

CABLE REREGULATION

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Congress enacted the "Cable Television Consumer Protection and Competition Act of 1992" over the veto of President George Bush.¹ This act purports "to provide increased consumer protection and to promote increased competition in the cable television and related markets." We here analyze some important economic implications of the act. Our analysis of cable-television history (especially the brief period of deregulation, 1984–92) and of the contents and amendments of the new act indicate that the achievement of public-interest goals is most unlikely. The Cable Act of 1992 admits self-interested outsiders (mainly, broadcasters in competition with cable operators, along with municipal tax collectors) to the profits generated by the supply of cable TV services. Further, the act will redistribute the profits of local cable companies by changing property-rights assignments *without* fostering new competition. Whether the nominal price of some homogeneous unit of cable services rises or falls, we argue that service quality (including the introduction of new technologies and products) will decline over time.

Following a review of the period of cable deregulation, this article treats two major aspects of the 1992 Cable Act. These are (1) the reinstatement of rate regulation at the municipal level of government

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¹This act (P.L. 10–385) is codified at 47 U.S.C., Sections 521–609.

under the aegis of the Federal Communication Commission (FCC),² and (2) the restrictions imposed on ownership forms and on the ability of cable operators to choose which programs to carry. While other aspects of the act are important, a study of these two issues is central to the economic consequences of cable reregulation.

Deregulation of the Cable Industry, 1984–92

Several regulatory regimes have existed over the brief history of cable television in the United States (Posner 1972, Williamson 1976). A consensus between over-the-air broadcasters, the cable industry, and other interested parties was reached in 1972 under President Richard Nixon. This consensus set rules regulating the new and increasing cable competition facing broadcasters (Besen 1974). The goal then was to protect markets of the television networks and local broadcasters. Part of this protection included cable rate regulation by municipalities (overseen by the FCC).

The most recent regulatory regime prior to the Cable Act of 1992 was inaugurated by the Cable Communication Policy Act of 1984. The 1984 act freed cable operators from rate regulation provided that communities were supplied cable service under “effectively competitive” conditions. (Rate deregulation took effect in December 1986, with other parts of the deregulation beginning in 1984.) Rate deregulation—essentially the lifting of rate regulation by city governments—had a clear impact on important dimensions of the cable industry. The impact of deregulation on prices, technology, and programming will be considered first. We then investigate the important relation between the interests of municipal governments and competition in the cable industry.

Prices, Deregulation, and Product Quality

The most strident criticisms of the cable industry have been aimed at the supposedly unwarranted price increases that occurred during deregulation. Changes in monthly rates for basic cable services between 1986 and 1991 were calculated by the U. S. General Accounting Office (GAO 1990a, 1990b, 1991). The price of the most popular tier of basic rate service increased from \$11.71 per month in November 1986 to \$18.84 in April of 1991, an increase of 61 percent.

²Since the enactment of the act, the FCC has issued two separate orders mandating that cable operators lower their rates. The first order, issued in April 1993, required a 10 percent rate reduction; the second order, issued in February 1994, demanded that rates be lowered by 7 percent.

The period of deregulation (1984–92) coincided with rapid growth in cable-industry investments in programming and technology. Deregulation stimulated investment in programming by basic cable networks (such as CNN, TBS, and CNBC) and premium networks (such as Disney, HBO, and Showtime). Such spending more than doubled between 1984 and 1990. A sizable portion of this programming included new and innovative cable networks providing better television to ever more numerous markets. For example, cable television now includes quality children's programming on Nickelodeon, around-the-clock sports on ESPN, original documentaries on the Discovery Channel, gavel-to-gavel coverage of U.S. Congressional activity on C-SPAN, and both Hispanic and Black Entertainment Television. Beyond these developments, several dozen multiple system operators (MSOs) and cable-program services have launched the Cable Alliance for Education, providing hook-ups and basic cable service to all junior and senior high schools passed by cable systems. *Cable in the Classroom* offers free use of 20 different cable networks providing a diversity of classes in math, English, science, social studies, biology, foreign languages, health, vocational, and technical studies.

In short, there is evidence—admittedly anecdotal—of rapid technological development during the short period of deregulation. Increased plant and equipment investments resulted in a rise in the percentage of cable systems offering more than 30 channels between 1984 and 1992. Between 1984 and 1990 that percentage grew from 38 to 67 percent, with the cable industry planning to spend nearly \$17 billion more in the 1990s to improve plant and equipment. Most of these expenditures, if realized, will be used to deploy fiber-optic technology and to enlarge cable's existing broadband network.³

³Cable investments are concentrated in Cable Labs, an industry research and development consortium. This consortium tests high-definition television, interactive services, and a number of other new technologies. Technological developments created within the cable industry—specifically, a marriage of the coaxial cable and fiber-optic technologies—are currently being brought to fruition in selected markets. For example, on December 18, 1991, Time-Warner launched the world's first 150-channel cable television system in Queens, New York. The service, called *Quantum*, adds 75 channels to existing systems at a total monthly rate of \$23.95. The *Quantum* system includes 57 channels dedicated to pay-per-view distribution and promotion, with on-screen ordering of movies and events. Sixteen separate movie titles are available at all times with five newly released major hit films and the balance chosen to appeal to the widest possible variety of cable viewers' interests (movies are priced between \$1.95 and \$4.95). A variety of other new program services are available on *Quantum* and include the Monitor Channel, Nostalgia Television, NASA Network, Vision Interfaith Satellite Network, Mind Extension University, International Channel and Scola. Other channels have been set aside for experimentation on interactivity and additional cable services to the home. Grocery and other kinds of interactive shopping will soon be feasible using a cable channel. Eventually the system might handle high-definition television, voice interactivity, and linkages with computers, fax machines, and

