

*A tepid—and arguably successful—move to put
the government on the side of competition*

Economic and Political Consequences of the 1996 Telecommunications Act

BY THOMAS W. HAZLETT

THE 1996 TELECOMMUNICATIONS ACT APPEARS to be encouraging competition in key segments of the telephone and cable television industries. Stock price data suggest that the wave of “megamergers” in telecommunications—probably an unanticipated result of the Telecommunications Act—is associated with consumer benefits. Improvements in competitiveness are modest by some standards but impressive when judged against the results of other legislation with the announced goal of increasing market rivalry (e.g., the 1984 and 1992 Cable Acts).

Federal policymakers also appear to be reaping benefits from the Telecommunications Act. The deregulation—which very cautiously opened markets, mandating extensive rule-making by the Federal Communications Commission (FCC) in the transition to competition—is associated with increases in political contributions to federal policymakers from telecommunications firms and executives. That situation is an intended consequence of the act’s major reform: removing policy jurisdiction from Judge Harold Green’s divestiture oversight and placing it in the hands of the FCC, a regulatory agency answerable to Congress.

THE GROUNDHOG’S DAY TELECOM OPERA

MEDIA COVERAGE OF THE 1996 TELECOMMUNICATIONS ACT

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reads like an opera. In a typical news account on every anniversary of the act (which was signed by President Clinton on February 8, 1996), the policymaker boasts that the Telecommunications Act will lower prices on local and long-distance telephone calls and cable TV rates through competition. The activist denounces the Telecommunications Act “as an abysmal failure that has led to consolidation, not competition, and higher prices, not consumer cost savings.” The telecommunications executive praises the farsightedness of the act but pleads for special relief for one itsy-bitsy little subsector (his). The congressional policymaker concedes some problems but points to the FCC as the source. The FCC policymaker concedes some problems but points to the courts as the source. The activist condemns the entire process as a problem and points to corporate PAC money as the source. And the yet-to-be-written grand finale keeps the audience hooked for yet another installment—the 1996 Telecommunications Act Anniversary Opera.

In truth, the telecommunications marketplace is a big, complicated place, and the Telecommunications Act was a big, messy bill. Not everything that the marketplace has produced since February 8, 1996, is a result of the Telecommunications Act. To analyze the effect of the act, we must compare market outcomes with what would have occurred in the absence of the legislation. The analysis becomes yet more complex when it is extended to encompass problems encountered from reforms not undertaken by the Telecommunications Act—sins of omission. Finally, we cannot evaluate this act, or any act, without a standard. In

other words, what do we expect an omnibus legislative package to achieve? New laws undeniably contain compromises and blemishes.

GRADING ON THE CURVE

AGAINST WHAT BASELINE SHOULD WE COMPARE THE 1996 Telecommunications Act? In the telecommunications policy world, only the following handful of major federal statutes can be used for comparison:

- Radio Act of 1927
- Communications Act of 1934
- Cable Communications Policy Act of 1984
- Cable Television Consumer Protection and Competition Act of 1992.

From the perspective of consumer welfare, the verdict on those measures is grim. The Radio Act allowed commercial broadcasters to cartelize the emerging radio market, blocking competitive entry via regulation. That anticompetitive outcome was cemented in place by the 1934 Communications Act, which brought the regulation of wireless and wireline communications under one umbrella agency. The regulation of long-distance service was well established under the regulated monopoly model. The 1934 Communications Act shuffled offices and name plates, granting a quasi-permanence to extant promonopoly policies.

Half a century later, the 1984 Cable Act preempted local regulation of cable television rates, allowing prices charged by operators to rise without constraint after December 29, 1986 (i.e., deregulation was phased in from October 1984). Although rates rose in the deregulation period slightly faster than previously, quality also increased. Operators expanded channel allotments and networks procured more expensive programming. During the 1987–88 upward price blip, subscriber growth increased from trend—evidence that the rate control regime had increased rather than lowered quality-adjusted prices. In its provisions related to cable television (TV) franchising, however, the legislation had clear anticonsumer consequences. It required local governments to license local cable entrants, and it barred telephone companies from receiving such franchises except in rural, sparsely populated communities. Those provisions clearly raised barriers to entry in the sector, thereby enhancing the emerging monopoly power of cable operators.

Finally, the 1992 Cable Television Consumer Protection and Competition Act modestly enhanced the opportunities for competitive entrants in cable TV markets with rules allowing upstart rivals better access to video programming. The measure's primary thrust, though, was rate reregulation. Cable systems responded to rate rollbacks mandated by the Federal Communications Commission by lowering quality. Consumers reacted negatively to the lower price–lower value package: Subscriber growth sharply dropped under the regulatory scheme. The outcome was

apparent even to regulators touting the benefits of regulation, and the reaction prompted the FCC to quietly relax controls beginning in late 1994.

It is likely that at least three of the four telecommunications laws described above produced zero net benefits for consumers—or worse. The 1927 Radio Act and the 1992 Cable Act definitely appear to have harmed consumers, raising the effective (quality-adjusted) price of service delivered to customers. The 1934 Communications Act had no appreciable effect on consumers; it merely codified rules already in place.

On the basis of that earlier legislation, a judging standard emerges. If the Telecommunications Act of 1996 results in positive net gains for the broad class of consumers—lower prices in quality-adjusted terms—the evidence should render the legislation a comparative public policy “success.”

EVALUATING MARKETPLACE EVIDENCE

THE TELECOMMUNICATIONS ACT, ACCORDING TO ITS SPONSORS, had these major economic policy goals:

- Increase competition in local and long distance telephone markets.
- Increase competition in cable TV markets.

