

# A Reply to Regulation and Competition in Cable Television

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The Comment by Albert Smiley<sup>1</sup> deals with both the economics and policy implications of my analysis.<sup>2</sup> In regard to the economics, it questions the ability of competitive forces to improve consumer welfare in local cable television markets, citing a host of arguments in support of imperfect competition. As he readily concedes, however, the necessary experiment has not been run: what will happen when municipal entry barriers have been removed and firms are free to compete?<sup>3</sup> I have tried to answer this question by way of induction through my analysis of particular markets. Based upon evidence that prices decline and services can improve upon competitive entry, I conclude that consumers would be well served by allowing unpredictable rivalry to proceed. Although one might argue that many or even most markets would fail to experience robust competition, consumers face virtually no downside risk. Thus, the experiment of competition is worth a try in all cable markets.

We have mounting evidence from the franchise monopoly regulatory regime which exists now, as well as evidence from the period before rate deregulation. Thus, this policy debate is far more tractable than Smiley suggests. Smiley amends my conclusion regarding open entry by saying that such a policy entails rewriting the Cable Act of 1984, and, therefore, we ought to consider either establishing auction mechanisms<sup>4</sup> for cable pricing schemes at the municipal level outside of the franchise process, or restoring rate regulation (as is being actively debated in Congress today).<sup>5</sup> Notwithstanding Smiley's assertions, none of these policy conclusions

1. Smiley, *Regulation and Competition in Cable Television*, 7 YALE J. ON REG. 121 (1990).

2. Hazlett, *Duopolistic Competition in Cable Television: Implications for Public Policy*, 7 YALE J. ON REG. 65 (1990).

3. See Smiley, *supra* note 1, at 133.

4. Auction mechanisms function when the municipality awards the franchise to the firm offering the lowest prices.

5. Smiley, *supra* note 1, at 136 n.45.

follows necessarily from my analysis. In fact, each is undesirable from the perspective of consumer welfare.

### I. The Evidence Supports Open Entry

Open entry does not require rewriting the Cable Act. It is imprecise to say that the Cable Act blesses localities with the authority to create franchise monopolies. The Ninth Circuit held in *Preferred Communications, Inc. v. City of Los Angeles*<sup>6</sup> that creation of an exclusive cable franchise was no more constitutional than was the creation of a single newspaper permit. In examining the policy mandate laid out in the Cable Act, the court noted that it could not "agree with the suggestion in the legislative history that the provision 'grants to the franchising authority the discretion to determine the number of cable operators to be authorized to provide service in a particular geographic area.'"<sup>7</sup> Open entry could be established without rewriting the Act by courts holding exercise of municipal franchise authority unconstitutional when used to prevent competition. Indeed, it appears that courts are beginning to do just this.<sup>8</sup>

Establishing auction mechanisms for cable pricing schemes is another policy option that is inconsistent with my analysis, and undesirable from the consumer's perspective. Although the auction mechanism is a policy that is not experiencing widespread debate today, it is reminiscent of so-called Demsetzian franchise monopoly schemes in the economics literature.<sup>9</sup> The "Dutch auction"<sup>10</sup> proposed in the Comment by Smiley has always been available to local franchising authorities. The reason they have not employed it, and the reason that Smiley's proposal is not being discussed in the cable policy debate today, is that there is no effective way to regulate rates or to extract non-price concessions via the auction method. The problem with price auctioning is that quality differences between bidders confuse the definition of lowest price.<sup>11</sup> Not only is the

6. 754 F.2d 1396 (9th Cir. 1985), *aff'd* 476 U.S. 488 (1986).

7. *Id.* at 1411 n.11.

8. The latest in this series has been rendered by Federal District Judge Consuelo Marshall in *Preferred Communications, Inc. v. City of Los Angeles*, No. CV 83-5846 (C.D. Cal. Jan. 5, 1990) (memorandum order).

9. I use the term "so-called" due to the manner in which the 1968 analysis by Harold Demsetz has been interpreted in the policy literature. *See* Hazlett, *Franchise Bidding and Natural Monopoly: The Demsetz Solution on Cable* (June 1989) (unpublished paper presented at the Western Economic Association annual meeting, on file with author).