Municipal Misuses of Regulation

A critical feature of cable regulation throughout its history, and of the 1992 Cable Act, is the relation between local cable companies and the municipal governments exercising jurisdiction over service areas. Under current law, local franchising authorities (usually city councils) impose franchise fees of up to five percent of gross revenues, set basic cable rates where there is no "effective competition" (as defined by the FCC), determine the number of cable franchises to award in their area, determine channel "set asides" for public, educational and governmental-access stations, and establish customer-service requirements. The franchisor-municipality has the authority to appropriate still other monetary as well as non-monetary benefits from the franchised cable operator (Zupan 1989).⁴

The assigned locus of rate and franchise regulation—municipal governments—and the powers assigned go far in explaining the regulatory problem. Instead of curing actual or perceived problems in cable markets, municipal regulation causes many of these problems. The lack of expertise of city councils in the process of developing and granting complex franchise contracts and in conducting complicated rate hearings is one sound reason for opposing rate regulation at the local level. In addition, city councils are political bodies that will, under reelection pressures and other political constraints, attempt to redistribute wealth in a self-interested fashion. Consequently, cable rates may be politically suppressed, franchises may be granted for reasons having nothing to do with consumer welfare, and cable operators may be protected from competition in order to maximize the sums municipalities extract from these firms.

Whether cable supply at the local level is efficient or not depends upon municipal-governments' propensities to promote or to stifle competition. Thomas Hazlett (1990a), in a review of cable-industry litigation, found that municipalities intentionally impede competition and consistently demonstrate anti-consumer intent by trying to protect cable monopolists.⁵ During the deregulatory period and before, municipalities had no obligation to promote competition in cable supply; that is, franchising authorities were not compelled to grant multiple ("overlapping") franchises. While some observers justify exclusive

personal communications networks (PCNs).

⁴For example, a cable operator in Sacramento, California was required to plant 20,000 trees (Varley 1986: 36). In Miami the cable operator had to agree to provide \$200,000 annually for a police department anti-drug-abuse campaign in order to receive the franchise.

⁵Hazlett (1991) convincingly illustrates and expands this view in a study of the regulatory experience in California between 1981 and 1985.

cable franchising by using a natural-monopoly argument, there is no hard evidence demonstrating that such conditions apply, in any relevant degree, to local cable supply. In fact, there is a good deal of evidence to the contrary (Owen and Greenhalgh 1986).

Municipalities' resistance to granting multiple franchises is better explained by the gains local politicians extract for themselves from aspiring cable monopolists. Between 1980 and 1990 the cable industry paid local governments \$3.3 billion in franchise fees, with local fee revenues growing rapidly in the late 1980s (\$715 million in 1990 alone). While viable local competition for the supply of programming has evolved gradually (chiefly from satellite suppliers) and will likely accelerate due to fiber optics and other new technologies, municipal governments continue steadfastly to reject overlapping competition from multiple cable operators.⁶ Wealth is more easily collected from a single operator, while revenues (and, hence, municipal tax receipts) are also likely to be higher if the cable operator is a protected monopolist than if it faces competition from other cable operators.⁷

Municipal governments typically promote monopoly supply of cable services despite the fact that virtually all well-executed empirical studies of competition in the cable industry find significant welfare benefits to consumers from overlapping municipal cable supply (Merline 1990; Levin and Meisel 1991; Beil, et al. 1993). Because politicians' objective functions include in-kind transfers, higher reelection prospects, etc., as well as revenues, it is not surprising to find that municipalities were among the chief advocates of cable reregulation: rate regulation also serves as an important tool for achieving politically motivated wealth redistributions between cable operators, consumers, voters, politician-franchisors, and the municipal fisc. Hazlett (1991: 294) argues that "price controls are important institutional tools for regulators. . . . Rate regulation allows franchising authorities to remain 'in the loop,' exercising some level of control over monopoly rents which they have created and assigned."⁸

The Cable Act of 1992 reimposes rate re-regulation and significantly broadens ownership restrictions. What will be the effect of these new cable regulations? To answer this question, the tradeoffs between the

⁶By 1989 only 55 communities were served by overlapping and competing cable firms (see Kagan et al. 1989, 1990).

⁷Webb (1983), Zupan (1989), Mayo and Otsuka (1991), Beil, et al. (1993), and Ford and Jackson (1993) all provide empirical evidence that cable systems operate in the inelastic region of demand. Falling cable-operator revenues resulting from the recent FCC rollback of basic cable rates support these findings (see McAvoy 1994, and Stern 1994).