Events since the act was passed have raised the possibility that the legislation also had these unannounced goals:

- Increase mergers between large telecommunications firms.
- Increase congressional jurisdiction over the telecommunications industry.

I evaluate the effect of the legislation on each of these possible outcomes.

LONG DISTANCE COMPETITION

WHAT PROGRESS HAS BEEN MADE UNDER THE 1996 Telecommunications Act to enhance competition in long-distance service? (Long-distance service is sometimes called interexchange service, and a company offering such service is called an interexchange carrier, or IXC.) There has been none. That verdict is easily reached because the liberalization of long-distance related specifically to the entry of Bell Operating Companies (BOCs); other local exchange carriers were already free to integrate into long-distance markets within their local service territories (where, specifically, the ban applied to the BOCs). However, entry into long-distance by the BOCs was conditioned on the satisfaction of a 14-point checklist and on a “public interest” determination made by the FCC. In the three years following the act, the FCC denied several petitions submitted by various BOCs, and granted none. Thus far, the act has done nothing to promote competitive entry into long distance.

That situation does not render the policy senseless, however. It is plausible to think that (a) the protective licens-

ing layer that has slowed BOCs' long-distance entry was necessary to gain a majority to pass the Telecommunications Act, and/or (b) the IXC-entry process of the act is working to provide an incentive for BOCs to open local markets. The latter view claims that, given additional time, the "open local, integrate into long" bargain will prove beneficial to consumers.

The first argument is assuredly correct. The fierce opposition of the IXCs to pro-BOC legislation very likely would have blocked any legislation if a compromise had not been reached. The Telecommunications Act, as introduced in early 1995, did not include either the 14-point checklist or the public interest determinations as requirements for BOCs'

of competitive local-exchange carriers (CLECs)—it appears at least neutral.

CLEC Market Shares The status of CLECs, fledgling entrants attempting to take market share from established incumbent telephone carriers, is of interest. Although the health of competitors can be a misleading guide to the state of competition, in this instance it seems to be a reasonable starting point. The revealed preference of consumers shows that prices adjusted for quality are declining where competitors gain market share from rate-regulated incumbent monopolies.

Annual CLEC revenues show a strong overall growth trend from 1993 to 1998, including accelerated growth for the series in the post-act period. The small sample size limits the conclusions that may be drawn, but a significant increase in the growth rate of CLEC revenues seems to occur in the post-act period. In 1993–95, CLEC revenues rose by \$475 million, or 114 percent. In the two years following the passage of the act, CLEC revenues

grew by \$2.2 billion, or 245 percent. The trend is supported by press accounts that claim that, as of March 1999, "165 new phone companies [have been] spawned by the law." The pattern suggests that the act may have been beneficial to the emergence of CLECs and that CLEC market share has continued to grow in recent quarters.

That conclusion is reinforced by a provision of the act that eliminated state laws granting monopoly franchises for the provision of local telecommunications. Although many states had been independently abolishing or reforming such statutes and probably would have continued doing so, the federal preemption embodied in the act appears to have bolstered that trend. CLEC market shares are still modest (2.5 percent of lines, 5.0 percent of revenues), perhaps constraining the total benefits produced thus far but not obscuring the direction of change.

CLEC Stock Market Performance The performance of the small number of publicly listed CLECs during the five-year period from 1994 to 1998 presents a mixed picture. Only four companies can be charted throughout that period, a span during which the act was drafted, debated, amended, passed by Congress, signed by the president, enacted by the FCC, and litigated in federal courts. Because the act ostensibly aimed to enhance competition in the local exchange market, it is reasonable to conclude that firms specializing in providing such service enjoyed windfall gains during that period.

All four companies produced positive returns for shareholders over the period; two companies (Winstar and Intermedia) beat the Standard & Poor's 500 Index (S&P500) and two (ICG and GST) did not. The split may be somewhat misleading because Winstar's performance was sufficient-

Taken as a whole, stock market evidence suggests that forward-looking investors see competitive local exchange services as a good investment.

entry into long distance. Those provisions were expressly added at the behest of the IXCs and were clearly intended to slow entry into long distance for a number of years.

The second argument—that the freezing of BOCs' entry will prove useful over time—is clearly speculative. By the FCC's own admission, the policy has not yet succeeded in opening local telephone markets. On that premise, each BOC's petition for permission to enter IXC markets within its local service area has been rejected. The prevention of enhanced competition in long distance has some cost to customers, and that cost is being borne upfront. In present value, risk-adjusted terms, the payoff in future competitive benefits will have to compensate, with interest, for early losses. That argument represents a highly leveraged public policy position, particularly in light of AT&T's recent acquisition of the largest U.S. multiple cable system operator, TCI. The merger signals AT&T's decision to enter local telephone markets with its own facilities—abandoning the regulation-intensive approach available via the purchase and resale of unbundled network elements from existing local exchange carriers.

