced or prioritized services is not discriminatory under the economic standard. It is obvious, therefore, that the FCC has defined a set of "discriminatory" prices that would not qualify as such under meaningful legal and economic definitions of discrimination. Labeling as "discrimination" different prices for different goods is a fundamental defect in the Commission's approach.

Second, the FCC's proposed rule does not appear to preclude a BSP from charging different prices to different customers for the same type of service provided at the same cost, a practice that would clearly be prohibited under Section 202. Say, for example, that standard access quality can be provided to two customers A and B at the same cost. Charging different prices to A and B is undue discrimination under the legal definition (Section 202), because the services are "functionally equivalent" and have the same cost (by assumption), implying discrimination is present. (The price difference may be justified by some other explanation, but we assume they do not apply here.) Likewise, the prices are discriminatory under the economic standard, since the ratio of prices does not equal the ratio of costs $(P_A/P_B) \neq (C_A/C_B)$. While both law and economics may indicate the pricing practice is "discriminatory," this difference in prices does not violate the FCC's proposed "non-discrimination" rule.

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Third, the FCC's rule permits identical prices for "like" services when costs are not identical. To illustrate, suppose content provider A and B both receive standard access service, but the content offered by A imposes a congestion externality on the BSP's network. This congestion requires remedial action by the BSP, which is costly, or reduces its demand, which is also costly. Under the economic definition, an identical price to A and B is discriminatory. Similarly, as highlighted above, a uniform price for the same service with a different cost is also

incompatible with the legal definition under Section 202.

As revealed in these three cases, the FCC's proposed rule permits discriminatory pricing—that is, the FCC permits different prices for exactly the same service offered at the same cost and under the same market conditions. But, the FCC's proposed rule also blocks pricing practices that are non-discriminatory under any established or meaningful standard—specifically, the FCC prohibits different prices for different services. In essence, the FCC has concluded that it is discriminatory if a gallon of water has a different price than a gallon of milk. It is clear that the FCC's proposal is a puzzling implementation of a "non-discrimination" rule in that it has no ties to accepted theories of discrimination.

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But What About 251(c)(2)?

The FCC is obviously aware of the constraints contained in Section 202 of the Communications Act, and is quite upfront in its rejection of the established definition of non-discrimination under that section in its "Open Internet" NPRM. As an alternative, the agency supports its non-discrimination proposal on the "unqualified prohibitions added to Title II in the 1996 Telecommunications Act";[11] specifically, the interconnection provisions contained in Section 251(c)(2)(D) that require incumbent local exchange carriers to provide "interconnection" to their networks "on rates, terms, and conditions that are just, reasonable, and nondiscriminatory."[12] The Commission's argument is, by far, too clever.

This alleged difference in Sections 202 and 251(c)(2) is not a new idea, but was explicitly observed in the FCC's *First Report and Order* implementing the local competition provisions of Section 251 of the *Telecommunications Act* ("*Section 251 Order*") back in 1996:

> The nondiscrimination requirement in section 251(c)(2) is not qualified by the "unjust or unreasonable" language of section 202(a). We therefore conclude that Congress did not intend that the term "nondiscriminatory" in the 1996 Act be synonymous with "unjust and unreasonable discrimination" used in the 1934 Act, but rather, intended a more stringent standard.[13]

This argument is echoed in the *Open Internet NPRM:*

> We note that our proposed nondiscrimination and reasonable network management rule bears more resemblance to unqualified prohibitions on discrimination added to Title II in the 1996 Telecommunications Act than it does to the general prohibition on "*unjust or unreasonable* discrimination" by common carriers in section 202(a) of the Act.[14]

The two arguments are the same. As such, of interest is how the FCC implemented the "non-discrimination" principle in the *Section 251 Order*, and whether its view of discrimination in that decision is compatible with the non-discrimination rule now on the table. A review of the *Section 251 Order* reveals that the appeal to Section 251(c)(2) provides neither analytical nor legal cover for the FCC's proposed "non-discrimination" rule.