⁸The process of rent transfers through local franchising arrangements is described in Ekelund and Saba (1981).

price and the quality of goods such as cable service must be clearly understood.

The Effects of Rate Reregulation on Cable Quality

The price consumers pay for a good or service is only one of many terms of the contract between consumers and suppliers. In exchange for a certain price per unit of good or service sold, a supplier agrees to supply various quality attributes and services to consumers.⁹ Although consumers always prefer to pay as little as possible for any *given* package of goods or services, it is equally true that few quality attributes of goods or services are fixed and unchanging. Consequently, because price reductions can cause the quality of a good or service to fall, it is wrong to believe that consumers typically are made better off by government-mandated price reductions.

The lesson here is elementary and uncomplicated, yet nevertheless vital in light of the fact that it is ignored by those who applaud cable rate reregulation. We first develop a simple model to show that rate regulation will likely make consumers worse off. Application of this model to the cable-television industry is then quite straightforward.

Consider Figure 1. Pecuniary price is on the horizontal axis, and product quality is on the vertical axis.¹⁰ Each *U*-curve depicts alternative combinations of price and product quality that yield for consumers the same level of utility. Although indifferent to where they are on a given curve, consumers are not indifferent to which curve they are on: *U*-curves further to the left represent higher levels of consumer satisfaction; *U*-curves further to the right represent lower levels of satisfaction.

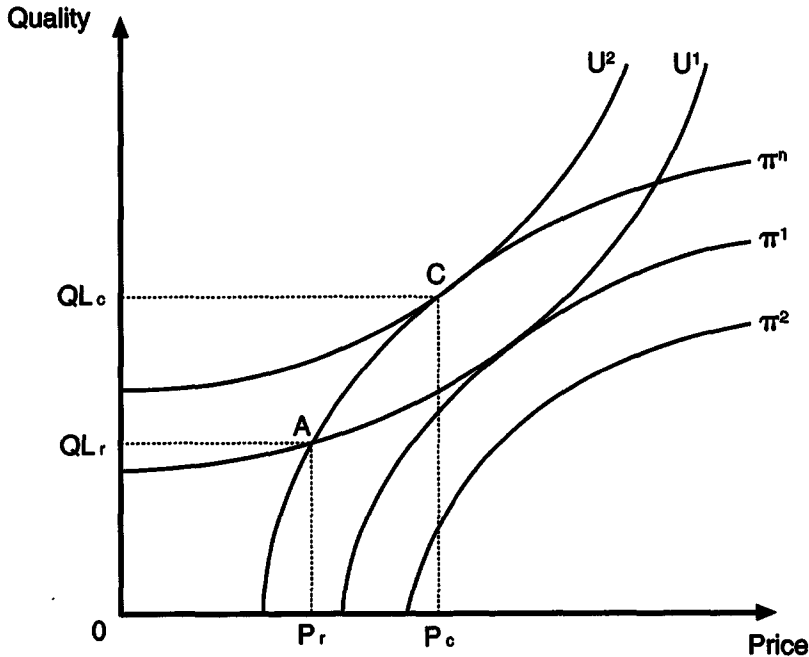
Each curve labelled π depicts alternative combinations of price and product quality that yield the same rate of return for producers. Producer profits increase as producers move from π -curves further to the left to π -curves further to the right. π^n represents normal

⁹Some attributes of product quality are supplied according to explicit agreement between buyer and seller (e.g., a car-dealer's agreement to give a buyer a free loaner car whenever the buyer's own car is in the shop overnight for repairs). Other attributes of product quality are implicit in the sales contract. Sales contracts with no explicit warranties are enforced under section 2-314 of the Uniform Commercial Code as containing a warranty of implied merchantability.

¹⁰Product quality has a multitude of specific features. For cable television, quality includes such obvious features as reliability of service (i.e., few service interruptions), program selection, clarity of video and audio reception, and availability of up-to-date remote-control technology. In addition, quality includes less obvious things such as friendliness of cable-company personnel and responsiveness to customer complaints. We compress all of these features of product quality into a single aggregate measure in order to make it tractable in a two-dimensional graph.

FIGURE 1

QUALITY CHANGES IN AN INTERACTIVE SYSTEM



profits; because no producer earning less than normal profits will continue operating in the long-run, no price-quality combination to the left of π^n is sustainable.

Figure 1 shows that, in equilibrium, unregulated producers will always offer that combination of price and quality that exists at the point of tangency between a π -curve and a U -curve. This is true for monopolists no less so than for competitive suppliers (although the equilibrium rate of profit for monopolists will typically be higher than that of competitive firms).

If a firm in a competitive industry earns above-normal profits, rivalrous responses by competitors will drive this firm's profits down to normal. Thus, competition continually presses prices toward the normal-profit curve. In addition to the pressure applied by competition to keep prices low, the quest for profits by competitive firms also prompts firms to improve quality. A producer who offers a quality improvement that consumers find attractive is able to charge a higher price and, hence, earn above-normal profits for a time. But competition from rivals who imitate this quality change will eventually push the price down to the normal-profit level. Such quality improvements will continue so long as consumers value these improvements by at least

as much as the increase in price necessary to give producers the incentive to make these improvements.

