VIDEO KILLED THE FRANCHISE STAR: THE CONSUMER COST OF CABLE FRANCHISING AND PROPOSED POLICY ALTERNATIVES

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Congress, state legislatures, and the Federal Communications Commission are all considering proposals to reform local video franchising to promote competitive entry. Consumers should welcome such reforms. We estimate that consumers pay an extra $8.4 billion annually in the form of higher rates and fees as a result of video franchise regulations. In addition, these price increases generate $2 billion in "deadweight loss," or value that consumers forego annually because higher prices induce some consumers to go without cable television. Unlike previous studies, our estimates include the cost of "nonprice concessions" (such as PEG channels) and franchise fees, in addition to the market power effect of cable franchising. We analyze a variety of options federal and state officials have to reduce these costs, including exemption of telephone companies from cable franchise regulations, FCC pre-emption of "unreasonable" franchising practices, and federal or state adoption of "open entry" laws to replace local franchising.

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INTRODUCTION

Congress, state legislatures, and the Federal Communications Commission are all considering initiatives to reform local video franchising to encourage competitive entry. Local franchising has been a mainstay of cable television regulation. Under federal law, a cable company cannot operate without a franchise, and only a local franchising authority may grant a franchise. In the early days of cable, franchises were seen as regulatory tools to deal with what was perceived as a natural monopoly. To that end, most municipalities would grant only one franchise to a monopoly cable provider. They would then try to mitigate the monopoly's market power by using the terms of the franchise. Municipal governments also found that by granting favorable franchise terms and protecting the incumbent from competitive entry, they too could share in the monopoly rents. More than two decades of historical data and academic research, however, have shown consistently that wireline video service is not a natural monopoly, and that cable rates are lower in areas that allow direct competition.

Acknowledging the benefits of competition, Congress in 1992 sought to eliminate the franchising barrier to entry by prohibiting local franchising authorities from unreasonably refusing to award more than one franchise. Nevertheless, most jurisdictions continue to be served by only one wireline video provider. Today, telephone companies and other utilities have begun to roll out video service, just as cable companies have begun to offer telephone service. The major obstacle to new video competition, however, is the thousands of franchises that must first be negotiated and acquired.

Part I of this Article reviews the economics literature related to cable franchising and demonstrates that there is no reasonable economic justification for monopoly video franchising today. Consumer rates are lower in areas where there is wireline video competition. Costs passed directly to consumers in the form of higher rates for service, fees, and equipment as a result of video franchise regulations total approximately $8.4 billion annually. We also find $2 billion annually in "deadweight loss," or value that consumers forego because higher prices induce some consumers to go without cable television. The total cost to consumers of franchise regulation thus equals about $10.4 billion annually.

Part II analyzes the options available to the Federal Communications Commission to deal with the franchising barrier to entry. These include exempting telephone companies from cable franchising regulations, as well as preempting local franchising laws and rules that act as unreasonable barriers to entry. Part III discusses the options available to state and federal legislators, concluding that local

franchises should be eliminated in favor of simple open entry rules.

I. ECONOMIC ANALYSIS OF CABLE FRANCHISING

Franchise regulation typically involves several different factors. No competitor can offer video service without the local government's permission.[1] Local authorities can regulate the price of "basic" cable service unless the FCC determines the local video market is competitive. Franchise authorities often impose regulatory mandates requiring franchisees to provide a variety of services for free or at below-cost charges, such as channels for public, educational, and government access; studios for creation of public access programming; and wiring of various public facilities. These are often called "nonprice concessions." Finally, franchisees must pay the local government a fee that is limited by federal law to five percent of gross revenues.

Rates for "expanded basic" and premium channels have been regulated under a variety of regimes since the 1970s.[2] Prices for expanded basic are no longer regulated. Since 90% of cable customers choose to buy expanded basic,[3] cable rates are effectively deregulated for most consumers. Even when most cable rates were regulated, it was doubtful that price regulation fully prevented cable companies from exercising market power and raising prices. Indeed, many studies find that price regulation ultimately had little effect on rates, and when rate regulation was effective cable companies responded by increasing other charges or reducing quality.[4]

Entry regulation, nonprice concessions, and franchise fees, on the other hand, have always existed in most localities. In contrast to price regulation, these other forms of regulation have been quite effective in limiting entry, requiring cable firms to provide free or subsidized services, and raising revenue for local governments.

1. The 1984 Cable Act mandated that local governments must franchise cable companies; prior to that, some states and localities—such as San Diego, California; Tucson, Arizona; and the entire state of Montana—required cable firms to have only a general business license. *See* Thomas W. Hazlett, *Cable TV Franchises as Barriers to Video Competition* 17 (2006), http://ssrn.com/abstract=889406.

2. The federal government preempted local rate regulation in the 1984 Cable Act, reimposed rate regulation in the 1992 Cable Act, and removed most of it in the 1996 Telecommunications Act. *Id.* at 29-30.

3. Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992, *Report on Cable Industry Prices*, 20 FCC Rcd. 2,718 (2005) [hereinafter *Report on Cable Industry Prices*].

4. Hazlett, *supra* note 1, at 29. ("Suppressing nominal rates prompts cable operators to retier, charge for additional (previously complimentary) services, tighten credit rules, tack on 'late fees,' and lower service quality. The latter is achieved by hiring fewer customer service representatives and repair technicians, while reducing expenditures for programming."). *Id*.

A. Franchise regulation in theory could promote the public interest

Franchise regulation could potentially promote consumer welfare in three ways. First, if video is an "unsustainable" natural monopoly with substantial sunk costs that prevent competitive entry, then competition is inefficient, and regulation of entry and prices could promote consumer welfare. Second, protecting a cable company from competition might lower its cost of capital by lowering the risk it faces, and price regulation could pass these savings on to consumers. Third, since local governments typically control the rights-of-way used by wireline video providers, some regulation of construction and placement of wires, along with a fee that compensates the public for use of the rights-of-way, can safeguard the public's property.