LOCAL-EXCHANGE COMPETITION

A GREAT DEAL OF ATTENTION HAS BEEN DIRECTED TOWARD the massive administrative process prompted by the act in FCC rulemakings and in federal court challenges to those rulemakings. Related discussion often leads to a comment on the futility of the act in promoting local competition, with the various sides choosing up villains. Evidence from the marketplace is not as negative, however. Indeed, by one measure—market share—competitive entry appears to be positively correlated with the Telecommunications Act, and by another measure—stock market performance

ly in excess of the market return to make the performance of the portfolio of CLEC stocks superior to the market as a whole. If, for instance, an investor had put \$10,000 in each of the CLECs at the beginning of 1994, the equally weighted portfolio would have been worth \$179,226 at the end of 1998. The same amount (\$40,000) invested in the S&P500 would have been worth just under \$100,000. Hence, capital gains in the small, publicly listed CLEC sector were roughly twice the gains for the S&P500. Some of the supranormal return is likely a risk premium for holding CLEC stocks, which all have betas in excess of 1. Nevertheless, the CLEC returns appear to be somewhat in excess of the market as a whole even with the adjustment.

Despite the fact that only a small sample of CLECs is publicly listed throughout the relevant period, the sample becomes substantially larger by sample end. The growth is consistent with the idea that competitive forces are increasing in the local telecommunications marketplace, although it is not clear how much of the increase is causally linked to the Telecommunications Act. By 1998, we observe that a number of firms have been successfully launched and are competing in local telecommunications markets. Moreover, some of those firms have substantial capitalizations: Level 3 Communications, whose initial public offering was in 1998, is valued at more than \$17 billion, and Teligent, Winstar, Nextlink, Allegiance, Covad, Intermedia, ICG, and RCN

all have market caps of about \$1 billion or more. It is clear that the stock market takes these forays into the local telephone “monopolies” seriously. By way of comparison, throughout the years following the 1984 Cable Communications Policy Act (legislation promising greater competition in local cable markets), there never developed a single public firm of any size whose business strategy focused on offering head-to-head competition in cable service.

Taken as a whole, then, stock market evidence suggests that support provided to CLECs by the Telecommunications Act was positive but modest and that forward-looking investors see competitive local exchange services as a good investment.

Market Returns of Local and Long Distance Providers To enable the reader to gain some appreciation of how the Telecommunications Act may have influenced the most important industries “deregulated” by the legislation, I calculate rates of return (net of the market) for the leading local and long distance service providers. The set of firms examined in Table 1 includes the three major IXCs (AT&T, MCI/WorldCom, and Sprint) and seven ILECs: SBC, Bell Atlantic, Ameritech, US West, BellSouth, Cincinnati Bell, and GTE. The four CLECs publicly listed throughout the 1994–98 period are displayed, as well as firms in related industries such as cable TV (TCI, Comcast, Century, Adelphia) and wireless telephony (AirTouch and Nextel).

What does Table 1 reveal? Lacking more exacting event study results, we observe that no sector appears to dominate the returns competition. Although firms on average appear to beat the S&P500, indicating that telecommunications shares exhibited relatively strong growth in equity value during the relevant period, individual firm returns are highly volatile and exhibit no visible sectoral patterns. The best performing large firm through this period was MCI, which, acquired by rival long distance provider WorldCom, grew to have a capital value in excess of AT&T's. AT&T, still the largest long distance provider in terms of revenues and customers, underperformed the market as a whole. Sprint was in the middle.

Among the large ILECs, four firms beat the market and two firms underperformed. The equally weighted average annual abnormal return for the six firms was 3.25 percent, less than the equally weighted average annual return of 4.92 per-

Table 1

Telecommunications Firms Ranked by Shareholder Returns, 1994-98

Company	Sector	Mkt Cap (millions)	1/94 Price	12/98 Price	1/94-12/98	Annual Growth	Adjusted Ann. Gr.
Winstar	CLEC	\$1,360	\$3.060	\$39.000	1174.51%	66.37%	38.57%
MCI	IXC	157,400	13.750	71.750	421.82	39.16	15.91
Cincinnati Bell	ILEC	2,690	3.257	15.356	371.53	36.36	13.58
Ameritech	ILEC	71,600	17.368	63.375	264.89	29.55	7.90
BellSouth	ILEC	89,400	15.375	49.875	224.39	26.54	5.39
US West	ILEC	27,700	20.031	64.088	219.94	26.19	5.10
Century	CATV	1,140	10.625	31.719	198.53	24.45	3.66
SBC	ILEC	102,900	17.930	53.389	197.76	24.39	3.60
Sprint	IXC	29,900	28.442	84.125	195.77	24.22	3.47
AirTouch	Cellular	53,000	25.250	72.438	186.88	23.46	2.84
Comcast	CATV	23,300	20.741	58.688	182.96	23.12	2.55
Intermedia	CLEC	954	6.500	17.250	165.38	21.56	1.25
GTE	ILEC	62,200	27.294	64.523	136.40	18.78	-1.07
Bell Atlantic	ILEC	89,500	23.084	53.622	132.29	18.36	-1.42
Jones Intercable	CATV	1,480	15.875	35.625	124.41	17.55	-2.09
AT&T	IXC	148,200	34.079	75.750	122.28	17.32	-2.28
Adelphia	CATV	2,330	20.750	45.750	120.48	17.13	-2.44
TCI Group	CATV	30,200	27.250	55.313	102.98	15.21	-4.04
ICG	CLEC	909	24.000	33.625	40.10	6.98	-10.90
GST	CLEC	254	5.875	6.560	11.66	2.31	-17.06
Nextel	ESMR	8,160	42.000	23.625	-43.75	-10.87	-25.76
S&P 500	INDEX		466.510	1,163.630	149.43	20.06	

cent for the IXCs but greater than the CLEC mean of 2.97 percent. That data can most easily be interpreted to indicate that the act was not associated with any radical restructuring of the telecommunications sector; a dramatic shift in policy would have resulted in markedly superior performance by one industry segment or another. Incumbent monopolists and oligopolists were not rendered unprofitable by the act, nor were competitive entrants showered with windfalls. The data temper the positive assessment of the CLEC post-act performance. General prosperity in the sector unrelated to the legislation may account for the positive returns to CLECs, ILECs and IXCS.