In Figure 1, the competitive equilibrium is at point C , with price P_c and quality QL_c . Given the prevailing costs and demand conditions, consumer welfare can be no higher than that which is represented by the indifference curve U^2 . Any combination of price and quality other than P_c, QL_c is either to the left of π^n (and, hence, not sustainable in the long run), or is on a consumer indifference curve yielding lower consumer welfare than U^2 . Suppose, for example, that the current combination of price and quality is P_r, QL_r (shown at point A in Figure 1). Although firms are making normal profits, consumer welfare is not maximized with this particular combination of price and quality. Producers who improve quality will for a time be able to sell this higher-quality offering for a price higher than P_r . The quest for profits by producers will thus push quality up from QL_r to QL_c ; rivalry among producers will ensure that in the long run no producer earns more than normal profits (i.e., producers supplying a level of quality QL_c will be able to charge no price higher than P_c).

It is now easy to see the effects of a government-mandated reduction in price. If firms are competitive, any such price reduction *not* accompanied by a corresponding reduction in quality causes firms in this industry to shut down. Realistically, however, firms have the more attractive option of lowering their product quality until their costs are reduced enough to enable these firms to earn at least normal profits at the regulated price.

In Figure 1, this process begins with regulators forcing prices down from P_c to P_r . Prohibited by law from charging prices higher than P_r , firms thus reduce product quality from QL_c to QL_r . Given this price regulation, the industry is in equilibrium at point A . In the long run, firms are no worse off at point A than at point C . Consumers, however, are indeed worse off. Before the mandated price reduction, consumers enjoyed an amount of utility shown on curve U^2 , but with this regulation, consumer utility is reduced to U^1 . Lower prices are not an unambiguous boon to consumers as long as product quality is a variable.

What is true for competitive suppliers is true in this case for monopolistic suppliers as well: Price regulation of monopolistic suppliers will sponsor quality changes that diminish consumer welfare. Even monopolists have incentives to make their product offerings attractive to consumers. A monopolist's profits, as well as consumer welfare, are enhanced by the monopolist's expenditures on product-quality improvements that cause revenues (via increased consumer demand) to rise by more than the costs of the improvements. Although a

monopolized industry may not provide as much quality as a competitive one, even the most entrenched monopolist has some incentive to provide quality products and service to its customers. Therefore, any forced reduction in price by government will inevitably lead to deterioration of product quality, even when the industry is monopolized. The monopolist will respond to a mandated price reduction by lowering product quality in an attempt to maintain its profits. The general lesson is that price regulation will inevitably lead to product-quality deterioration. Consumers suffer as a consequence.

Enthusiasts for government regulation might insist that a solution to the problem of reduced product quality is further regulation decreeing that suppliers not diminish product quality. But such an argument rests on a fantastic belief—namely, that government regulators can know and observe every facet of product quality that is relevant to consumers. Because in reality product quality exists simultaneously in hundreds, perhaps thousands, of different dimensions, it is impossible for even the most well-intentioned and sage regulator to garner the knowledge necessary to ensure against deterioration in product quality.

Thus, because regulation of every aspect of product quality is a practical impossibility, regulation that effectively forces cable rates down—such as is achieved by the Cable Act of 1992—will almost surely generate quality reductions that harm cable subscribers. Cable operators will respond to mandated lower rates by offering less-abundant selections of channels, lower-quality equipment, and less-responsive customer service. Suppliers may also reduce investments in quality control and in improvements of their capital stock. These are only some of the innumerable routes cable operators can choose in order to maintain their profits while simultaneously charging the lower rates imposed by regulators.

There is some (admittedly anecdotal) evidence concerning the price-quality tradeoff from the period of cable deregulation. Basic cable penetration increased significantly over the period of deregulation. During the six years prior to deregulation, the number of homes passed by cable systems—the number of *potential* subscribers to cable—doubled from 34.9 million in 1980 to 69.4 million in 1986. But cable penetration—the percentage of homes passed that actually *subscribed* to cable—increased by only four percent, from 55.0 percent to 57.2 percent. In fact, in the *three* years prior to deregulation, penetration increased by only 1.8 percent. In the first three years *after* deregulation, in contrast, basic penetration increased by approximately 7 percent. By 1991, penetration exceeded 61 percent of the homes passed by cable systems.

Increased cable penetration over this period of deregulation is consistent with the fact that rate deregulation was accompanied by product improvements making cable services, even at higher prices, more attractive to consumers. Increased penetration is consistent with the fact that cable operators improved quality in the kind of price-quality interplay described in the theory outlined above. Although evidence of increased penetration hardly proves that cable rates became perfectly competitive during the deregulatory period, it does suggest that deregulated rates were closer to competitive levels than were rates allowed by municipal price regulators. As argued above, all companies—whether operating under competitive or monopolistic conditions—will choose to improve their products if consumers are willing to pay for such improvements.

Municipal rate regulation appears to have hurt consumers by preventing cable operators from raising rates and by limiting the kind of innovative expenditures that they made after deregulation. Under the 1992 Cable Act, municipal governments or the FCC will once again suppress rates to levels that make consumers worse off than they were under deregulation.

