Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.

Insurance Industry Doing Fine

The article "Financial Derivatives and the Insurance Industry" by Lawrence Haar (1993 Number 3) makes some interesting points about the application of financial derivatives to insurance markets. However, the author does not make mention of the fact that such financial derivatives already exist and are traded on the Chicago Board of Trade. Those options have met with little market acceptance.

Over the years, there have been many proposals to apply futures to insurance markets, none of which have taken hold in the marketplace. This is probably because the worldwide insurance system, made up of thousands of primary insurance companies, reinsurers (companies which share in the risks of primary companies), and retrocessionaires (which provide reinsurance for reinsurance companies), does a remarkable job of spreading risk around the globe.

There may come a day when a better mousetrap to spread risk will be invented and then insurance companies will beat a path to its door. In the meantime, the current system appears to be serving its mission of spreading risk.

Some assertions made by Mr. Haar appear to be inaccurate. In commenting on Hurricane Andrew, he states that two major insurance groups are facing insolvency. We are not aware of this. Hurricane Andrew, which cost $17 billion in claims, resulted in 10 insolvencies. But the companies involved collectively wrote less than 1 percent of industry premiums. He also asserts "policies have not been honored." This statement conflicts with our understanding of the situation. We know of no instance in Florida where policies have not been honored. Even when companies were declared insolvent, the claimants were paid from the state's insurance guaranty fund.

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Jury Still Out on Health of Insurance Industry

HAAR replies:

In response to Dr. Sean F. Mooney's thoughtful letter concerning my article "Financial Derivatives and the Insurance Industry," allow me to offer some responses.

First, with regard to the fact that insurance derivatives are already functioning, I begin by noting that as Dr. Mooney is no doubt aware there is often a long lag between when articles are conceptualized, edited, and ultimately published. In my case, more than two years were involved. Moreover, I see my article as more of a recommendation for the use of such financial products, in the context of insurance industry regulation, than as a postulation on their existence. According to the *Wall Street Journal* (December 15, 1993), the Chicago Board of Trade has only offered "catastrophe derivatives" for about a year, and their use remains newsworthy.

Turning to Dr. Mooney's second point that the world's present insurance system "does a remarkable job of spreading risk," it is still hard to ignore that there are major problems which are now receiving attention at regional, national, and even international academic and policy levels, such as health care reform, the Lloyd's of London debacle, and the automobile insurance crisis—surely, all is not well. Moreover, my point is that rather than spreading risk, the insurance industry could function more efficiently and the consumer could be better served if risks were sold to pure speculators. Ultimately, if writing event-dependent options against one's underlying cash position were so profitable, insurance firms would still be earning a substantial portion of their profits from underwriting and not the management of their float—and this is not the case. In the aggregate, the industry loses money from underwriting. (See *The Economist*, September 19, 1992.) Moreover, according to the brokerage firm of Donaldson, Lufkin & Jenrette, the industry's reserves against future losses are too small by some $75 billion. As for Dr. Mooney's optimism that better methods of "spreading risk" will be adopted when they arrive, I fear that decades of regulation may have sapped the industry's vigor while creating a host of stakeholders wedded to the present system.

As for the financial implications of Hurricane Andrew and Cyclone Iniki, it seems that the jury is still out: various new regulations and laws are being considered to control the pricing, policies, and coverage offered by underwriters. Perhaps if insurance derivatives were widely adopted the need for such intervention would be eliminated.

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Creating Competition in Telecommunications

In "Cable TV Reregulation: The Episodes You Didn't See on C-SPAN" (1993 Number 2), Thomas W. Hazlett continues to advance a set of erroneous assumptions and false claims that he has set forth in other forums, most notably a September op-ed in the *Wall Street Journal*. What Hazlett consistently fails to reveal is that he is a paid consultant to the local telephone industry and that he has represented their political interests before the Federal Communications Commission (FCC) in cable rate rulemakings. Hazlett is certainly entitled to his opinions; but he should also be obligated to tell his readers who he is working for.

I do not dispute Hazlett's contention that rate regulation of cable television resulted in many unintended consequences. After all, the cable industry warned of such consequences throughout the legislative debate that shaped the Cable Act of 1992. However, Hazlett is wrong when he implies that cable companies have side-stepped the full impact of reregulation. That piece of news would come as a surprise to dozens of cable executives who are wrestling with the consequences of industry-wide rate reductions that exceed $1 billion this year.