10. Smiley, *supra* note 1, at 136.

11. R. SCHMALANSEE, *THE CONTROL OF NATURAL MONOPOLIES* 71-73 (1979).

selection of a uniform product therefore necessary for the price auction to establish any meaningful ranking, it is not clear what sort of cable package consumers desire to purchase. Even if this information were available, local governments may not set such programming standards because the First Amendment protects cable operators as "electronic publishers" and precludes such regulation. Hence, it is difficult to speak either of price auctioning or rate regulation, when product quality cannot be controlled.<sup>12</sup>

Finally, the restoration of rate regulation is not a necessary policy conclusion from my analysis, and is in fact inimical to consumer interests. We know that municipal rate regulation did not increase consumer welfare before that option was foreclosed by adoption of the Cable Act in 1986. Although Zupan<sup>13</sup> found that local rate regulation was associated with a large impact, the significance of this finding is questionable because his sample of sixty-six cable systems included only six which were deregulated.<sup>14</sup> Furthermore, they were deregulated at the option of the municipal government itself, a fact that suggests a problem of selection bias in the deregulated subset.<sup>15</sup> Zupan further concluded that political franchising authorities imposed highly inefficient obligations in the form of wasteful cross-subsidies on cable firms.<sup>16</sup> In my study<sup>17</sup> of nearly 300 cable systems in California, I was able to observe 67 deregulated systems. In contrast to the deregulated systems studied by Zupan, these California systems were deregulated by state law. Thus, the selection bias resulting from local government discretion disappears. My results indicate that there were no welfare improvements from rate regulation. Although nominal rates rose under decontrol, quality (particularly number of channels on basic service) rose at least as rapidly. The fact that output was not constrained after deregulation is also revealing. Penetration actually rose, though by a statistically

12. It is well-known that the first response of a price-regulated supplier is, assuming a binding price ceiling, to lower product quality. Where quality is elastic, such responses can quickly obviate the effectiveness of price controls. See R. MILLER & R. MEINERS, *INTERMEDIATE MICROECONOMICS* 419 (3d ed. 1986). This outcome appears to obtain under cable rate regulation, as discussed below.

13. Zupan, *The Efficacy of Franchise Bidding Schemes in the Case of Cable Television: Some Systematic Evidence*, 32 *J.L. & ECON* 401 (1987).

14. *Id.*

15. *Id.* If the locality had the choice to regulate, but chose not to, is the resulting free market price the product of deregulation or the conscious policy selection of the local government?

16. Zupan, *supra* note 13.

17. T. Hazlett, *The Demand to Regulate Franchise Monopoly: Evidence from CATV Rate Deregulation in California* (September 1989) (forthcoming in *J. ECON. INQUIRY*).

insignificant amount in deregulated markets. This is just the reverse of what would be predicted under the hypothesis that localities choose to constrain rates below monopoly levels.<sup>18</sup>

This ineffectiveness of local rate regulation is also convincingly supported at the federal level by the recent survey of basic cable prices and penetration pursuant to the Cable Act's deregulation by the General Accounting Office (GAO).<sup>19</sup> Examining evidence from over 1,400 cable systems for the period December 1, 1986 to October 31, 1988, the GAO found that the average number of channels included in the most popular basic service package increased from 27 to 32.<sup>20</sup> Although the price of this package rose twenty-six percent against a Consumer Price Index increase of about six percent, mean price per channel rose from forty-four cents to only forty-six cents, an increase less than the rate of inflation.<sup>21</sup> Again, the key statistic—penetration—revealed that no output restriction resulted from deregulation. Indeed, the average penetration rate increased from fifty-five percent to fifty-seven percent under decontrol.<sup>22</sup> Moreover, the GAO found thirty-four percent of cable systems to be deregulated prior to the federal decontrol timetable, thus giving observers a contemporaneous sample of cable prices to compare to the newly unleashed prices.<sup>23</sup> The GAO measured increases of twenty-four percent in this large control group, virtually identical to the twenty-six percent increase in the deregulated sample.<sup>24</sup>