Of course, not every consumer is better off with higher rates and improved service, but more consumers to whom cable is available find cable to be worth the price. While penetration increased between 1984 and 1992, some subscribers may have canceled their service because they either could not afford the improved service at a higher price or because they did not think the expanded service at the increased price to be a good value. Those particular subscribers would be better off if rates and quality of service were suppressed by regulation. Consumers as a group, though, appear to have reaped substantial benefits from cable deregulation.

Policymakers may be legitimately concerned about rate increases and quality improvements that eliminate lower-income consumers from the market. But this is a problem of distributional equity that exists whether or not higher cable rates reflect competitive or monopolistic pricing. Specific remedies (e.g., consumer subsidies) to address the problem of consumers who cannot afford cable and cannot receive a sufficient number of free television stations over the air are more appropriate than rate regulation. A solution that suppresses the price and, thus, the quality of cable service reduces overall consumer welfare.

Property Rights Restrictions

In addition to strengthening the ability of local franchising authorities to regulate cable rates, the 1992 act imposes inefficient carriage

requirements on cable operators. The act also unwisely restricts ownership possibilities of cable operators and of video programmers. We discuss two of the more important property-rights restrictions contained in the 1992 act.

Carriage Requirements

Section 4 of the 1992 act requires cable operators to carry in their most basic tier of channel selection the signals of local commercial television stations as well as the signals of qualified low-power stations. Section 5 requires each cable operator to carry the signals of all qualified local noncommercial educational television stations.

These requirements are, at best, redundant and, most likely, harmful to consumers. First, because a cable operator must carry a local network affiliate “whose city of license reference point . . . is closest to the principal headend of the cable system” (Sec. 4(b)(2)(B)), each local network affiliate is protected artificially from the competition of network affiliates elsewhere.

Second, local cable operators—be they monopolists or not—have strong incentives in the absence of government regulation to carry the particular mix of programming that maximizes consumer satisfaction. Thus, Congress need enact no statute, and the FCC need promulgate no regulation, prescribing cable-operator programming in the name of consumer welfare. If a cable-operator’s subscribers are willing to pay higher rates (or if homes passed by cable are more willing to subscribe) when the cable operator offers a program package containing stations A, B, and C than when it does not offer these stations, the cable operator will carry these stations without any prompting from government. This is true regardless of whether stations A, B, and C originate locally or nonlocally, or whether they feature all, some, or no educational programming.

Consequently, stations have incentives to maximize the appeal of their programming in order to be carried by as many cable operators as possible. Stations that do relatively poor jobs of providing interesting and appealing programming (as defined by the tastes of cable subscribers and potential subscribers) will be carried by fewer cable operators than will stations that provide more appealing programming. Because of the ability of cable operators to gain access (via satellite) to the signals of broadcasters from distant regions, it is no exaggeration to say that competition among television stations takes place potentially on a nationwide basis. Broadcasters now have the technical ability to compete not only with the small handful of other broadcasters in each of their local vicinities, but with broadcasters located across the country. If, for example, the local New Orleans affiliate of NBC offers

a programming mix that is more appealing to residents of Houston than is the mix offered by NBC's Houston affiliate, the cable operator in Houston can (if law allows) replace the local Houston affiliate with the New Orleans affiliate. Residents of Houston would be better off, and the profits of the Houston cable operator would be higher because of greater subscriptions and, possibly, higher rates. Such competition for cable carriage would heighten the sensitivity of television stations and other video programmers to viewer demands.

Of course, because residents of a particular city or county typically have high demands for local news and information, local stations are generally better able to meet such demands than are regional or national broadcasters or local broadcasters from other cities or towns. But the conclusion to draw from this fact is not that local stations deserve special legislative protection for their markets. Rather, the appropriate conclusion is that, because of the natural advantage in local markets enjoyed by local stations over stations originating elsewhere, only local stations that are especially inept at devising programming to meet viewer demands are in need of such protection. There is no good reason to erect statutory barriers shielding local stations from the competition of distant stations. Nevertheless, such shielding is just what section 4 of the act does.

Likewise, cable subscribers as a group plausibly have demands for educational programming sufficient to prompt each cable operator to carry at least one station specializing in this type of programming. Section 5's requirement that cable operators carry one or more "qualified local noncommercial educational television stations" is at best unnecessary and, likely, harmful to consumers. This requirement is unnecessary because cable operators would typically carry a sufficient number of educational channels even in the absence of this regulatory requirement; it is harmful when it forces operators to carry a greater number of educational channels than their subscribers want.

Because cable operators have incentives to carry the mix of programming that maximizes consumer welfare, the carriage requirements of Sections 4 and 5 of the act can, if they have any effect, only lead to suboptimal mixes of station offerings. The act will cause a crowding out of stations that cable viewers prefer in favor of stations that are less preferred but whose carriage is required by law. Cable viewers will be harmed.

Ownership Restrictions

Section 11 of the act restricts available modes of ownership and control of cable operators and video programmers. These restrictions affect both horizontal and vertical ownership interests. In particular,

the horizontal restraint in the act requires the FCC to issue regulations restricting the size of cable operators as well as the number of cable operators that can be lawfully owned by a single person or firm. Vertical regulations empower the FCC to restrict cable operators from owning interests in video programmers. Further, these new regulations severely limit the ability of cable operators to carry programming produced by video programmers with which cable operators are affiliated.