Hazlett's evidence for his conclusion lies in a patchwork of false assumptions. For example:

• "The cable industry is, on average, highly profitable." Wrong. A 1992 study by Peat Marwick makes it clear that the cable industry is not particularly profitable. It states, "The profitability of cable operations of the five major cable firms we studied is less than or equal to the average profitability of publicly traded U.S. nonfinancial industries." The report goes on to state, "We have no reason to believe the companies we studied, which represent 36 percent of basic service cable television subscribers, are not representative of the entire cable industry."

• "Recent evidence . . . reliably places competitive rates at about 20 to 30 percent lower than monopoly systems' rates on a per-channel basis." Wrong again. In fact, FCC data shows that the prices charged in competitive markets and markets that have a single cable operator are statistically indistinguishable for systems of 5,000 or more subscribers—which accounts for 85 percent of all cable subscribers.

• "[T]he 1992 Cable Act.failed to include provisions that would unleash the major competitive forces in the industry." Untrue. In the hubbub over rate regulation, the Cable Act's sweeping program-access provisions have been largely overlooked by everyone but the cable industry and its competitors. The Hughes satellite was launched in 1993; and DirectTV and USSB direct satellite television services, which will offer the same programming offered by cable systems, are scheduled to be available to consumers in April of this year.

Finally, Hazlett concludes that cable companies must have "dodged the bullet" on regulation because cable stocks are considerably up over the past year. Again, he is wrong. Cable stocks did rebound following the implementation of rate regulation—for an entirely different reason. The events of 1993 demonstrate that the United States is on the brink of a revolution in telecommunications, and cable TV technology is at the heart of that revolution. Investors recognize this, and their confidence in the cable industry is predicated on the industry's promising future as a provider of advanced communications services—not on their confidence about the impact of government rate regulation.

I will agree with Hazlett's conclusion that competition is a better approach than reregulation, but our view of competition is much larger than Hazlett's narrow, one-sided approach that would serve only the local telephone companies. In order to adapt to the evolving world of communications technology, federal policies should seek to create competition in all aspects of telecommunications—including local telephone service, the true communications monopoly.

Today there is great enthusiasm for policies that will foster the development of an advanced telecommunications infrastructure in the United States. Creating such an infrastructure is vital to America's future. Clearly, the best way to achieve this objective is through policies that promote multiple networks and multiple providers that compete to provide Americans the most advanced and affordable communications services—rather than any "single-wire" or monopoly model. In fact, leading policymakers in Congress and in the Clinton administration have expressed their support for widespread "facilities-based" competition in telecommunications.

Cable television companies are those most likely to provide facilities-based competition to the local telephone companies for advanced communications services. And the cable industry supports policies that will make such competition viable.

Cable television companies have constructed communications networks that reach over 95 percent of American homes. Those networks carry up to 900 times as much information as the telephone company's twisted pair. Furthermore, as cable companies continue to install more fiber-optic trunks over the next five years, capacity will double and system reliability will increase dramatically. Digital compression will ultimately bring the capacity of cable networks to 500 channels or more and will enable cable companies to deliver voice, video, and data over the same wire.

Those developments will eventually allow cable companies to provide virtually every type of communications service conceivable, including voice communications; and thereby become facilities-based competitors to the local telephone monopoly.

But two important obstacles lie between cable companies and their future as competitors to telephone companies: state and local barriers to competition in the local telephone loop, and the need for public policy to support capital formation in the cable industry.

Today, many state and local laws prevent competitors from entering the market to provide local telephone service. Indeed, 47 states have laws that limit competition to the local telephone companies. Several cable companies have already found their efforts to provide competitive voice communications services blocked by state and local regulations that prohibit competition in the local loop. Federal regulators must preempt those restrictions that preclude competition for local telephone service.

The telecommunications infrastructure is rapidly becoming a seamless national network, and potential competitors must be able to enter the marketplace on a national basis. If potential competitors to the local phone companies are expected to fight regulatory barriers in each of 50 states, there is simply no possibility that competition will emerge in this century, if ever.

Cable television companies can build on their existing facilities to develop advanced telecommunications networks far more efficiently and inexpensively than telephone companies can. However, cable companies first must be able to obtain the capital—currently estimated at over $20 billion—necessary to build those advanced facilities.