First, and most obviously, charging different prices for different things is in no sense discrimination, whether evaluated using the logic of economics, Section 202, or Section 251.[15] An unbundled switch port does not have the same price as an unbundled loop, and a DS1

does not have the same price as a DS3. (An interesting question is: does the proposed rule prohibit a BSP from interconnecting with some carriers using higher capacity circuits? Clearly, higher capacities are less vulnerable to congestion and thus offer enhanced quality.)

Second, the FCC's application of 251(c)(2) discrimination in the *Section 251 Order* expressly permitted the very type of arrangement that would now be expressly precluded by the agency's proposed non-discrimination rule. Specifically, the *Section 251 Order* allows differences in the quality of interconnection, stating that non-discrimination,

> … does not excuse incumbent LECs from providing, when requested and where technically feasible, access or unbundled elements of *higher* quality (emphasis added).[16]

Moreover, the FCC permits payments for this higher quality, observing

> … the 1996 Act requires a requesting carrier to pay the costs of unbundling, and thus incumbent LECs will be fully compensated for any efforts they make to increase the quality of access or elements within their own network.[17]

Thus, the *Section 251 Order* permits, if not mandates, a "charge for enhanced access." The FCC's insistence that discrimination under Section 251(c)(2) prohibits charges for different qualities is entirely at odds with its own implementation of that portion of the statute in a case where the statute was directly applicable (unlike the present case).

Moreover, the rules proposed in the *Section 251 Order*, as opposed to that in the *Open Access NPRM*, incorporate the intent of the "undue," "unjust," and "unreasonable" qualifications to discrimination. For example, the *Section 251 Order* allows for unequal treatment if equal treatment is not possible:

> In the rare circumstances where it is technically infeasible for an incumbent LEC to provision access or elements that are equal-in-quality, we believe disparate access would not be inconsistent with the nondiscrimination requirement.[18]

In this decision, the FCC permits discriminatory treatment when equal treatment is not technically feasible. Such permission must invoke the logic of "undue," "unreasonable," or "unjust" discrimination to be viewed as legitimate. As shown in the FCC's implementation of the *Section 251 Order*, the FCC has never imposed a non-discrimination standard that is unconditional in nature, even when the statute can be argued to encourage such a strict interpretation.

Notably, our analysis here is not meant to suggest that the discrimination standards of Sections 202(a) and 251(c)(2) are identical. Our point is simply that the FCC's appeal to Section 251(c)(2) to support a rule prohibiting charging different prices for different services (or qualities of service) in inconsistent with its own implementation of that statute, and it is plainly incompatible with Section 202(a).

As a last grab to close its analytical gaps, the Commission argues that their strict "discrimination" standard would not be problematic because the agency would also adopt a subjective "carve out" for "reasonable network management" that would be adjudicated through a series of *ex ante* adjudications. According to the Commission, the "types of discrimination that would be considered 'just' and 'reasonable' would likely [constitute] reasonable network management" and, as such, "would be sufficient to address concerns that a general prohibition on discrimination lacks necessary flexibility."[19] Such a statement is not logically true.

As noted above, standard and prioritized/enhanced services are different

services, and a different price for different services is not discrimination under any meaningful standard.

Equally as important, "reasonable network management", by its own language, is *conduct* regulation (and an amorphous concept at that). Yet, as explained in detail in PHOENIX CENTER PERSPECTIVES 10-02, *Sabotaging Content Competition: Do Proposed Net Neutrality Regulations Promote Exclusion?,* the specific non-discrimination rule proposed by the Commission is unquestionably *price* regulation.[20] As a result, no amount of *ex ante* adjudications by the Commission (which is the current, and we continue to believe the appropriate, mechanism to handle claims of anticompetitive conduct) can eliminate the pricing distortions created by the FCC's attempt to reinvent the definition of discrimination. Instead, all *ex ante* adjudications will do is highlight the inevitable increase in exclusionary conduct created by the regulation itself.[21]