COMPETITION IN MULTICHANNEL VIDEO MARKETS

THE EFFECT OF THE TELECOMMUNICATIONS ACT IN PRO-

The data indicate that households are more likely to subscribe to unregulated cable packages than to price-controlled cable packages.

moting cable TV competition is complicated by two events: the 1992 Cable Act and the advent of digital direct broadcast satellite (DBS) service (by Direct TV/USSB) in June 1994.

The 1992 Cable Act offered rate reregulation for monopoly cable systems and modest policy measures designed to enhance competition. Chief among the latter was a provision making some agreements between cable satellite networks (such as A&E or HBO) and cable systems non-exclusive, so that new competitors in cable markets could purchase programming to better attract customers. Digital DBS service was initiated soon after passage of the act, and suppliers publicly credit the program access measure with enhancing their market prospects.

The primary effect of the 1992 Cable Act, however, was in reregulating the rates charged by 11,000 cable TV systems. Rates in the industry had been deregulated since 1987, when the federal preemption of local rate controls in the 1984 Cable Act became effective. The market pricing period from 1987 to 1992 was replaced by reregulation, starting with a rate freeze in April 1993. Pursuant to the 1992 Cable Act, FCC then enacted two rounds of rate rollbacks—10 percent in September 1993 and an additional 7 percent in July 1994.

Lower Prices and Lower Quality The effect of the controls was rather dramatic. As seen in the cable TV component of the Consumer Price Index, collected by the Bureau of Labor Statistics, the average U.S. cable bill was about 10 percent lower in October 1994 than it would have been under the trend that was prevailing

when the Cable Act was passed in October 1992. Yet, the results were not encouraging for consumers. Despite the price reductions, cable subscribership did not increase. Indeed, cable penetration and viewership, the leading output measures in the industry, abandoned long-standing growth trends. Even the recovery from the recession of 1990–91 could not sustain cable household growth in the wake of the Cable Act.

The harsh marketplace reaction to the controls enacted under the 1992 legislation led to major changes in the regulatory structure. By the time the 1996 Telecommunications Act passed, the FCC had decided to effectively deregulate cable TV rates. Beginning in November 1994, the commission enacted rules that allowed cable systems to raise rates substantially when adding new program networks to basic cable menus. A series of “social contracts” were signed

with cable system operators that further loosened controls. The liberalization quickly produced results: Cable subscriber growth turned up again in 1995. The higher rates successfully discouraged perverse attempts by cable operators to lower quality and defer investments in upgrading systems—activities that had rendered the previous rate rollbacks counterproductive.

Higher Prices and Higher Quality Although many press accounts in 1997 and 1998 associated rising cable rates with the Telecommunications Act, the argument is incorrect. Most cable systems were officially deregulated, as required by the act, but not until March 31, 1999. Moreover, the implication that there are consumer welfare losses associated with rising rates is rejected by the evidence. Rising prices are clearly linked to increasing demand for cable services, demand shifts fueled by quality enhancements. The data indicate that households are more likely to subscribe to unregulated packages than to price-controlled cable packages. Because the former packages are nominally more expensive, we can infer that subscribers perceive them to be of higher quality.

Price Control Repeal The statutory elimination of regulation may yield important additional benefits because it reduces risk in investments in cable TV system infrastructure. Such dynamic considerations are especially important when cable operators are vertically integrating into the Internet access business. Given the generous bandwidth of cable TV systems, high-speed modems can be cost-effectively delivered to many of the 97 percent of U.S. households passed by cable TV wires. (Of that number, about 70 percent subscribe.) This recent discovery has sent cable system values soaring; languishing at about \$2,000 per subscriber for nearly a decade, 1999 transactions in the capital market saw investors paying more than \$5,000 per subscriber. The cable euphoria is tied to

Table 2

Largest Competitive Multichannel Video Program Distributors

Company	Mode	Date Begun	1999 Subscribers
Direct TV/USSB	Satellite	1994	3,481,704 ^a
PrimeStar	Satellite	1990	2,029,452 ^b
EchoStar	Satellite	1996	1,168,029 ^c
Ameritech	Overbuilder	1996	>200,000 ^d
SNET ^e	Overbuilder	1997	28,000 ^f
GTE	Overbuilder	n.a.	102,567 ^g
Knology Holdings	Overbuilder	1994	80,068 ^h
RCN	Overbuilder	1997	276,088 ⁱ
OpTel	SMATV	1993	217,593 ^j

^aMarch 29, 1999 figures from www.dbsdish.com. ^bIbid. ^cIbid. ^dAmeritech Extends Cable Competition in Detroit Metro Area, Ameritech Press Release, www.ameritech.com ^eSouthern New England Telephone, acquired by SBC Communications in 1998. ^fEmail communication from SNET (July 15, 1999). ^gMay 1999; Fast-Growing Knology 'Scares' Cable, MULTICHANNEL NEWS (June 22, 1998), pp. 52-3. ^hAs of June 30, 1999 (SEC filing by RCN). ⁱOpTel, Inc. Reports Results for First Quarter, OpTel Press Release (Jan. 14, 1999). SMATV (satellite master antenna television) suppliers serve residential developments, typically on a contract basis. They are also called "private cable" operators.

investor enthusiasm for the cable modem business. @Home, the leading supplier of such service, was capitalized (in March 1999) at \$17 billion despite having just 500,000 subscribers. (The investment translates to \$34,000 per subscriber.)