Horizontal Restrictions. On its face, empowering the FCC to police against untoward aggregations of monopoly power in the cable industry seems laudable. Unfortunately, though, this provision of the act will not promote consumer welfare. Restricting the number of subscribers to a particular cable system risks sacrifice of possible economies of scale in the distribution of video programming over cable without significantly increasing competition among cable operators.

Because cable operators have a high proportion of fixed to variable inputs, the average cost of serving each subscriber falls as more and more subscribers are added to a particular cable system. Given the notorious difficulty of estimating the cost-minimizing level of output by any means other than actual experimentation by firms in the industry (McGee 1974), there is a substantial risk that the FCC will restrict too severely the number of homes any particular cable operator is allowed to reach. Efficiency advantages of economies of scale are thereby threatened.

The counterargument supporting these horizontal restrictions is that they are necessary to protect cable consumers from monopoly exploitation. But this counterargument ignores the fact that, with few exceptions, most cable operators enjoy exclusive grants of monopoly privilege from local franchising authorities.¹¹ Failure to allow competitive overlapping cable systems is the primary source of monopoly power in the cable industry, not economies of scale or large size of cable operators. When a franchising authority grants a monopoly to a cable operator, that operator will invest in the efficient scale of plant given its likely market as defined by the politics of the franchise agreement. And the rates charged by this monopoly cable operator will be determined either by consumer demand in the politically defined franchise area (if the operator is unregulated) or by regulators as provided under the Cable Act of 1992. In either case, no benefits flow from restricting the number of customers a particular cable

¹¹The number of franchise areas served by genuinely competitive cable operators is quite a small proportion of the total number of franchise areas—currently less than one percent of the approximately 10,000 total operators.

operator may serve. Monopoly will remain a problem unless and until the practice of exclusive cable franchising is eliminated. Regulating the number of consumers able to be served by a particular cable operator does not promote consumer welfare, especially as long as exclusive franchising remains the general practice.

Although the 1992 act seemingly takes steps to eliminate exclusive franchising, effectively it does not do so. Section 7 mandates that franchising authorities "not unreasonably refuse to award an additional competitive franchise." Regrettably, Congress extracted the teeth from the provision by limiting the liability franchising authorities face as a consequence of granting exclusive franchises. According to the act, plaintiffs who successfully sue a franchising authority regarding "regulation of cable service or . . . approval or disapproval with respect to a grant, renewal, transfer, or amendment of a franchise" are entitled only to injunctive or declaratory relief. Suits for damages are prohibited by Section 24(a) of the act. Thus, the act's apparent insistence on competition in cable provision rings hollow.¹²

A plaintiff who wins the legal right to distribute cable in a particular locale has only the beginnings of a genuine victory. Details of the franchise agreement remain to be worked out before the plaintiff cable operator can begin operation. A franchising authority wishing to protect the monopoly position of an incumbent cable operator can impose a host of conditions, regulations, and fees on the aspiring cable competitor that will delay indefinitely the entry of this competitor into the market. In the absence of damage suits, the only way courts can realistically guard against such obstructionist tactics by franchising authorities is to engage in detailed oversight of these authorities' behavior. Understandably, courts will not enthusiastically embrace such tasks.

Vertical Restrictions. Section 11 of the act requires the FCC to conduct a proceeding "to prescribe rules and regulations establishing reasonable limits on the number of channels on a cable system that

¹²If Congress were truly interested in promoting competition in the video-distribution industry, it would have overturned the FCC's ban (in place since 1970) on cross ownership that makes it illegal for local telephone companies to operate cable-television systems within their service areas. The fiber-optic technology used by telephone companies gives these firms sufficient band width to deliver into homes not only traditional telephone services, but video-entertainment services as well. Telephone companies are obvious competitors of cable operators. Unfortunately, the 1992 act does nothing to open video-distribution markets to competition from phone companies. For a discussion of the feasibility and desirability of competition between telephone companies and cable operators, see Hazlett (1990b). Hazlett (1992) also argues that the reasons given twenty years ago for why competition between telephone companies and cable operators would be unworkable are no longer viable.

can be occupied by a video programmer in which a cable operator has an attributable interest." In prescribing these rules, Congress commands the FCC to ensure that cable operators affiliated with video programmers give no special favors to their affiliated programmers when selecting the programs to carry on their cable systems. Congress is concerned that video programmers unaffiliated with cable operators will suffer undue difficulty finding outlets for their programming if cable operators own interests in competing programmers. Congress is also worried that cable-affiliated programmers will withhold their programming from unaffiliated cable operators [see Sec. 2(a)(5) of the act].

Neither concern is valid. The particular mode of ownership of the various stages of distribution of video programming in no way biases cable operators when they choose which programs or stations to carry; nor does the mode of ownership bias programmers to give undue favor to cable operators with whom programmers are affiliated. But such vertical restrictions on cable-operator ownership of programming are potentially harmful to viewers.

