

POLITICAL PULSE

Net Neutrality Not Neutered

Thursday, December 14, 2006

Donald Luskin

Two big defeats for "net neutrality" regulation don't make a deregulatory trend.

Telecom was the second worst-performing S&P 500 sector in the week following the election, anticipating that the new Democratic congress would be likely to impose so-called "net neutrality" regulation (see "[Stock Market Exit Poll](#)" November 15, 2006). But this week the telecom sector has surged, bringing its post-election performance about equal to the overall market's, pretty much locking in its position as best-performing sector for calendar 2006. There have been two catalysts.

- First, the Michigan legislature has enacted this week a statewide cable franchising framework, clearing the way for incumbent telco AT&T to install fiber-to-the-home in 1,100 cities and compete in video services. The Michigan bill had been held hostage to demands from Democrats that net neutrality provisions be included, which would have regulated pricing, access and other terms of service of AT&T's new broadband network. In the end, the net neutrality provisions were eliminated from the bill, and Jennifer Granholm, Michigan's Democratic governor who strongly favors net neutrality, has said she will nevertheless sign it. In an apologetic letter to an executive of Google, the leading corporate lobbyist in favor of net neutrality, Granholm explained that insisting on net neutrality wasn't worth putting at risk AT&T's promised investment of \$620 million in the project, which will result in 2,000 new jobs in Michigan.
- Second, the blockade by the FCC of the AT&T/Bellsouth merger over imposition of net neutrality provisions as a condition of approval is probably about to be cleared. Two Democratic commissioners have insisted on the provisions, and two Republican commissioners have not -- with the tie-breaking Republican commissioner Robert M. McDowell having recused himself due to a conflict of interest. On Friday Chairman Kevin J. Martin announced that counsel has waived the conflict, enabling McDowell to cast the tie-breaking vote -- presumably approving the merger without net neutrality provisions.

Telecom stocks seem to be treating these events as test cases for the post-election policy environment, in which the compelling logic of growth and job creation has prevailed over the drive for more regulation of large corporations. Or, to put the same thing in more cynical operational terms, the telco lobbyists are still able to outflank the Internet content provider

Update to strategic view

US TELECOM STOCKS:
Passage of a cable franchising bill in Michigan, and the likely FCC approval of the AT&T/Bellsouth merger -- both without so-called "net neutrality" regulations -- don't necessarily give an "all clear" for the telecom sector. The Democratic congress, egged on by organizations such as MoveOn.org, will surely put forward net neutrality legislation in 2007, and at this point we don't have confidence that the Bush administration is engaged enough on the issue to veto it. We continue to urge caution on the telecom sector, which is especially vulnerable given its outsize gains in 2006.

[\[see Investment Strategy Dashboard\]](#)

lobbyists -- and we still have a Republican administration. To be sure, these events are both very positive news, but we'd caution against extrapolating them into an "all clear" on restrictive broadband regulation. Even in Michigan, it's not over: Granholm has promised Google that she will promote new net neutrality legislation next year. In the new Democratic congress, majority and committee leadership is deeply committed to net neutrality -- House speaker Nancy Pelosi is a mouthpiece for California-based Internet content providers such as Google, and both incoming House Telecommunications Subcommittee chair Ed Markey and Senate Commerce Committee chair Daniel Inouye are aggressive populists with a particular taste for punishing supposed corporate abuses. And Democratic grass-roots lobbying organizations such as MoveOn.org will continue to egg them all on, richly funded by Google, Microsoft and other corporations who believe they would benefit from net neutrality.

So far net neutrality initiatives have been put forward as amendments or conditions to other initiatives already set in motion by the telecom industry. In the two examples above, latching onto a cable franchising bill and a corporate merger, net neutrality failed. But even in that form, net neutrality initiatives have been destructive of growth -- net neutrality amendments were sufficient to thwart this year's national cable franchising bill put forward by GOP senator Ted Stevens, finally abandoned last week as the curtain came down on the Republican-controlled congress. Now, in a Democratic congress, with committees controlled by net neutrality advocates, net neutrality legislation can be put forth on its own -- just as Granholm is threatening to do in Michigan. That will be a whole new order of policy risk. At this time we simply don't know whether Senate Republicans will be willing to block with the threat of filibuster -- and if they won't, whether the Bush administration will be sufficiently engaged on the issue to veto. Their record on matters of regulation -- remember Sarbanes Oxley -- is not unblemished.

BOTTOM LINE: Telecom has been the best-performing sector in 2006, predicated in part on the potential for uniform cable franchising regulations to unleash a massive new round of positive net present value broadband infrastructure development. So-called "net neutrality" regulations threaten that positive net present value and discourage capital investment, and thus threaten the long-term earnings outlook for the telecom sector. While the last week has seen two important positive developments in thwarting the rise of net neutrality regulation that had been appended to other initiatives, it also saw the death of a key cable franchising bill at the hands of net neutrality. Now a Democratic congress presents an unknown world of risk from new stand-alone net neutrality bills supported by grass-roots advocacy organizations such as MoveOn.org. In its worst form, net neutrality could gut telco and cableco broadband profitability and retard infrastructure investment. We continue to urge caution on the sector, especially given its spectacular performance in 2006. **TM**