Cable companies face particular challenges in obtaining financing to build advanced infrastructures. Tele-Communications, Inc. (TCI), the nation's largest cable company—and one of the most financially well-equipped—found it necessary to merge with Bell Atlantic to obtain the capital for the advanced networks that will provide the next generation of communications services. Other cable companies without TCI's size and financial strength will find it very difficult to obtain adequate capital to similarly upgrade their infrastruc-

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tures.

Capital represents an enormous hurdle to cable companies in their effort to compete with telephone companies, due largely to the tremendous difference in the size and financial strength of the two industries. The local telephone industry is more than four times as large as the cable television industry, and generates more revenue than the cable television, broadcast television, and motion picture industries combined. At the same time, Regional Bell bond ratings range from A+ to AAA, while cable bond ratings are consistently BBB- or below.

Cable companies must have the opportunity to obtain capital and invest it in new technologies in order to become true competitors to the local phone companies. It's not at all clear that every cable company will have the opportunity—or predisposition—to merge with a telephone company. And certainly our public policy should not force cable companies to take that route in order to provide advanced communications services.

The cable television industry advocates public policies that will promote a competitive marketplace for telecommunications:

• The market for local phone service should be opened to competition through federal preemption of all state and local barriers.

• Telephone companies should be allowed to provide video service in their local service area after one of the following has occurred: (1) The market for local phone service has become "effectively competitive," or (2) after seven years have elapsed. This "staged entry" of telcos into video services will allow cable companies the opportunity to acquire the capital necessary to build competitive telecommunications infrastructures.

• New competitors to the local phone companies should not be subject to all of the regulatory requirements that are applied to current phone monopolies. They should, however, make contributions to preserve the universal availability of basic telephone service.

• Mergers and joint ventures between telephone and cable companies should not be prohibited. In many cases, such mergers may provide the sole means for introducing advanced communications services to particular areas, especially rural and low-density areas.

Although Thomas Hazlett's analysis of cable reregulation is flawed in many ways, he is generally correct in advocating competition as a remedy for the unintended consequences of regulation. The cable television industry is eager to enter into a competitive environment for telecommunications, and to introduce revolutionary new services for consumers.

But to ensure that competition will thrive in communications, lawmakers must enact policies that will allow the phone industry's potential competitors to acquire capital and invest it in new technologies. Many cable companies are already laying the foundation for a national information superhighway; therefore, it is imperative that government policies ensure this high-capacity platform can be used to its fullest potential. Those high-tech systems represent an invaluable resource that the United States can use toward meeting its telecommunications objectives. The existing infrastructure must be part of the national communications superhighway.

By opening the local telephone loop to competition, and by adopting a policy of staged entry by telephone companies into cable television, lawmakers can take a major step toward achieving a competitive telecommunications marketplace that will benefit American consumers.

Decker Anstrom
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National Cable Television Association
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Cable and Telephone Competition *Now*

HAZLETT replies:

As an academic researcher, I am delighted to be considered important enough by the paid lobbyists for a trade association to be the target of both a gratuitous personal attack and an artfully crafted (if thoroughly disingenuous) apologia for monopoly power. I am happy to know that the National Cable Television Association (NCTA) burned considerable resources devising the misinformation which Mr. Anstrom hopes the reader will swallow whole. I am equally happy to set the record straight.

Mr. Anstrom opens with the charge that "What Hazlett consistently fails to reveal is that he is a paid consultant to the local telephone industry. . . ." His lurking innuendo ("consistently fails to reveal") should be given the light of day. He refers to a previous go-around in the *Wall Street Journal* (begun with my op-ed on September 24, 1993, "Why Your Cable Bill Is So High") where a cable company lobbyist wrote—precisely as has Mr. Anstrom—that I failed to reveal my previous work on behalf of Bell Atlantic. The answer to that charge was that in my submitted draft I had (proudly) noted such. The *Journal's* editor deleted this as irrelevant—to which I objected. The editor won. To its ultimate credit, the *Journal* did allow me to explain the situation in the letters column some weeks later, however. Mr. Anstrom continues to not only propagate such charges but to stretch them into a sinister pattern of conduct. Given the substance of his economic arguments, however, I don't much blame him for choosing the low road.