Although local rate regulation appears to be ineffective in lowering price, it remains a politically important tool. Price controls are employed as an enforcement device to ensure that various political agreements are followed by the cable franchisee. These include cross-subsidy arrangements called for in the franchise, as well as certain "off-budget" dealings, including campaign contributions to incumbents. Both municipal and cable industry lobbyists concur that securing the benefits of these marginal dealings is the real purpose

18. *Id.*

19. UNITED STATE GENERAL ACCOUNTING OFFICE, NATIONAL SURVEY OF CABLE TELEVISION RATES AND SERVICES (August 1989). The Cable Act deregulated rates in most markets as of December 29, 1986.

20. *Id.* at 1-2.

21. *Id.* at 2, 26.

22. *Id.* at 2.

23. *Id.* at 4.

24. *Id.*

of price control.<sup>25</sup> To argue that such a tool is unneeded because cities have the option of issuing competitive franchises ignores the fact that this alternative constitutes a MAD (mutual assured destruction) policy. Municipal issuance of competitive franchises would destroy the monopoly, but municipal authorities would not benefit from this. Delaying rate increases is a far more viable tool, as the city council may simply play a waiting game without relinquishing its essential jurisdiction to determine the level of profits or their assignment.

## II. The Need to Recognize Politics in Analysis

This analysis began with the original hole in the Smiley trade-off: there was no consideration of the actual political competition waged in the assessment of the entry rules. However, an appreciation of relevant political forces in policy analysis is important. Smiley's contention that I give no weight to consumer interests is true only in the limit. My basic theory is that consumer interests are relatively under-represented with respect to those of monopoly suppliers and incumbent politicians. This theory does not assume that consumers are irrational. Indeed, I cite the three specific instances known to me where consumers were allowed to vote on cable competition, and voted their interests overwhelmingly.<sup>26</sup> Moreover, the circumstances surrounding these votes are also important in revealing the incongruent interests of incumbent politicians. In each instance, the city councils had unanimously voted against competitive entry.<sup>27</sup> This evidence is hardly surprising in light of the pattern of anti-competitiveness established in numerous court battles waged by cities to retain their rights to bar competition,<sup>28</sup> a position ardently defended by their lobbying associations, most notably the National League of

25. Cable industry analyst John Mansell writes: "Cable's legislative head-aches are a by-product of the Cable Act. Rate deregulation curtailed local leverage, thereby forcing franchising authorities to threaten more drastic action in order to extract commitments." PAUL KAGAN ASSOC., CABLE TV FRANCHISING I (May 31, 1989). For a list of other concurrences, see Hazlett, *supra* note 17.

26. Hazlett, *supra* note 2, at 109 n.160.

27. *Id.*

28. The City of Los Angeles has defended its right to monopoly franchise cable all the way to the U.S. Supreme Court and back, in a largely unsuccessful effort, despite employing a selection process which did not even examine prices. Preferred Communications, Inc. v. City of Los Angeles, 754 F.2d 1396 (9th Cir. 1985), *aff'd* 476 U.S. 488 (1986). Rates were set *after* the franchise award, in bilateral negotiations. See Harris, City Trying to Pick a Cable Service Using Old, Incomplete Data, Los Angeles Times, Aug. 30, 1981, at II-1, II-3.

Cities.<sup>29</sup> My primary contention that abstract economic analysis is insufficient to appropriately address the actual policy question is not adequately addressed by Smiley's response that, theoretically speaking, many policies can be devised.

In the three years since I began this particular investigation, the cable competition question has been further ignited by the significant prospect of TELCO<sup>30</sup> entry into the cable television market.<sup>31</sup> Virtually all of the strategic entry issues raised by both my Article and Dr. Smiley's Comment could well be obviated with such an entrant, and the apparent viability of such has produced near panic in the cable television industry. In many respects, video provision by TELCOs, or their cable television supplier customers,<sup>32</sup> renders the entire question of "natural monopoly" moot. But the old sources of protectionism will not instantly cease to exert themselves. Indeed, in appropriately raising the specter of competition to coaxial copper cable in the form of fiber optics, Smiley misses the political dynamic which carries over from one technology to the next.