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Moreover, in light of recent proposals to reclassify broadband as a Title 2 service,[22] an interesting question is whether the FCC's proposed non-discrimination rule is a substitute or complement to such reclassification. The proposed rule, as just shown, is entirely inconsistent with the Section 202 definition of discrimination. If Section 202 (under Title 2 reclassification) and the proposed rule both apply, then there will be two inconsistent standards simultaneously applied to broadband providers, so that nearly any action is objectionable under one standard or the other. On the other hand, if reclassification makes moot the proposed rule, then we must inquire as to the value of a rule trumped by another that is in no way intended to accomplish the same end. Plainly, the Commission's proposed non-discrimination rule for unlike services would not restore the purported Title II protections that proponents of net neutrality claim were stripped away by the Supreme Court in *Brand X*.[23]

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Unintended Consequences

Even under the best-designed, analytically consistent regulations, there can be costly unintended consequences. When regulations are fabricated from whole cloth, however, the risk is likely to be much higher, since the impacts of such regulations have not been contemplated theoretically or measured empirically. While we have demonstrated several adverse effects of net neutrality proposals in prior research (including the FCC's new rule)[24], it is not difficult to show the FCC's proposed non-discrimination rule is likely to bring many unintended consequences.

Blocking Voluntary Transactions

From a practical (rather than legal) standpoint, a significant problem with the FCC's proposed bright-line non-discrimination rule is that is outlaws voluntary transactions. We addressed this issue formally in POLICY PAPER NO. 28, *Neutrality and Foreclosing Market Exchange: A Transaction Cost Analysis*, where we demonstrated that such a rule could lower BSP profits, reduce content competition, and raise prices for consumers.[25] In other words, the rule is a lose-lose-lose proposition.

A simple example illustrates the point. Consider, for example, that a content provider needs enhanced access to customers for the delivery of its content. The content is highly valued, so the BSP is willing to offer prioritized access as well as pay the content provider a per-subscriber fee for the right to distribute the content over its network. (This example is based on the ESPN360-BSP arrangements.)[26] This agreement is beneficial to both parties and to consumers.

In this case, the BSP provides prioritized access to a content provider in return for remuneration. This agreement is outlawed by the FCC's proposed non-discrimination rule. Preferential access is provided in a financial transaction.

Perhaps the FCC would conclude it was not discriminatory since the BSP is paying rather than charging the content provider. Nevertheless, payment is simply a negative price, and other content providers are not afforded the same arrangement.

Furthermore, it is not hard to imagine a case where a content provider would be willing to pay (voluntarily) the BSP for prioritized delivery of a service that increases consumer well being. This type of transaction, which we modeled in POLICY PAPER NO. 28, is plainly prohibited by the FCC's proposed rule, and (under certain conditions) plainly anti-consumer, anti-content, anti-competitive, and anti-network deployment.[27]

Blocking Quality Improvements

Given the FCC's proposed ban on quality enhancement, an important question to ask is whether or not the value of the Internet depends on the quality of service offered? In addition, do the quality requirements vary by content? If the answer to either question is "Yes," which it undoubtedly is, then the FCC's proposed non-discrimination rule reduces the value of the Internet.[28]

The FCC's proposed rule states that BSPs "may not charge a content … provider for enhanced or prioritized access." The rule permits, however, BSPs to charge end-users for prioritized access.[29] But, clearly, charges to end-users and content providers are not fungible in all cases (if not most cases). The technical requirements for prioritized or enhanced access are far beyond the technical competence of most consumers, and requiring the customer to contact its BSP to order and arrange for such services is hardly a favor.

Furthermore, the FCC's proposal can lead to gross inefficiency from a transactions perspective. Say, for example, a company like Amazon, which may sell millions of online videos annually, wants to obtain the prioritized delivery of its content to improve the quality experience for its customers. The company can negotiate with BSPs to arrange for such preferences, thereby ironing out the technical details for successful prioritization in relatively few transactions.[30] The FCC rule, however, replaces these few business-to-business deals with millions of consumer-to-BSP transactions, assuming such transactions could accomplish the same thing. The inefficiency is apparent.

