Cable TV Reregulation

The Episodes You Didn't See on C-SPAN

Thomas W. Hazlett

The story seemed so simple that headlines told it all: "Rising Rates Bring Cable Firms Static from Public," asserted the *Los Angeles Times*. Greedy cable companies were gouging customers with "an annual overcharge of $6 billion," Rep. Ed Markey contended. Federal legislation to deregulate cable in 1984 had led to skyrocketing rates—up 61 percent in the first four-and-a-half years—as this uncontrolled industry was "arrogantly [flexing its] raw, unbridled monopoly power" according to then-Sen. Albert Gore. Reagan-era reforms allowed the free market its chance, and consumers soon concluded that the industry could not police itself.

It was clearly time for government reregulation to correct the free-market excesses of the 1980s. Even the cable operators, who argued that years of rate regulation had "artificially" kept cable rates low, unwittingly conceded that deregulation had led to a surge in prices. The industry, denying that cable companies held monopoly positions, struck a pose as defenders of free enterprise. That could have played well on the Comedy Channel.

The Legislation

What came out of the Beltway clash between the forces of good and evil was the Cable Consumer Protection and Competition Act of 1992. This omnibus regulatory measure ostensi-bly permits local governments to again control cable rates, instructs municipalities to stop awarding monopoly franchises, strikes down predatory tactics of incumbent cable operators, and allows broadcasters to charge cable companies for retransmitting their off-the-air signals. The bill's chief proponent, Ed Markey, chairman of the House Finance and Telecommunications Subcommittee, confidently argued that the legislation would roll back basic cable rates by one-half. With analytical minimalism he asserted, "This is a very simple debate. A yes vote is for the consumer, a no vote is for the cable industry, make no bones about it."

The cable bill is actually a highly complex piece of legislation that contains good, bad, and ugly. The good includes measures to increase entry into local cable or multichannel video markets by mandating that municipalities grant competitive cable franchises and by prohibiting selective price-cutting and exclusive program contracts—key tactics for incumbents fending off new competition. The bill's provision for retransmission consent, which allows broadcasters to charge cable companies for their programming, is both logical and efficient over the long run. Previously, the cable operator was free to snatch local broadcast signals off-the-air without charge.

The worst feature of the bill is rate regulation. While price controls are inherently difficult to

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Thomas W. Hazlett is an associate professor of agricultural economics at the University of California, Davis. From 1991 to 1992 he was chief economist at the Federal Communications Commission.

apply, in cable they are impossible. The key to making price controls effective is monitoring quality, because suppliers will attempt to circumvent regulation by shaving input costs and lowering product quality. Cable operators can easily change their product—programming—at the flip of a switch. The easiest means is via "retiering," adding low-quality and/or subtracting high-quality channels from the regulated basic package. Indeed, it is unconstitutional to stop the cable operator from determining the quality of its channels over the long run. That would require content control, and federal courts have firmly held that cable companies, as electronic publishers, cannot be regulated in terms of program content.

The ugly features of the bill are the 24 FCC rulemakings that will fatten the portfolios of the Washington communications bar and effectively tie up the Commission's staff for two to three years, though some might consider the latter a side benefit. Some of those rulings will help consumers; others will hurt. One regulation eliminates damage awards against cities that refuse to issue competitive franchises. In a practical sense that will negate the bill's other provision directing cities to open up local markets by issuing licenses to new entrants.

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Beyond those are the bill's glaring omissions. It applies cosmetics to a patient needing plastic surgery. There is abundant monopoly power in the cable television marketplace that price controls have failed to fix. Competition, where flourishing, has slashed prices and expanded services and is feasible in the typical U.S. cable market. Regulation has largely thwarted competition in the industry, however. In drawing up the 1992 Cable Act Congress pointedly failed to include provisions that would unleash the major competitive forces in the industry. The victims of that failure are American consumers and the U.S. economy.

The History

In each decade since cable television was first offered in 1948, regulations have changed with the changing economic interests of the central players. In the 1950s the FCC twice rejected a staff recommendation to regulate cable as a common carrier. Television broadcasters, which had a dominant influence on the Commission, had no objection to the cable companies' transporting signals to additional homes in distant valleys the broadcasters themselves could not reach.

In the early 1960s, however, a cable operator in San Diego discovered that by microwaving Los Angeles television signals 120 miles south and splicing them into his San Diego cable, it could offer consumers extra choices, stimulating even households with excellent airwave reception to sign up for cable. Thus, cable went from the broadcasting industry's complement to its competitor.

In response to that development the FCC adopted a series of complicated regulations to suppress the growth of cable television. The Commission required new competitors to prove that they were not upsetting the public interest by reducing the profitability of the broadcasters.

