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***Regulation in Financial Translation***

**How Investors View the Internet Ecosystem  
and the Open-Internet Order**

**Anna-Maria Kovacs, Ph.D., CFA**

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Anna-Maria Kovacs is a Visiting Senior Policy Scholar at the Center for Business and Public Policy.

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**How Investors View the Internet Ecosystem and the Open-Internet Order**

In light of the FCC's recent Open Internet Order, it is worth stepping back and considering the way investors look at the Internet ecosystem. They focus, obviously, on financials and the business plans that generate those numbers.

When they look at the large broadband Internet Service Providers (ISPs), they see balance sheets with high debt loads and very low cash balances. The ISPs are heavily invested in networks and spectrum. In contrast, when investors look at the large edge providers, they see huge cash balances and little or no debt.

To put some numbers on this, the three largest ISPs (AT&T, Verizon, Comcast) hold only 2% of their balance sheets in cash, while the three largest edge providers (Apple, Microsoft, Google) hold 62% of their balance sheets in cash. Even Netflix, which is much smaller, holds 25% of its balance sheet in cash and has done so for a while.

Between them, the three largest edge providers hold \$350 billion in cash—to put that in perspective, it's roughly the amount the National Broadband Plan Taskforce estimated in 2009 as the cost of deploying fiber throughout the U.S.<sup>1</sup> The hope of bringing fiber to all Americans was immediately discarded, on the premise that no one has that much capital. Yet just three edge companies hold that much cash on their balance sheets in 2015.

Not surprisingly, investors treat the ISPs' equities like risky bonds and demand dividends that are very high for the current low-interest rate environment. Yields range from 4.5% for Verizon to 6.1% for Frontier, far above the 10-year Treasury rate of 2.1%.

Conversely, investors treat the large edge providers' stocks like an unusual combination of high-growth and safety. That reflects not only their huge cash balances but also their entrenched positions in market segments that are highly concentrated. In other words, investors see a small number of edge providers as dominating the Internet ecosystem.

The open-Internet order<sup>2</sup> reinforces these very different views of ISPs v. edge providers that are held by investors. ISPs are held to the bright-line rules, the catch-all rule, and many of the

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<sup>1</sup> More precisely, slide 45 of the September 29, 2009 Taskforce presentation estimated that it would cost an incremental \$350 billion of capital expenditures and operating expenditures for one network to bring broadband at a speed of over 100 Mbps to between 111 and 116 million households. Slide 43 indicated that fiber-to-the-premise was the only technology that could reach those speeds. The presentation can be found at: <http://transition.fcc.gov/headlines2009.html>

<sup>2</sup> The open-Internet order was voted by the Federal Communications Commission (FCC) on February 26, 2015 and issued on March 12, 2015. Available at: [https://apps.fcc.gov/edocs\\_public/attachmatch/FCC-15-24A1.pdf](https://apps.fcc.gov/edocs_public/attachmatch/FCC-15-24A1.pdf).

requirements of Title II of the Communications Act,<sup>3</sup> including the requirement that their pricing and conduct be just and reasonable. Edge providers are not held to any of these requirements.

Investors are, for the most part, taking a wait-and-see approach because they realize the order may not be upheld in court and because they don't know how it will be implemented for however long it is in effect. It is a complex order and, at least to non-lawyers, vague in many respects. So investors are waiting to see what the courts and FCC will do with it, but they are focused on certain aspects.

In terms of the impact on edge providers, investors see the order as reinforcing the dominance of the current leaders. All edge providers are free to block, throttle, and prioritize traffic and none are obliged to be just or reasonable in either pricing or conduct. But it is the largest who are most able to take advantage of that freedom, who can afford to build or cheaply lease networks that effectively prioritize their traffic over that of their smaller edge competitors. Thus, this order reinforces investors' view that the current leaders in various segments of the edge portion of the Internet ecosystem are safely entrenched. The one large shadow cast on that view comes from abroad. Recent actions in the European Union and elsewhere are making it clear that once established for ISPs, a regulatory regime might be extended to the edge as well.<sup>4</sup>

That makes investor concerns about the impact on ISPs all the more important. First and foremost, there is a concern that there will, in fact, be rate regulation of various sorts. Whether it takes the form of limits on pricing of traffic exchange, wholesale pricing of other sorts, or retail rates, the investment community is holding its breath waiting for the first hint that the FCC will regulate ISP rates.

There is also a broader concern about limitations on the ability of ISPs to respond to consumers' desire for choice and innovation, whether in pricing or service features. There seems to be a push in D.C. for one-size-fits all pricing and services that goes completely counter to consumers' desire for individuality and choice, i.e., "what I want, when I want, wherever I want it, in whatever combination works best for me." If ISPs can't tailor their offerings to satisfy that need for individuality, consumers will abandon them in droves—as they have abandoned

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<sup>3</sup> The bright line rules are no blocking, no throttling, and no paid prioritization, with the first two subject to reasonable network management. The catch-all rule, subject to reasonable network management, prohibits unreasonable interference by broadband Internet access service (BIAS) providers with end-users' and edge providers' use of Internet access, services, applications, and content. Title II regulates telecommunications service providers as common carriers. The order uses "BIAS providers" and "ISPs" as interchangeable terms.

<sup>4</sup> European Commission, *A Digital Single Market Strategy for Europe*, Brussels, May 6, 2015.

the inflexible POTS<sup>5</sup> regime. In an environment in which consumers demand choices, lack of flexibility in designing business plans is anathema to investors as well as consumers.

Investors will also watch how the FCC will enforce the rules, especially in the period when it is essentially interpreting the rules. For one thing, it will be some time before companies really know what the rules of the road are. For another, consumer confusion about who is really causing any quality-of-service problems they experience may result in ISPs facing many complaints for the behavior of other parties over whom they have no control. For ISPs, even if they are found innocent, the process of defending themselves will be time-consuming and expensive. That problem is biggest for the small ISPs, of course, but it could become a big problem for all ISPs. Thus, investors will be watching enforcement very carefully, both the process and the level of fines.

Privacy in the Internet context is another area that creates lots of confusion for consumers. It is vital to consumers at the same time that it is central to the ad-driven model of the ecosystem. Inconsistent treatment at various levels of the ecosystem makes it very difficult for consumers to feel—and be—as safe as they want to be. That is bad both for consumers and investors, and is, thus, another area of focus for investors.

Bottom line, right now investors are in watch-and-see mode. Investment in the sector, especially in ISPs, will depend heavily on the FCC's implementation of its order as well as, of course, the courts' decisions.

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<sup>5</sup> POTS stands for plain-old-telephone-system.