Mr. Anstrom's assertion that I have "represented their [phone companies'] political interests before the FCC in cable rate rulemakings" is an outright falsehood. As an economist, I do not represent anyone's political interests. I have written expert affidavits, studies, or sworn testimony in FCC proceedings and state and federal courts at the invitation of both telephone companies (such as Bell Atlantic) and cable companies (such as Time Warner). In fact, in recent months telephone companies (such as Bell Atlantic) have vehemently attacked some of my work submitted into FCC proceedings by cable interests! Moreover, if I were to follow Mr. Anstrom's maxim to "reveal who I was working for," I would have to list (for historical accuracy) more cablecos than telcos.

What is constant is that my research and testimony are based on economic analysis, as soundly as I can conduct such, and that my policy prescriptions are procompetitive. I am honored by the fact that I am regularly denounced by industry incumbents in several markets; that is the price of consistently favoring competition. Meanwhile, even Mr. Anstrom concedes that much of my cable analysis is sound: I am not averse to agreeing with "pro-cable" positions. Indeed, I chortle when I see the cable industry (directly or indirectly) using my research findings to show that cable deregulation in the 1980s delivered significant consumer benefits. (Note to Decker Anstrom: you would be chagrined to know that the NCTA has made quite a big deal out of my analysis of rate regulation—unbeknownst to the industry's lobbyists. Call me sometime.) I do not change my findings to fit the company or interest group; the correct charge Mr. Anstrom could level would be that I am entirely disloyal with respect to "political interests."

Finally, Mr. Anstrom's innuendo of secret influence and failure to disclose suffers from temporal impossibility. I actually mailed my draft of the *Regulation* article off well before I had spoken with anyone or done any work regarding the FCC proceeding Mr. Anstrom mentions. My *Regulation* draft was finished on March 4, 1993; my FCC affidavit was filed June 17. (Due to the long lag to publication, writers were given a chance to make minor last-minute updates on the galleys that did not change the substantive analysis prior to the issue appearing in the fall.) Moreover, the basic model of cable rate regulation is one which I have been advocating in academic papers for years (see, e.g., Thomas W. Hazlett, "The Demand to Regulate Franchise Monopoly: Evidence from CATV Rate Deregulation in California," *Economic Inquiry,* April 1991), and summarized in both the *New York Times* and *Wall Street Journal* in 1990. First, this shows that the analysis was not crafted or influenced, as Mr. Anstrom implies, with regard to "who [I am] working for," and, second, that my explanation of market dynamics has stood well the test of time. The cable industry's publicly stated view of rate controls, on the other hand, has undergone a remarkable metamorphosis as dictated by political opportunity, as shown below.

Alert readers may still be willing to give Mr. Anstrom the benefit of the doubt on these matters of writers' ethics, however, for the cable industry has proven itself an adept shopper in the market for "scholarly" opinions. What cable lobbyists "consistently fail to reveal" is that their industry has engaged in an outrageous tactic: paying academic economists an undisclosed fee to write op-eds opposing regulation. Prior to the passage of the Cable Consumer Protection and Competition Act of 1992, I was myself approached on two different occasions by a P.R. firm to tout the cable industry line on rate reregulation for a fee of $1,000. Despite the fact that I opposed rate reregulation and largely agreed with the NCTA's position on the matter, I was offended by the offer—by which I was to submit my three-page article draft to cable industry flacks for prepublication review and then send "my" piece off to newspapers selected by the P.R. firm—and refused to participate. (Due to poor bookkeeping [reminiscent of shoddy cable television billing practices?] I was actually asked a second time. Alas, another quick and dirty $1,000 of Monopoly money declined.)

This malodorous practice was described in a 1991 *Business Week* article: "Cable operators are using more subtle public relations techniques as the industry redoubles its campaign against new regulations. In June 1990, Cleveland's *The Plain Dealer* published an article by an apparently independent expert blasting the legislation. But Ohio University economics Professor Richard K. Vedder was paid $1,000 to write the piece by public-relations man James M. Savarese. Savarese, who works for the cable industry, even vetted the article so that it hewed to the party line, Vedder says he should have disclosed the link:

'Maybe I was a little naive.'" Not so naive Mr. Anstrom. He produces a string of "erroneous assumptions and false claims," to use his handy phrase, which attempt to sweep away the obvious indices of market power which monopoly cable systems boast. Let's dissect them one at a time.