The agency's protection of broadcasters broke down in the 1970s, however. As private satellite transmissions became possible, cable programming such as HBO and the super stations became cheap and easy to distribute nationally. The barriers to competition became more and more costly to enforce and less and less possible to justify. As the deregulation wave hit television, both the federal courts and the Carter administration's FCC swept away virtually all restrictions on cable competition by 1980. The Cable Communications Policy Act of 1984 enhanced that deregulation by preempting local rate regulation of cable companies.

The cable industry was largely free from government controls until the regulatory reruns of 1992. Bombarded by consumer complaints about unresponsive cable service and rising cable rates in the wake of price deregulation, Congress enacted the Cable Consumer Protection and Competition Act of 1992. Federal policy had gone full circle around cable—twice.

The Economics

The clearest evidence that the cable television market is a monopoly—though not a natural one—comes from comparing the market value of a system with its capital replacement cost. In the typical cable market, systems are valued at about $2,000 per subscriber, while the capital replacement cost is only about $600. Thus, the market is capitalizing future returns that are anticipated to be worth far more than the cost of entering the market. The industry-average ratio of market value to capital replacement cost is about three times what would be found in a competitive industry in long-run equilibrium.

The richness of the revenue streams does not spring from entrepreneurship. The cable industry is, on average, highly profitable. As long ago as 1987, cable industry trade journals' pro forma balance sheets for hypothetical cable systems suggested that 60 percent of the value of a cable system was attributable to the value of the franchise and goodwill—before the system served a single customer.

The cable operator will demonstrate its market power as soon as it faces direct, head-to-head rivalry. In the approximately 65 U.S. markets where such competition rages, rates fall significantly. Recent evidence from surveys and statistical studies, including the FCC's 1990 and 1993 inquiries, reliably places competitive rates at about 20 to 30 percent lower than monopoly systems' rates on a per-channel basis. Competitive systems also appear, from all accounts, to witness dramatically improved customer service. While other city officials tend to duck whenever the subject of cable service comes up, the deputy mayor of Allentown, Pennsylvania, home to a 25-year cable rivalry, boasts that his city has no trouble keeping the local companies in line—they live in fear of a highly mobile subscriber base.

An April 1992 report on cable "overbuilds" by Paul Kagan and Associates examined the 50 largest competitive cable areas in the country and estimated that competitive systems accounted for a little over 1.1 million subscribers. With 54.9 million basic subscribers nationwide, that represents about 2 percent of U.S. cable households. The average monthly cable bill (including basic and premium service, converter charges, additional outlets, pay-per-view, etc.) was about 18 percent lower in competitive markets than for the nation as a whole, despite the fact that competitors carried about five additional basic cable networks.

That cable operators can profitably operate side-by-side is curiously a point of contention. Not only have dozens of unexceptional U.S. cable markets demonstrated the happy coincidence of head-to-head operators, but the video markets are becoming profoundly more lucrative. Technology suppliers are offering an array of new pay-per-view, interactive television, voice telephony, and data transmission services. Cable operators now assert that they are telecommunications providers—not simply television transmitters. No one seriously doubts that telephone companies could deliver video services (either with off-the-shelf, stand-alone technology or via an integrated broadband on fiber-optic lines) or that wireless cable operators are gaining toeholds in markets wherever they can assemble sufficient channel capacity. Indeed, fearing all such entry, the cable industry is trying to beat the telephone companies in the fiber optics world and is skirmishing at the FCC to delay new spectrum allocations for video competitors.

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Ironically, cable television monopolists now occupy the fortress that broadcasters once held. Shielded by municipal franchises, the cable-telephone company cross-ownership ban, and parsimonious allocations of radio spectrum for wireless video, cable operators know perfectly well how to erect obstacles to competitive invaders. Possibly even more ironic is the fact that the legislation to curb the market power of cable operators will offer consumers not even a token measure of relief.

To anticipate the consequences of reregulating cable rates we have only to replay our experiment with deregulation—in reverse. The Cable Act of 1984 decontrolled basic cable rates across the United States on December 29, 1986.

(Premium rates had long since been decontrolled.) In the ensuing months cable subscription fees rose, while the basic cable package grew in the number of channels and the quality of programming offered. These simultaneous phenomena have dominated the public debate. Consumer activists, press reports, and congressional cable critics contended that, once freed, cable rates shot through the roof. According to a 1991 report by the General Accounting Office, basic cable rates increased 36.5 percent in real terms in the first four-and-a-half years of deregulation. Cable industry advocates responded that the increased rates enhanced the overall quality of service. The same GAO report noted that the average number of channels included in the basic cable service package increased from 27 to 35 (29.6 percent) over the same four-and-a-half year period, while U.S. cable operators increased spending on basic programming from about $300 million to over $1 billion.