Although the breakthrough in data services effectively doubles the cable TV revenue stream (typical cable subscribers pay about \$35 per month, whereas high-speed Internet access subscribers pay that amount again), it requires substantial capital investments. Existing plant must be upgraded, and such upgrades are costly. Removing the risk premium associated with rate controls lowers the cost of capital in the sector, allowing the necessary investments to be made more efficiently. Conversely, the introduction of cable modems further removes rate regulation from serious consideration as a policy option. Constraining cable rates proved a failure even when industry technology was more settled. In the current maelstrom, rate rules encouraging efficiency-enhancing investments while preventing monopoly price markups are even more difficult to craft.

Reducing Entry Barriers The Telecommunications Act contained two provisions to advance competition in multichannel video markets:

- Curtailment of certain local zoning and ordinances banning DBS
- Permission for local telephone companies to obtain franchises from municipalities or from the FCC (FCC-granted franchises fall under the newly created Open Video System model wherein most channel capacity is reserved for third party programmers.)

It is unlikely that the DBS measure significantly affect-

ed the marketplace, although DBS operators publicly state that the reform helps them compete. But the second provision has led to substantial entry into previously monopolistic cable markets by several firms (see Table 2) including telephone companies permitted to own cable facilities by the 1996 Telecommunications Act. The largest overbuilders are Ameritech, a Bell Operating Company acquired by SBC-Communications, and RCN, an independent telecommunications provider offering integrated service (local telephony, video, and Internet access) in direct competition with established telephone and cable companies. Incumbent cable companies respond to entry by dramatically lowering prices and upgrading service quality. As the result of the competitive efforts of just those two firms, approximately 2.3 million households face substantially improved choices in the multichannel video market, which accounts for a little more than 2 percent of the U.S. market.

Although cable overbuilders (including many additional firms) now provide service to but a small fraction of U.S. households, their impact is growing. As in local telephone service competition, the level is modest, but the trend appears positive. The visible signs of success are more impressive in light of previous failures to promote competition with the 1984 and 1992 Cable Acts. The latter legislation abolished exclusive municipal franchises, but there was no documented increase in overbuilding from 1992 to 1996. In contrast, the 1996–99 period features a growing competitive market segment spearheaded by two integrated, well-capitalized telecommunications providers.

An even stronger growth pattern is seen in DBS, although it is problematic to associate that growth with the Telecommunications Act. As seen in Table 3, the subscriber growth rate before the Act (1993–95) exceeds the rate following the act (1995–97). We must be careful in categorizing the change, however, because the actual units sold increases in the latter period (sales growth is simply a lower proportion of an expanding base). The Telecommunications Act may not have launched DBS, but it apparently has not retarded it. The 1998 year-end DBS subscriber total of 9.28 million presages an important development regarding multichannel video competition: At DBS's 1998 growth rate, approximately 15 percent of U.S. households would have subscribed to DBS in the first half of 2000. That figure will officially designate the U.S. cable market as "effectively competitive" according to the 1992 Cable Act.

Table 3

Growth in Multi-Channel Video Subscribers Before and After 1996 Telecommunications Act

	1993	1995	1997	Pre-TA Growth	Post-TA Growth
DBS	602	2,200	5,047	265.45%	129.41%
CABLE	58,834	62,956	65,929	7.01	4.72
MMDS	400	850	1,000	112.5	17.65
TOTAL	59,836	66,006	71,976	10.31	9.04

Sources: Annual FCC Cable Reports; Sky Report (DBS).

Reselling vs Facilities-Based Competition Video dialtone (VDT) was the subject of the FCC's long-running regulatory rulemaking from 1987 to 1996. The nine-year administrative process produced an exhaustive record of how the commission should mandate that cable systems owned by telephone companies provide for common carriage of third-party programming. The VDT proceeding finally succeeded in licensing one provider—New Jersey Bell, a subsidiary of Bell Atlantic—to operate one system. The Dover, New Jersey, VDT system signed up 1,250 subscribers before being terminated in the wake of the passage of the 1996 telecommunications law. The system migrated to the new model for video common carriage, Open Video Systems (OVS), created by the act.

The story of VDT is summarized by a single number: 1.47—the ratio of VDT filings to VDT subscribers. (Indeed, it is the high-end subscriber number achieved after nine years of administrative procedures.) A total of 851 comments, reply comments, and petitions for reconsideration were filed by various parties in FCC's rule-making process.

The OVS process has resulted in a few thousand competitive cable subscribers—more than besting the total output of nearly a decade of VDT rulemaking. But it is striking that the two most carefully crafted models for competitive entry into local video markets, each meticulously designed to produce consumer benefits, have rendered the least amount of actual service to customers among the competitive alternatives available.

The lack of success by regulation-intensive frameworks to open up local cable markets mirrors the disappointing results obtained in the FCC's network element unbundling proceeding in telephony. The most successful CLECs, in the opinion of investors risking capital, rely primarily on their own physical facilities to provide local connections. With AT&T acquiring TCI, the country's largest operator of cable systems, and then executing a long-term agreement

with Time Warner, the country's second largest cable operator, the long-distance leader has signaled its strategy to provide independent (non-ILEC) local access. The apparent abandonment of local reselling in favor of vertical integration into facilities-based competition signals a verdict common to cable and local telephony.