Put simply, if charges to content providers and consumer are not fungible—and they obviously are not—then welfare is lost by a rule prohibiting voluntary arrangements between

content firms and BSPs. In this sense, prohibiting charges for quality enhancements is not much different than prohibiting quality enhancements directly for many types of arrangements. As such, the FCC's proposed rule reduces the quality dimension of the Internet and, as a consequence, reduces its value. Whatever benefits the proposed rules are alleged to create must be sufficient to offset such losses.

Conclusion

The concept of discrimination is well established in both economics and communications law. Yet, in drafting its new proposed non-discrimination rule, the FCC has deliberately chosen to ignore both the economics and the law, concocting its own definition of "discrimination" based upon a tortured statutory interpretation that is inconsistent with its own previous interpretation in a direct application of the same statute. As a result, we now have a proposed bright-line non-discrimination rule that not only lacks analytical legitimacy, but also will likely have significant adverse effects on the social value of the Internet. If the Commission is serious about promoting an "open" Internet then, consistent with our previous recommendations, a return to first principles is very much in order.

NOTES:

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1 *In re Preserving the Open Internet*, GN Docket No. 09-01, Notice of Proposed Rulemaking, 24 FCC Rcd 13,064, FCC 09-03 (rel. Oct. 22, 2009) (*Open Internet NPRM*);

2 It could be argued that the non-discrimination rules are *no quality differential rules* disguised as pricing rules. For our analysis, however, we analyze the proposals as they appear, which is as price regulation.

3 D. Kaserman and J. Mayo, Government AND BUSINESS (1995) at 273; W. Viscusi, J. Vernon, and J. Harrington Jr., ECONOMICS OF REGULATION AND ANTITRUST (1995) ("charging different customers prices that are not in proportion to marginal cost (at 290)"); D. Carlton and J. Perloff, MODERN INDUSTRIAL ORGANIZATION (2005) ("charges different customers different unit prices for the identical good (at 290)"); J. Tirole, THE THEORY OF INDUSTRIAL ORGANIZATION (1995) ("two units of the same physical good are sold at different prices (at 133)").

4 Kaserman and Mayo, *id*. at 273.

5 47 U.S.C. § 202(a).

6 *See, e.g., MCI Telecommunications Corp. v. FCC,* 917 F.2d 30, 39 (D.C. Cir. 1990) and citations therein.

7 *Id.*

8 *Id.*

9 *See supra* n. 3.

10 The rule does not prohibit the BSP from providing enhanced services to its affiliate but standard service to all others. As long as the price is the same, it is legal.

11 *Open Internet NPRM, supra* n. 3 at ¶ 109.

12 47 U.S.C. § 251(c)(2)(D).

13 *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996,* 11 FCC Rcd 15,499, FCC 96-325, FIRST REPORT AND ORDER (August 8, 1996) at ¶216 (*Section 251 Order*).

14 *Open Internet NPRM, supra* n. 1, at ¶ 109 (emphasis in original).

15 L. Phlips, THE ECONOMICS OF PRICE DISCRIMINATION (1983), permits a more encompassing definition of price discrimination, allowing "discrimination" to occur with product differentiation (or variety). This expanded definition "implies that price discrimination is likely to be a rather ubiquitous phenomenon (at 7)." However, even under this definition, price discrimination exists only when net prices differ, implying prices may be different but only to the extent that costs are different. As a result, even taking an extremely liberal view of price discrimination offer no redemption for the FCC's approach. Moreover, Phlips (1983) argues that price discrimination is mostly a welfare improving practice since it typically opens new markets.

16 *Section 251 Order, supra* n. 13 at ¶ 313.

17 *Id.* at ¶ 313.

18 *Id.* at ¶ 312.

19 *Open Internet NPRM* at ¶ 110.