Consider how a hypothetical cable operator in Charleston, South Carolina (call it "Charleston Cable") decides which stations to carry. Suppose Charleston Cable is unaffiliated with any video programmer and has an activated band width of 30 channels. Charleston Cable has dozens of programmers/stations from which to choose to occupy its 30 available cable bands. It will carry the mix of 30 stations that maximizes its profits. Suppose that 29 of the 30 available bands are already committed, and that Charleston Cable is deciding whether to put TBS or WGN in the 30th band space. If WGN will add \$5,000 per month to Charleston Cable's profits and TBS will add \$4,000, Charleston Cable will carry WGN.

Charleston Cable's carriage of WGN provides more consumer satisfaction than carriage of TBS. The reason WGN earns more money for this cable operator than that added by TBS can only be because carriage of WGN improves Charleston Cable's ability to sign up additional subscribers and, absent rate regulation, strengthens its ability to charge higher monthly rates to subscribers. Unaffiliated cable operators undoubtedly have strong incentives to carry the mix of stations that best meets their customers' demands.

Importantly, the situation does not differ if Charleston Cable is owned by a video programmer—say, Turner Broadcasting Co., the owner of TBS. Charleston Cable will still carry WGN in lieu of TBS as long as WGN contributes more to Charleston Cable's profits than does TBS. As a profit-maximizer, Turner Broadcaster—the (now-assumed) parent of Charleston Cable—will not sacrifice the extra

thousand dollars per month in Charleston Cable's profits that would result if Turner Broadcasting forced Charleston Cable to carry TBS rather than WGN.

It might be argued that this analysis overlooks the addition to Turner Broadcasting Co.'s advertising profits that result from TBS's carriage in Charleston. That is, even though Charleston Cable's profits would be \$1,000 lower by carrying TBS instead of WGN, Turner Broadcasting might earn, say, \$1,500 of extra profit from advertising revenue by having TBS broadcast in Charleston. In this scenario, Turner Broadcasting earns \$500 more per month by forcing Charleston Cable to carry TBS than by allowing its cable subsidiary to carry WGN.¹³ The apparent conclusion is that Charleston Cable will more likely carry TBS if Turner Broadcasting Co. owns Charleston Cable than if Charleston Cable is unaffiliated. More generally, it appears as if vertical integration of video programmers and cable operators affects which stations are carried over cable systems.

But this conclusion is faulty. It overlooks the fact that if Turner Broadcasting Co. could earn an additional monthly profit of \$1,500 in advertising revenue by having TBS carried on the Charleston cable system, TBS would be carried on this system even if Turner Broadcasting Co. owns no interest in Charleston Cable. Suppose again that carriage of TBS by an unaffiliated Charleston Cable yields \$4,000 net monthly profits for Charleston Cable from its subscribers while carriage of WGN yields \$5,000. Also, continue to assume that Turner Broadcasting Co. would earn \$1,500 in additional monthly profits from advertising sales if TBS were carried on the Charleston cable. Under these circumstances, Turner Broadcasting Co. is willing to pay up to \$1,500 monthly to have TBS carried by Charleston Cable, and Charleston Cable will agree to carry TBS in exchange for some monthly payment by Turner Broadcasting Co. of \$1,000 or more. Thus, as when Turner Broadcasting Co. owns the Charleston cable operator, an independently owned Charleston Cable will carry TBS.

The general lesson is that affiliation of cable operators with video programmers does not create an inefficient bias on the part of cable operators to carry programs produced by their affiliated video programmers. Moreover, as is well known in the economics literature, monopoly power possessed by a firm at one stage in the production

¹³Turner Broadcasting Co., through its subsidiary Charleston Cable, earns \$5,000 per month in profits by carrying WGN. But it earns \$5,500 per month by having Charleston Cable carry TBS. This \$5,500 is the sum of \$4,000 from subscribers earned by Charleston Cable from carrying TBS and \$1,500 of advertising revenues earned by Turner Broadcasting directly from TBS broadcasts in Charleston.

process cannot be augmented by integration of that monopolist with firms at other stages of the production process. Nor can additional monopoly power be created by vertical integration (Blair and Kaserman 1983, Bork 1978). Vertical integration occurs because it reduces the total cost of producing the final product.¹⁴ If vertical integration is unable to produce, augment, extend, or strengthen monopoly power, and if it often generates production or distribution efficiencies, there is no reason to constrain vertical relationships in the name of consumer welfare (Posner 1981).

The danger of such restrictions on ownership is that they can be used to stifle efficient but politically non-influential producers in favor of less efficient but politically influential producers. More generally, politically influential producers can bias the exercise of government's regulatory power so that rivals are obliged to abandon efficient practices. In brief, antimonopoly regulations such as these are too frequently used to protect competitors rather than to protect competition.¹⁵

Cable Reregulation and the Public Interest

The Cable Act of 1992 will not make cable a better deal for consumers. A variety of interrelated reasons for this failure may be noted: (a) quality-reducing rate controls by municipal governments; (b) *ex parte* participation in the financial management of the companies by rent-seeking municipal governments; (c) admission of over-the-air broadcasters and other competitors to the "pie" of profits generated by cable operators; (d) property rights restrictions, such as new carriage requirements and horizontal and vertical ownership restrictions, engendering higher costs and inefficient behavior in the industry. Monopoly is the central problem in the supply and pricing of cable services and the Cable Act of 1992 is impotent in dealing with the problem.¹⁶

¹⁴A vast literature supports this proposition. See, e.g., Williamson (1985).