THE EFFECT OF TELECOMMUNICATIONS MEGAMERGERS

PERHAPS NO SINGLE DEVELOPMENT IN THE POST-TELECOMMUNICATIONS Act marketplace has received more popular comment than the wave of mergers between the following large-scale telecommunications providers (the acquiring company is named first):

- SBC and Pacific Bell (April 1996)
- Bell Atlantic and Nynex (April 1996)
- WorldCom and MCI (October 1997)
- AT&T and TCI (May 1998)
- SBC and Ameritech (June 1998)
- Bell Atlantic and GTE (July 1998).

None of those attempted mergers has been blocked by the antitrust authorities. As of this writing, the first four mergers have been consummated and the final two are pending. In addition, many smaller combinations have occurred, along with a rash of product development partnerships and marketing alliances. Such furious corporate restructuring in the telecommunications sector is identified by Wall Street analysts as preparation for dramatic changes in the way that communications services are created, supplied, and sold—a theory supported by the contemporaneous explosion in Internet stock values. Many analysts believe that customers will increasingly shop for branded, integrated packages of services. Large-scale firms can offer such “one-stop shopping” either on their own by integrat-

Figure 1

**AT&T/TCI Merger Announcement:
Abnormal Stock Returns for Six Major Competitors**
(Adjusted by S&P 500)

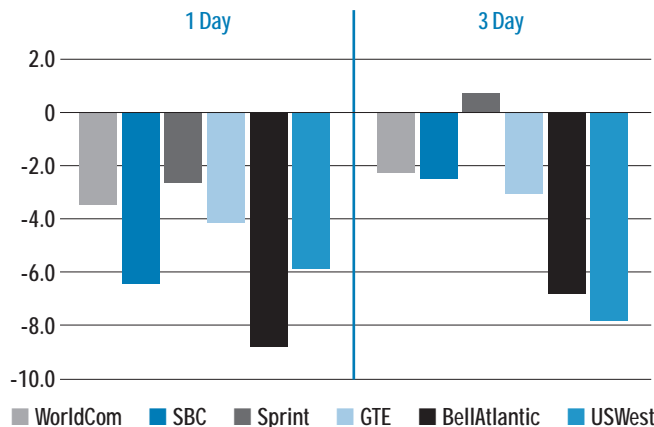
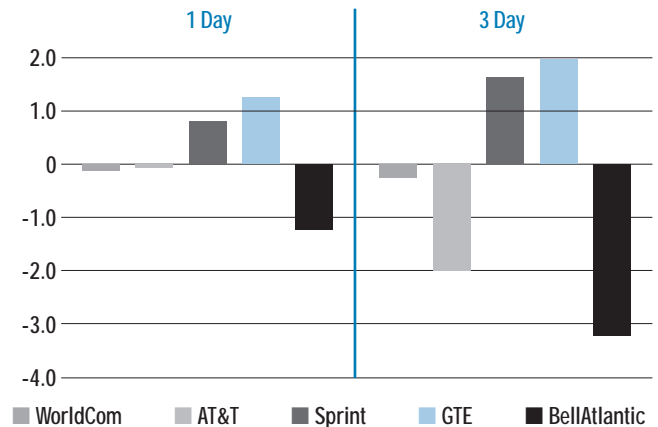


Figure 2

**SBC/Ameritech Merger Announcement:
Abnormal Stock Returns for Five Major Competitors**
(Adjusted by S&P 500)



ing into disparate product lines or by tying together the offerings of independent service providers. Mergers and joint ventures are seen as two sides of this coin.

The economic effect of such mergers and alliances is theoretically ambiguous. The standard method used by the antitrust agencies to screen such combinations for legality is to compare the likely benefits (greater efficiency in creating and distributing products to customers) against the likely costs (greater market concentration that may allow firms to raise prices to customers). Combinations likely to provide net efficiencies are presumptively legal. That analysis, conducted in each case by the U.S. Department of Justice Antitrust Division, gave the “green light” to the four completed megamergers and is still being conducted for the SBC-Ameritech and Bell Atlantic-GTE mergers. Even so, the capital markets provide evidence about the efficiency implications of the mergers.

I evaluate three recent telecommunications megamergers (AT&T-TCI, Bell Atlantic-GTE, and SBC-Ameritech) by analyzing stock price reactions. The basic idea is to observe abnormal stock returns around the time a public announcement takes place to see what investor behavior (driving securities prices up or down) says about expected effects of the announcement. Abnormal returns are actual returns adjusted for the return of the market portfolio (here, the S&P500). If, for example, an individual stock exhibits a return of 8 percent over some period, during which the S&P500 return is also 8 percent during the same period, then the abnormal return for the individual stock is zero. Because investors have strong incentives to carefully judge future changes in firm profitability on the basis of current information, and because capital markets are relatively efficient in rewarding good predictions while punishing inaccurate ones, stock price movements are

thought to embody sophisticated—and unbiased—projections of events, including merger announcements.

If two firms in an industry merge (i.e., there is a horizontal combination) and the stock prices of the remaining competitors increase in response, we may (lacking a better explanation) conclude that the observed anticipation of increased industry profitability is the result of an anticompetitive combination. (The “takeover effect” may be an alternative explanation, where rising returns for rivals are not associated with rising consumer prices.) If, conversely, competitor stock prices fall on announcement of a merger between two rivals, financial investors

Consumers will benefit from lower prices and more efficient service because of the dramatic changes in market structure after the Telecommunications Act.