Both sides were right. Prices and quality rose simultaneously. To determine whether price or quality increased more, we must focus on the real, quality-adjusted price of basic cable service. Because that is inherently a subjective determination, we must look beyond the simple data to examine how consumers were voting with their pocketbooks. There the evidence is clear. Even after the hefty price increases following deregulation, the number of subscribers to basic cable service increased: the number of subscribers as a percentage of homes passed by cable rose by nearly 3 percent in the first two years of deregulation, according to the GAO, and by as much as 12 percent over the four-and-a-half-year period, according to other measures.

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Even more dramatic are the ratings increases recorded by cable channels following deregulation. Share data reported by the FCC show that nationwide cable audiences almost doubled—from an average share of 14 to 26 percent—in the five years following passage of the 1984 Cable Act. Segregating the specific package that was decontrolled, basic cable, and adjusting for increases in cable subscribership (some of which were due to ongoing construction of new cable plant), we see that viewing times just within cable-subscribing households increased by an astounding 114 percent between the 1984/85 and 1989/90 television seasons (from 14 to 30 percent of all-day viewing shares).

Thus, consumers' revealed preferences suggest that they considered the higher-priced product significantly improved. The finding of increased programming quality reinforces the implication of the subscribership data: subscribers believed that the improvements in programming quality more than wholly offset the substantial price increases for basic cable service. The unavoidable conclusion is that local rate regulation was ineffective in reducing *quality-adjusted* prices for cable television.

When the regulator sets product price, but has no control over quality, suppliers predictably adjust to whatever controls are established. We saw that dynamic at work during the decontrol period following the 1984 Cable Act. Cable companies raised rates without constraint and rapidly added channels by using satellite services that only came into the market because of decontrol. Indeed, the number of cable satellite channels declined from 46 in 1982 to 35 in 1984, before jumping to 65 by 1987—the obvious response of cable programmers to local rate deregulation.

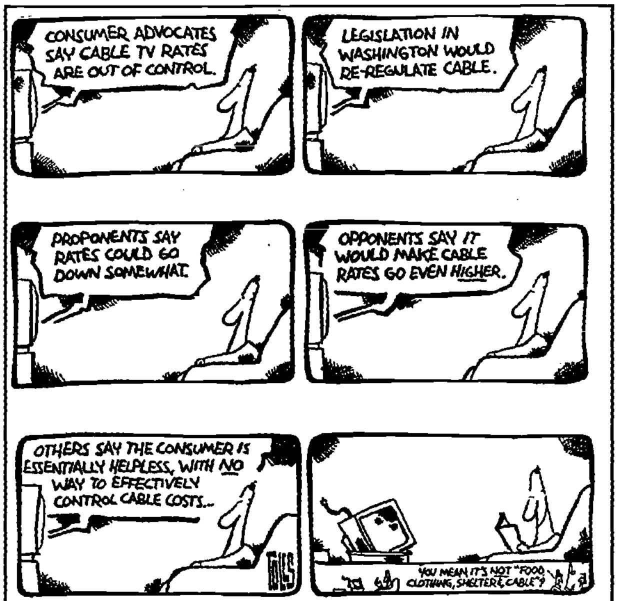
It is apparent that the easiest way to avoid rate controls is to delay the addition of new services in the first place. That allows cable systems to charge monopoly prices, albeit on a lower-quality bundle. If all else were equal, cable companies would prefer not to be constrained and, as in the deregulated marketplace, to charge higher prices for higher-quality, more abundant programming. But either way the consumer gets stuck. The irony in the cable market is that the consumer considers himself better off with the latter bargain: he would rather deal with his local cable monopoly without the "protection" of price controls.

The trade journals show how the cable industry plays the rate control game. Once cable operators have added channels, they can easily evade price controls simply by "retiering"—removing high-quality programming from the price-controlled, basic cable service. Congress explicitly chose to mandate direct regulation only on a limited package of signals to which virtually no viewers subscribe. The cable companies, with some justification, argue that the 1992 law forces them to create phantom tiers of service because it offers different regulatory schemes for limited basic and expanded tiers.