¹⁵U.S. antitrust laws have a long history of being used in this fashion. See Dewey (1990), and McChesney and Shughart (1995).

¹⁶It is interesting that some representatives of the cable industry itself place the problem at the door of monopoly provision. Nowhere is the anticompetitive nature of proposed legislation better expressed than in the comments of James P. Mooney (President and CEO of the National Cable Television Association) before the U.S. Senate in 1991. (Senate bill 12 closely paralleled the final act as passed). According to Mooney (1991: 156-57) "there is a fundamental paradox contained in the franchise renewal provisions of S.12. . . . On the one hand, S.12 seeks to promote competition and curb the "market power" which single cable franchises supposedly enjoy in certain markets. On the other hand, the bill reinforces the notion that there can and should be only one cable provider per community. Rather than encourage cities to invite a second cable system to overbuild the incumbent, S.12 focuses on revoking the incumbent's franchise in order to allow a new sole provider of

While empirical evidence for the viability of competition in local cable markets is not conclusive, it is highly suggestive. Several researchers have developed compelling models of cable markets and of the impact of regulation in these markets (Mayo and Otsuka 1991). Other studies have focused on the impact of competition (i.e., overlapping cable operators) on price and output (Merline 1990). A recent study comparing monopoly and competitive municipal cable operators of similar technical and demographic characteristics found that competition generates substantial consumer benefits: Competition reduced monthly rates for basic and pay services by \$3.21 and \$1.15, respectively. The total potential gain to all consumers—estimating the effect of competition on all cable systems—was over \$3.6 billion per year (Beil, et al. 1993). Competition is, lamentably, not part of the Cable Act of 1992. As such, its absence is a missed opportunity to promote the public interest. Elimination of the monopoly-granting power of local governments is requisite to any progress in efficient cost-based cable supply.

Few pieces of legislation, however, are neutral in effect; the Cable Act of 1992 is no exception. This legislation introduces new problems within the context of monopolized local cable-service provision. In addition to those related to quality determination and rent seeking, new regulations introduce greater uncertainty into local cable businesses. Public and consumer interests are thwarted not only by direct municipal rate and franchise control; such interests are subverted in a far more indirect manner by the uncertainty that regulation creates among actual and potential franchisees. New and incredibly detailed franchise-renewal provisions give cities virtual *carte blanche* in manipulating franchisees and in limiting due process in franchise-renewal proceedings.

Such provisions, along with the politically controlled pricing system that is reintroduced into cable markets, will curtail further innovations in cable technology and programming investments. The intent of Congress in passing the Cable Act of 1984, which was to unleash cable technology by providing more revenue to cable operators and

cable service into the community. The premise that one should replace one cable company sequentially with another is false: the Cable Act allows for several cable franchises in the same area at the same time. *It is the cities, not cable companies, which are perpetuating the 'monopoly' characteristics of some cable franchises, and S.12 reinforces the perception that there can and should be only one cable franchisee per community*" [emphasis added]. Mooney argues further that what the municipalities want is "the authority to throw out incumbent cable operators at will in order to hold auctions for their cable franchises. The net effect will be to extort maximum financial benefits from each bidder, not encourage competition."

by assuring rate-setting flexibility to individual cable companies, is negated by the passage of the 1992 act. Cable operators have far less incentive to invest in plant and equipment or to innovate in providing new and better programming.

Nevertheless, over the long run there are some hopeful signs for the larger communications industry. The wired "information super-highway" is now operationally and technologically feasible. While much controversy surrounds the nature of the evolving system, Vice-President Al Gore (speaking for the Clinton administration) has proposed amending Title VII of the Communications Act of 1934. These proposed amendments would permit companies "to avoid the danger of conflicting or duplicative regulatory burdens" in the provision of telephone, video, and other information services (Flint and McAvoy 1994).

The Clinton administration's proposal would pave the way for cable entry into local telephone service by pre-empting state barriers and other encumbrances into local telephone markets. Similarly, it would eliminate state entry barriers to local telephone competition, as well as do away with FCC regulation of competitors that lack market power. The *quid pro quo* of the proposed deregulation is the proviso that open access be made available to all programmers on a non-discriminatory basis.

These sentiments are encouraging for the telecommunications industry in general, but the mistakes and anti-competitive bias of contemporary cable regulation must be avoided. The fact is that, despite 30 years of regulatory experience with cable television, no political or economic consensus has emerged on the nature and characteristics of that industry. Deregulation of the industry in 1984, which took full effect in 1987, was partial in that rate deregulation was not accompanied by the allowance of open competition in the vast majority of municipal markets. The impact of this deregulation on consumer welfare was ambiguous because most local governments, though not obliged by law to do so, continued to award exclusive franchises and to extract wealth in the form of cash and non-price concessions from the producers of cable services. Our study of recent and current legislation suggests that such approaches have been politically motivated and will fail to produce an industry geared to consumers' interests as long as politicians are running the show.

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