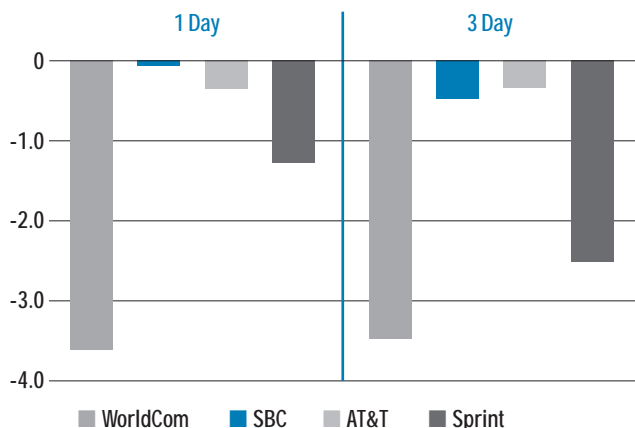
may believe that competition will intensify, thereby reducing prices and profits.

The abnormal returns for one-day and three-day trading windows surrounding the three merger announcements are displayed in Figures 1, 2, and 3. In that analysis, competitors are defined as large-scale integrated telephone companies that are the most direct rivals of the merged firms. The financial evidence indicates that investors generally do not believe that any of the three mergers will systematically raise profits for their competitors, thus suggesting that prices are unlikely to rise from enhanced market power. The clearest results are evident in the AT&T-TCI merger, which is accompanied by strongly negative one-day returns for all of its large-scale rivals. The Bell Atlantic-GTE merger announcement generated similar negative returns for the competitive cohort, but of lower magnitude. The SBC-Ameritech merger produced mixed results, but the overall three-day returns to competitors are negative, which suggests that rivals are not expected to profit from the merger.

Taken together, these results tend to support the efficiency view of the mergers and reject the market power explanation. The restriction of output associated with a merger that would raise prices to consumers would distribute gains across the entire set of horizontal competitors, but such gains do not appear to be anticipated by financial investors in the three mergers analyzed here. That evidence, together with formal DOJ approval of the previous megamergers, leads to the conclusion that consumers will benefit from lower prices and more efficient service because of the dramatic changes in market structure in the wake of the Telecommunications Act, regardless of whether the merger wave was intentionally encouraged by policymakers.

Figure 3

**Bell Atlantic/GTE Merger Announcement:
Abnormal Stock Returns for Four Major Competitors
(Adjusted by S&P 500)**



THE TELECOMMUNICATIONS ACT AND POLITICAL CONTRIBUTIONS

THE TELECOMMUNICATIONS ACT WAS THE PRODUCT OF *realpolitik*. Reforms of that size and scope involve compromises and pork barrel bargains so that an actual majority (or supermajority capable of circumnavigating the veto power of various interest groups and committee chairs) can form a coalition to enact law. In the competitive rivalry of the political world, disparate interest groups jockey for advantage, holding out for better deals as long as the expected benefit exceeds the expected cost. Often, the interest of incumbent officeholders in continuing contentious legislation in future legislative sessions (where support groups can be cajoled or threatened, and where electoral benefits for the official can be duly extracted) combines with the interest of reform opponents (who, as supporters of the status quo, are rarely without a considerable number of friends—which is how the status quo came to be) to block legislation altogether. That situation describes the 20-year legislative impasse that preceded the Telecommunications Act, when countless efforts to “update” the 1934 Communications Act were stymied, beginning with the ambitious effort by Congressman Lionel van Deerlin, chairman of the House Subcommittee on Finance and Telecommunications from 1976 to 1980.

To overcome the natural inertia in legislation, it is helpful to have some unifying motivation to prompt Congress to act. The classic motivating factor is public emergency, a situation where the standard reasons for not legislating are momentarily overwhelmed by political actors who seize the opportunity (partly out of the desire to claim credit for forging a solution and partly out of fear of appearing unresponsive or out of touch). No great crisis gripped the public, though, in 1996; the issue of telecommunications reform was no more visible than in previous years. Why did legislation pass in 1996 and not before?

It is difficult to pinpoint the motivating factors behind legislation, but I believe that major telecommunications legislation became more likely to pass because the political benefits to incumbent officeholders increased. There are always benefits to distribute in the passage of legislation, and typically there are costs associated with the benefits. The transfer of rights from one constituency to another is a standard example. The political gains from recipients are offset to some degree by the opposition engendered by the group that is taxed. What particularly motivates policymakers in the congressional and executive branches are reforms that bestow cost-free benefits on officeholders. One such benefit became available in telecommunications law—taking decisions about relaxing the AT&T divestiture’s line-of-business restrictions away from Judge Harold Green and putting them in the hands of Congress and an agency that Congress oversees, the Federal Communications Commission.

The intense rent-seeking and rent-defending activities that took place in federal district court represented a lost opportunity from the perspective of lawmakers. Since the

mid-1980s, the BOCs had been attempting to wiggle free of the constraints placed on them by the consent decree that ended the mammoth AT&T antitrust suit in 1982. That decree (supervised by Judge Green) divested AT&T of its local telephone service providers (the Baby Bells, or BOCs) and its manufacturing arm, Western Electric. Although the long distance company (which remained “AT&T”) and the manufacturing unit were allowed to offer a variety of services as befit their business strategies, BOCs were sharply restricted to providing local exchange service. Specifically, the companies were barred from providing long distance phone service, manufacturing phone equipment, or supplying information services (which included video products such as cable TV service).