While the media spotlighted publicity hounds inside the Beltway who trumpeted $6 billion in consumer savings, the legislation was so obviously subject to circumvention that the stocks of major cable companies rose during the week in which Congress overrode President Bush's veto of the legislation. Wall Street analysts projected that cash flow margins of about 45 percent would be reduced by 1 or 2 percent—primarily from the administrative costs of compliance. Within two weeks of the bill's passage, a cable executive speaking at a major trade show described the legislation's chief problem for the industry this way: "[W]hen the cities wake up to the fact that they didn't get rate regulation back—because nobody buys just the broadcast tiers we offer—then they're going to be hunting for new territory."

Yet the 1992 Cable Act allows the FCC to set rate benchmarks for higher tiers of programming (everything up to single-channel offerings), and to regulate in response to complaints from local customers or governments. This is the wild card in the rate regulation deck. When the Commission announced in April that it would require up to a 10 percent rate rollback not just on "limited basic" but on all basic tiers, the news was front page on virtually every daily in America: "Cable Subscribers to get $1 Billion Savings." (No mention was made of the promised $6 billion rate savings, five-sixths of which had apparently vanished.) Major cable stocks were hit hard by this news, and the cable industry cried foul.

Have no fear. Cable stocks are back up and the scare is over. The FCC regulations threaten to roll back prices up to 10 percent on a *per-channel* basis. That means that, for the average system with 35 channels, adding four cheap networks will lower per-channel prices by more than 10 percent. The industry is already joking about the new Fireplace Channel and the Fishbowl Network—price-diluting programs to evade controls. And negotiations are under way



to shift popular basic tier programming like ESPN, CNN, or USA to the unregulated premium tier. How this will all shake out is not clear, save for one important fact: over the long run, you will not save money on your quality-adjusted cable bill.

The Politics

As interesting as the historical evidence on the decontrol of cable rates is, the astute observer can forecast the impact of new rate regulation on cable simply by looking at its revealing politics. Not surprisingly, cable operators are adamantly opposed to rate regulation. The stance of the broadcasters, however, is most interesting. From the 1960s through the 1980s, the National Association of Broadcasters (NAB) encouraged the FCC to thwart the growth of its cable competitors. Today, no one would doubt that the NAB was absolutely correct: since the liberation of cable, broadcasters' advertising rev-

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enues have plummeted with their sharp decline in audience share. Broadcasters are in a brutal cross-industry competition with cable operators for American television audiences. Nevertheless, broadcasters lobbied heavily for the 1992 Cable Act.

Why would an industry support a measure that promised to reduce the price of a competitive product? Some aspects of the complex legislation, including retransmission consent, offered broadcasters explicit benefits, such as enhanced property rights over their programming. So the fact that broadcasters underwrote a nationwide advertising campaign to encourage voters to write their congressmen to support the bill could be explained in a number of ways.

Not so with the position the broadcasters took before the FCC in 1990. Before issuing its July 1990 *Cable Report*, the FCC asked for public comment on the specific issue of municipal rate regulation of cable television systems. The NAB eagerly submitted a brief that carefully detailed the broadcasters' views on the matter: "The intent of the Cable Act [of 1984] is that . . . franchise authorities should have the option of regulating rates for basic service to protect the public from monopolistic practices." The NAB went on to advocate strict rate regulation over *all* basic tiers—rather than the restructured limited basic tier—offered by cable operators.

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In urging regulators to force down the rates charged by rivals, the NAB anticipated that cable reregulation would on net make cable subscribers worse off and thus drive viewers back to broadcast television fare. The broadcasters are betting—with billions of dollars on the table—that quality depreciation of basic cable will outweigh any rate discounts in the eyes of the viewing public.

The political pleadings of the various interest groups line up in a formation that can only be explained by the view that rate regulation will end up hurting cable networks and helping broadcasters. Take the owners of cable programming, the satellite networks such as ESPN and Discovery. While vertical integration between large cable operators and many of the channels muddies the waters, it is clear that the programming community was violently opposed to local rate controls on cable. Explaining to Congress that reregulation would reduce the demand for their product, they lobbied diligently against the 1992 Act. That, too, is counterintuitive since lower retail cable prices should increase unit sales of programmers (whose revenues are directly tied to audience size).

But the satellite channels knew the discretionary position of the cable operator: it could simply restrict product quality to offset any rate constraint. Within weeks of the bill's passage, they were proven correct. "The Cable Act of 1992 has already adversely impacted cable operators," wrote a leading trade journal on November 30, 1992. "It is causing a virtual freeze in new programming decisions. Cable operators are proceeding very cautiously when it comes to adding new services like the Cartoon Channel and the Sci-Fi Channel because it may prove difficult, if not impossible, to recoup the investment."