• *The cable industry is not highly profitable*. False. The cable trick here is to examine operating data of companies which have had to purchase high-priced cable systems (due to monopoly pricing) and exclaim: "Wow! These guys are broke!" Of course, buying into a monopoly is expensive. The proper way to judge supracompetitive profits is by comparing the market's estimate of future returns (i.e., the price of a cable system) with the replacement cost of capital. (This is known as Q ratio analysis.) Since the value of cable systems, has, for several years, been about $2,000 per subscriber (Bell Atlantic bought TCI's 11 million subscribers at $2,301 per subscriber), and systems cost about $600 per subscriber to construct, this is ample evidence of supracompetitive returns. This is hardly news to Mr. Anstrom, of course. Indeed, the cable industry has just scored a huge court victory regarding federal taxes: cable systems can now depreciate the value of their franchises, which—according to the *Wall Street Journal*—are worth up to 80 percent of their total value. If cable operated in a competitive market and made normal returns, its franchises would be of little value. So cable operators see their monopoly franchises in clear terms, and they look like a million (depreciable) bucks.

• *FCC data do not show competitive prices are lower than monopoly rates.* False. The FCC—in line with every other reputable survey or study—has found a statistically *distinguishable* difference in prices of between 20 percent and 30 percent. The FCC's 1993 sample of head-to-head competitive systems is only 46 nationwide, however. To toss out those with less than 5,000 subs (more than half) is a cute lawerly trick without any *economic* justification—it simply eliminates the necessary degrees of freedom to perform *statistical* tests of significance. If one throws out systems under 100,000 subs, one can claim that there is no competitive price discount at all! (There are zero competitive systems this large.) By such gimmickry the cable industry pleads that it has so successfully expunged competition that no one can "prove" price decreases from greater rivalry. Alas, as my article reported, several other studies and surveys all confirm our intuition: Competition does indeed lower price. Cable lobbyists are going to have to perform contrived revisionism on far more than one FCC price regression to overturn the evidence.

• *The 1992 Cable Act unleashed major new competition to cable*. Hopefully—but where is it? We'll know it's here when our prices go down and the cable company actually answers its customer service line. So far, we're waiting. Better answer: beware of monopoly incumbents who preach about how much competition they face. These are the very same interests that said there was nothing to worry about in 1991 and 1992 because cable already faced ample competition—from VCRs, broadcasters, bookstores, and movie theaters—and assert that they behave competitively today (see above).

• *Cable stocks were not raised by rate regulation*. I didn't say they were. In fact, I dutifully reported that Wall Streeters believe cash flows will decline about 1-2 percent because of rate reregulation. (That I also reported that stock prices rose the week Congress overrode Bush's veto was *not* attributed to that veto. It was, however, a sign that the markets did not greatly fear the coming "$6 billion rate rollback.") Rate reregulation *per se* was a loser for cable firms, but the effects were modest and were overwhelmed by other factors. That was true when I said it in my article, and it's true now—Mr. Anstrom's convoluted deconstruction notwithstanding.

• *"Our view of competition is much larger than Hazlett's narrow, one-sided approach that would serve only the local telephone companies."* Absurdly false. My general view of competition, if Mr. Anstrom had bothered to ask (or read my work on the topic), is that the lines inhibiting competition in telephony (both wireless and wireline), cable (both wireless and wireline), and broadcasting—five transmission businesses now (or soon) sending similar digital signals across space—should be melted *now*. Indeed, I have gladly performed expert analysis requested by major cable firms seeking to compete in telephony. That my views would be magically conjured out of whole cloth by Mr. Anstrom is an impressive effort—but factually flawed.

Mr. Anstrom's comments are most instructive, however, when he mocks the benefits of competition and defends the rate regulation scheme as delivering actual price reductions of over $1 billion to consumers. Last year, the cable industry staged a huge national advertising campaign to tell Americans that the 1992 Cable Act would raise their rates. Now that the regulatory cat is out of the bag, the industry plays up (phantom) rate cuts and the ribald competitive forces supposedly unleashed by legislators. That cable monopolies now trumpet the benefits of the "regulated" status quo in video is quite telling, indeed.

The arguments attempted by Mr. Anstrom are so vacuous as to be cynical. Apparently his view is that *Regulation* readers are foolish and easily misled. He behaves as if he has a virtual monopoly on the flow of information. You can sort of imagine how a cable industry mouthpiece could fall into such a trap. I must thank Mr. Anstrom for providing yet one more compelling reason why we consumers would be well served by additional competition in the market for electronic news, information, and entertainment services.

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