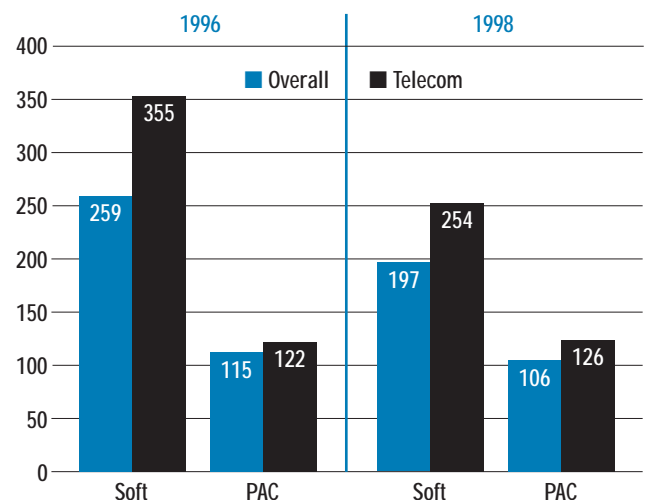
The rationale for such restrictions was that the BOCs continued to occupy monopoly bottleneck positions in the telecommunications marketplace and that they could—if allowed to integrate into otherwise competitive ancillary markets—inefficiently exclude competition. The restrictions were challenged almost at once by the BOCs, however, and the challenge gained momentum following a 1987 DOJ report that the telecommunications market was changing so rapidly that the rationale for restrictions was growing dubious.

Between 1987 and the mid-1990s, intense legal skirmishing occurred. As described by Peter Huber, author of the 1987 DOJ report:

[Judge Green’s] courtroom operated as a shadow FCC, an independent authority that scrutinized, cajoled, hectored, and prosecuted. There were hundreds of motions, complaints, and other requests to enforce, modify or interpret....

The 1996 Telecommunications Act put an end to all this. It transferred authority over the key line-of-business restrictions to the FCC, and it established a process and timetable for getting rid of them all.

Figure 4
Soft Money and PAC Contributions in
1996 and 1998 Cycles (1994=100)



Although some BOC requests were granted by the courts (with the D.C. Circuit Court typically overturning Judge Green, who exercised a high degree of skepticism regarding BOC filings), the activity generated by interest groups fighting for position created demand for judicial rulings rather than regulatory or legislative favors. That state of affairs was unsatisfactory in the opinion of incumbent representatives and senators. As the likelihood rose that BOC petitions would be granted (i.e., the restrictions would be abolished), Congress's incentive to enter the rent-seeking game increased (while there were still rents to seek). The incentive was felt by incumbents of both parties who were unified by an interest in promoting greater campaign support from interest groups and in fostering greater intimacy with corporate employers likely to be hiring after officeholders exited public life.

Moving the marketplace back to Congress's line-of-business restrictions was a popular, bipartisan objective among legislators. That perception more than likely propelled legislation that had been stalled for decades. And we can now judge whether Congress's self-interested objective has been met.

The evidence suggests that it has. In the 1996 and 1998 election cycles, federal political contributions by telecommunications firms rose absolutely and relative to the overall rise in political giving, according to data supplied by the Center for Responsive Politics (Figure 4). In both categories (soft money and PAC donations) in both cycles, telecommunications spending increased. Such success could be achieved by random chance just 6 times out of 100. To the quantifiable (i.e., financial) political gain, add the fact that the Telecommunications Act has provided a platform for an exceptionally newsworthy set of public issues, from the "big ticket" competitive issues discussed in this paper to the "hot button" social issues like TV violence, the V-chip, and Internet indecency. Even failings attributed (rightly or wrongly) to the act (e.g., cable rate increases) have afforded the opportunity for high-profile hearings and voluminous incumbent publicity. It would not be stretching the truth to say that the 1996 Telecommunications Act was close to an unmitigated political success.

CONCLUSION: GRADING ON THE CURVE

A SOBER ASSESSMENT OF THE MAJOR ECONOMIC PROVISIONS of the 1996 Telecommunications Act reveals that the legislation scores at the top of its class on standardized tests. In the principal markets reformed by the act, prices are not rising in quality-adjusted terms and, increasingly, customers are facing choices in service suppliers. More importantly, the capital markets—always looking to the future—indicate that those competitive forces will intensify. Billions of dollars are at stake in the growth and prosperity of firms that offer competitive local telephone and cable service. Monopoly services in the interim may cause justifiable impatience, but it must be pointed out that previous legislation—two comprehensive and much heralded Cable Acts in 1984 and 1992, for instance—never succeeded in pro-

ducing the degree of local telecommunications service rivalry that now exists on the competitive fringe.

How important was the 1996 legislation in promoting current and prospective benefits? The question is difficult to answer. Unfortunately, market forces do not bear the label, "Made in the Act." It is telling that earlier "reforms" produced demonstrably counterproductive effects for consumers, but such problems have yet to surface in the wake of the 1996 legislation. Indeed, the failings of the Telecommunications Act in promoting competition are likely to be found in its conservatism. The measure did not liberalize radio spectrum allocation or move aggressively to promote long distance entry by the BOCs. It mandated extensive safeguards and led the FCC to micro-manage reforms so tightly that the leading U.S. regulatory economist, Alfred Kahn, has proposed "deregulating the process of deregulation."

The cautious approach epitomized political compromise—words often heard in Washington in the same breath. In the Telecommunications Act, action was taken to put the government explicitly on the side of competition—an important move in markets where government has traditionally operated on the "natural monopoly" assumption. The opportunity to legislate was sweetened by the lure of taking back the brisk regulatory business brewing in Judge Green's courtroom. That opportunity does not diminish the reform but helps to rationally explain it.

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