This political dynamic is evident in the current policy debate concerning telco entry. The National League of Cities<sup>33</sup> endorsed federal relaxation of the rules prohibiting telephone company provision of television services in their local phone service areas in a lengthy brief filed with the Federal Communications Commission in late 1988.<sup>34</sup> However, they have hardly adopted a free entry position. Their brief stresses the importance of strengthening local control, meaning of course, the municipal franchising process. From the standpoint of the franchisers, the simple public choice economics is that more demand for the monopoly franchise is preferred to less. The cities want the telcos freed from federal restraints, but certainly not liberated from the local franchising loop.

29. See *infra* notes 24-25 and accompanying text.

30. TELCO is a cable industry term for telephone company.

31. See Hazlett, *Should Telephone Companies Provide Cable TV?* (forthcoming REGULATION, Winter 1990).

32. TELCOs need not provide cable television directly, but could build and maintain copper or fiber systems to lease to competitive, i.e., second entrant, cable companies.

33. They have been joined by the U.S. Conference of Mayors, the National Conference of Black Mayors, and the National Association of Telecommunications Officers and Administrators (local cable regulators) in this position. *NATOA Joins in Endorsing Telco Competition Proposal*, *Multichannel News*, Nov. 6, 1989, at 4.

34. See National League of Cities, *Comments of the National League of Cities, In the Matter of Telephone Company-Cable Television Cross-Ownership Rules Sections 63.54-63.58, FCC 88-249 37426, CC Docket No. 87-266* (Dec. 16, 1988).

This point has not been missed by other observers of the local franchising scene, including the Ohio Public Utilities Commission.<sup>35</sup> The Commission filed a brief in the same telco cross-ownership rule-making proceeding. They endorsed the FCC's proposal to open cable to telco competition, but were careful to include the likely behavior of local government franchisers in the policy equation. The Commission noted that:

Clearly, the franchise mechanism, on either an exclusive or non-exclusive basis, tends to inhibit competition to the detriment of consumers . . . . Competition is the natural alternative to regulation in guarding against monopoly abuses. However, viable competition in the cable market requires removing or modifying artificial barriers to entry such as the telephone company cross-ownership ban and local franchising.<sup>36</sup>

The FCC correctly sees that simply *permitting* telco entry is insufficient. The pro-competitive mandate requires "preempt[ion of] local franchising authorities to the extent necessary to eliminate this artificial barrier to entry."<sup>37</sup> Otherwise, the intensified competition in cable would inure to the benefit of only franchising agents empowered to cut better political deals, and not to consumers shopping for cable television.

## Conclusion

Smiley settles on the safe-sounding admonition that "generalizations about the appropriate role of overbuild competition are likely to be misleading,"<sup>38</sup> and re-recommends a case-by-case approach. Yet, he succeeds not in overcoming generalization, but only in obscuring it in his assumption that, generally speaking, local governments are best able to make the welfare trade-offs in the consumer's interest.<sup>39</sup>

35. Public Utilities Commission of Ohio, Initial Comments of the Public Utilities Commission of Ohio, In the Matter of Telephone Company-Cable Television Cross-Ownership Rules, Sections 63.54-63.58, CC Docket No. 87-266 (Dec. 1, 1988).

36. *Id.* at 7-8.

37. *Id.* at 12.

38. Smiley, *supra* note 1, at 131.

39. Indeed, at one point, he elects to straightforwardly argue this point. *Id.* at 135 n.49. This cannot be a side issue, however, as his primary policy proposition is that *generally* local government possesses superior regulatory instincts than offered by a blanket federal open entry (or other) pre-emption. Yet, the operational importance of this defense

The evidence regarding price and quality improvement in competitive markets, as well as the data from rate regulation and the franchising process itself, show that promoting free entry into cable television markets is, in general, the pro-consumer policy option which is realistically available.

of municipal authority is largely eliminated in the retraction regarding the inalienability of constitutional rights; it is the First Amendment that will open cable markets to competition.