The Solution

If cable rate regulation really could save customers one-half of the $12 billion they spend annually for basic cable television, it presumably would have had some negative impact on the price of cable television stocks. In fact, cable operator stocks are up over 30 percent in the past year, as the industry is now deftly circumventing rate controls with entirely predictable side-stepping maneuvers. That the cable industry has once again dodged the bullet of competition is what makes the episode such a sensational chapter in the annals of regulation.

Cable competitors are champing at the bit to carve up those local monopolies in multichannel video delivery, and the 1992 Act will help empower just the smallest and weakest of the lot. That, of itself, is fine. Consumers can only hope that cable overbuilders—the industry pejorative for *competitors*—and wireless cable companies knock over the monopolists in their town soon. But far more powerful potential competitors are being forcibly restrained today by federal policies that bar telephone companies from providing video services in the markets in which they provide local exchange service. The slow pace at which radio spectrum is being issued for additional wireless video delivery also constrains competition.

The argument against allowing telephone companies to compete with cable hinges on the cross-subsidy issue: the idea that captives of the local phone monopoly can be stuck with many common charges and forced to pay higher rates in the regulated market, all so the phone company can then unfairly outcompete challengers in the (unregulated) video market. That is a chimera in an era in which telephone company affiliates provide a host of services—including messaging, yellow pages, and cellular telephone calls—in level competition with nonwireline adversaries. The task of protecting against cross-subsidies will become easier, as well, when state regulators introduce price caps that hold public utilities to a given price structure that ignores costs and thus removes the motive for cross-subsidy altogether.

The cable operators themselves probably make the strongest argument for telephone companies to enter the video market when they cite the numerous opportunities for cross-subsidy due to the joint costs for providing video and telephony services. The simple reality is that in the digital age both businesses transport physically identical packages of electrons. The artificial separation of voice and video is becoming increasingly absurd, as the plunge by major cable companies into telephony—buying both "competitive access providers" (providing direct telephone competition for business service) and developing personal communications service subsidiaries already shows. As cable's integration into telephony grows, it would beg the equal protection clause to restrain the other side of the aisle.

With telephone companies and cable companies competing, there is little sense in excluding wireless technologies from the fray. The primary disadvantage of multichannel, multipoint distribution systems or wireless cable vis-à-vis cable television systems is the severe capacity constraints placed upon the former, which must strain to acquire the airwave rights to, at a maximum, 33 channels. The FCC imposed those limits. All the FCC had to do, however, was allow greater flexibility in the use of radio frequency rights to offer microwave operators an abundance of pay channels over-the-air. New technologies are turning up all the time; last year the FCC discovered that entrepreneurs had invented a practical means of turning the heretofore worthless spectrum at 26 to 28 gigahertz into a cellular television and telephone conduit. This service, currently operating on an experimental license in Brighton Beach, Brooklyn, is getting rave reviews on both cost and quality. The typical, decades-long delay in FCC spectrum allocation for new services may take an act of Congress to overturn: that would certainly be the consumer-friendly way to legislate in the public interest.

Meanwhile, it appears as though Americans will be treated to the form of regulation and the substance of monopoly. Trapped in the 98 percent of U.S. markets with only one cable operator, the typical consumer must envy the lucky soul who gets to choose between companies, who pays 20 percent less for a greater selection of channels, and who can actually reach his local cable repairman on the telephone. The experiment on regulation has been conducted, and the results are conclusive: real, quality-adjusted prices are *higher* with local rate controls. The experiment on competition has also been conducted, and the results are equally clear: quality-adjusted prices are well below the monopoly level. Yet the Washington channel turns its cameras to a wholly different debate involving fantastic figures and incredible claims.

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Each of the 24 rulemakings that the Cable Consumer Protection and Competition Act of 1992 mandated the FCC to make will laboriously follow official format, with a Notice of Inquiry (followed by public comment), a Notice of Proposed Rulemaking (followed by public comment), and a Report and Order (followed by legal challenges in the federal courts). The communications bar really warms up to the Further Notice of Proposed Rulemaking, the Second Further Notice of Proposed Rulemaking, or perhaps the Second Report and Order. Law reviews are already citing the "legal battalions and gigareams of paper" now stimulating the economy of Northwest Washington, D.C.

When all is said and done, the American television viewer will have lost time, money, and choices. As dynamic technical change makes the digital frontier ever more enticing to consumers of all stripes, the static, protectionist nature of old-style regulation imposes an ever larger burden upon society. The digital information revolution is speeding towards myriad new social opportunities, each one of which threatens some vested interest with access to a congressman. Obstructing new technologies has now become the principal role of the federal government in telecommunications regulation. Cable television has not only done an excellent job of televising the crucial events that shape our day; it has also graciously served as a paradigmatic example of the monopolistic results of regulation by sound bite.