20 George S. Ford and Michael Stern, Phoenix Center Perspectives No. 10-02: *Sabotaging Content Competition: Do Proposed Net Neutrality Regulations Promote Exclusion?* (March 4, 2010)(available at: http://www.phoenix-center.org/perspectives/Perspective10-02Final.pdf).

NOTES CONTINUED:

21 *Id.*

22 *See, e.g.,* Reply Comments of Public Knowledge — National Broadband Plan Public Notice #30, GN Docket No. 09-47 (January 26, 2010)(available at: http://fjallfoss.fcc.gov/ecfs/document/view?id=7020383705).

23 *See, e.g.,* June 27, 2005 Statement of Consumer Federation of America and Consumers Union on The Supreme Court's Decision in *Brand X* (available at: http://www.consumersunion.org/pub/core_telecom_and_utilities/002441.html); http://www.savetheinternet.com/faq.

24 G.S. Ford, L.J. Spiwak and M.L. Stern, *Expanding the Digital Divide: Network Management Regulations and the Size of Providers*, PHOENIX CENTER POLICY BULLETIN NO. 23 (October 2009)(available at http://www.phoenix-center.org/PolicyBulletin/PCPB23Final.pdf); G.S. Ford, T.M. Koutsky and L.J. Spiwak, *A Policy And Economic Exploration of Wireless Carterfone Regulation*, 25 SANTA CLARA COMPUTER & HIGH TECH. L.J. 647 (2009); G.S. Ford, T.M. Koutsky and L.J. Spiwak, *Consumers and Wireless Carterfone: An Economic Perspective*, PHOENIX CENTER POLICY BULLETIN NO. 21 (September 2008)(available at: http://www.phoenix-center.org/PolicyBulletin/PCPB21Final.pdf); G.S. Ford, T.M. Koutsky and L.J. Spiwak, *Using Auction Results to Forecast the Impact of Wireless Carterfone Regulation on Wireless Networks*, PHOENIX CENTER POLICY BULLETIN NO. 20 (Second Edition) (May 2008) (http://www.phoenix-center.org/PolicyBulletin/PCPB20Final2ndEdition.pdf); T.R. Beard, G.S. Ford, T.M. Koutsky and L.J. Spiwak, *Network Neutrality and Industry Structure*, 29 HASTINGS COMMUNICATIONS AND ENTERTAINMENT LAW JOURNAL 149 (2007).

25 G.S. Ford, T.M. Koutsky and L.J. Spiwak, *Network Neutrality and Foreclosing Market Exchange: A Transaction Cost Analysis*, PHOENIX CENTER POLICY PAPER NO. 28 (March 2007) (available at: http://www.phoenix-center.org/pcpp/PCPP28Final.pdf) *and reprinted as* T.R. Beard, G.S. Ford, T.M. Koutsky and L.J. Spiwak, *Network Neutrality and Foreclosing Market Exchange,* 1 INT. J. MANAGEMENT AND NETWORK ECONOMICS 160 (2009).

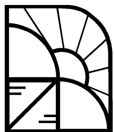
26 *See, e.g.,* E. Van Buskirk, The Business of Tech *ESPN to ISPs: Pay for Your Customers to Play Video*, WIRED (Februrary 5, 2009)(available at: http://www.wired.com/epicenter/2009/02/espn-stands-fir/); S. Nassauer, *ESPN Charges Net Providers For Right to Offer Broadband Web Site*, WALL STREET JOURNAL (August 1, 2006)(available at: http://online.wsj.com/article/SB115439535367922979.html?mod=rss_whats_news_technology).

27 *Supra* n. 25.

28 This loss of value would offset any gain in value alleged to occur as a consequence of the rule.

29 *Open Internet NPRM, supra* n. 1 at ¶ 106.

30 Amazon also negotiates on behalf of their customers with shipping carriers for different speeds of delivery. It is obviously grossly inefficient for a customer to obtain its own shipping for items purchased with Amazon (or other online retailer).



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