1. Natural monopoly

Price and service regulation can improve consumer welfare if the regulated industry is a "natural monopoly"—that is, if the relationship between costs and demand makes it possible for a single firm to serve the entire market at lower cost than multiple firms—and if sunk costs eliminate the potential for entry. "Sunk costs" are costs that cannot easily be recovered if the firm decides to exit the market. If there is a natural monopoly with sunk costs, price and service regulation may mitigate the monopolist's market power.

The existence of market power, however, does not by itself justify entry regulation. In most cases, if the market is a natural monopoly, then monopoly occurs without regulation. Entry regulation can improve consumer welfare only if a natural monopoly is "unsustainable"—that is, if a peculiar set of cost conditions would lead to the presence of more than one firm in the market even though a single firm can serve the entire market at lowest total cost.[5] When a natural monopoly is unsustainable, competitive entry may increase total costs and lead to higher average prices than if the market was monopolized and the monopolist was forced to sell at cost-based prices.

Even if the natural monopoly is unsustainable, however, competition can have two different effects on total costs. On the one hand, competitive entry could increase total costs if a single firm, operating efficiently, could serve the entire market at lower cost. On the other hand, competitive entry might also help decrease total costs by prompting the incumbent monopolist to become more efficient in order to compete more vigorously.

The concept of sustainability must be interpreted with care because

5. *See* WILLIAM J. BAUMOL ET AL., CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE 192-208 (1982).

it provides an easily abused piece of rhetoric to justify restrictions on competition that benefit incumbent firms. The fact that competition may lead some firms to incur losses need not signify that the market is an unsustainable natural monopoly. Losses are entirely consistent with a competitive market; they may simply signify that a firm is not as competent a competitor. Alternatively, losses may signify that the market is a *sustainable* natural monopoly—and losses are the incentive that ultimately drives the less efficient firms out of the market. Therefore, losses are not sufficient evidence to demonstrate that a market is an unsustainable natural monopoly.

If entry regulation promotes consumer welfare, one would expect to see it imposed only where local governments have determined that (1) video is a natural monopoly, (2) the natural monopoly is "unsustainable," (3) the monopoly will not waste the cost savings by becoming lax, and (4) price regulation will effectively pass the cost savings through to consumers. If all of those conditions hold, prices and service quality in markets where franchise regulation prevents competition should be at least as good as in markets where competition exists. If any of those conditions do not hold, however, franchise regulation of entry is at best superfluous and at worst a source of market power and increased consumer costs.[6]

2. Risk reduction

A second, distinct argument for entry regulation is that it can lead to lower prices for consumers when producers must invest in long-lived, specialized capital equipment that has little resale value. An industry or market requiring such investments need not be a natural monopoly. The price depends in part on the producer's cost of capital, which in turn depends on risk. Partially or fully protecting the producer from competition could reduce its risk, thereby lowering the cost of capital.[7] Effective price regulation could pass these cost savings through to consumers. If these price savings are sufficiently large, consumers might be better off with competition limited by entry regulation than they would be if competition were unrestricted.[8]

Under this theory, two conditions must hold if entry regulation is to

6. For a sample of the economics literature outlining the perverse incentives created when economic regulation substitutes for competition, *see, e.g.* Thomas W. Hazlett, *Competition vs. Franchise Monopoly in Cable Television*, 4 CONTEMP. POL'Y ISSUES 80 (1986); Thomas W. Hazlett, *Prices and Outputs Under Cable TV Reregulation*, 12 J. OF REG. ECON. 173 (1997); Thomas W. Hazlett, *The Demand for Regulated Franchise Monopoly: Evidence from CATV Rate Deregulation in California*, 29 ECON. INQUIRY 275 (1991).

7. *See* Victor P. Goldberg, *Regulation and Administered Contracts*, 7 BELL J. ECON. 427, 432 (1976).

8. *See id.* at 435.

improve consumer welfare. First, the potential price reductions that result from the reduction in the cost of capital due to the suppression of competition must be larger than the expected cost reductions that would occur as a result of unrestricted competition and innovation. It is unclear whether this is possible even in theory.[9] Second, price regulation or some form of binding contract must effectively pass these cost reductions through to consumers.

Empirically, the "specialized capital" theory implies that if entry regulation benefits consumers, we should observe lower cable prices or better service quality in jurisdictions where entry is controlled than in jurisdictions where competition was unrestricted at the time cable systems were first built or substantially upgraded.

3. Rights-of-way management

A third reason that franchise regulation might promote the public interest is that it gives local authorities a mechanism to manage the public rights-of-way.[10] The economic justification for public management of the rights-of-way is that it reduces transactions costs that might otherwise make certain uses of those rights-of-way unfeasible.[11] Municipal control over the rights-of-way, for example, allows utilities to more cheaply secure rights to use them than if the utility had to negotiate with many individual property owners. Additionally, unitary public control avoids hold-up problems.

The public rights-of-way are a scarce resource. If there are no restrictions on the way that utilities may make use of that resource, then there may be congestion.[12] Such congestion can impose significant costs on the public or other users in forms as diverse as misallocation of space, crowded utility ducts, or blight. Congestion can be addressed by instituting a cost-based charge calibrated to prevent overuse. The existence of scarcity by itself, however, does not justify limiting entry

9. *See, e.g.*, Robert B. Ekelund, Jr. & Richard S. Higgins, *Capital Fixity, Innovations, and Long-Term Contracting: An Intertemporal Economic Theory of Regulation*, 72 AM. ECON. REV. 32, 44 (1982) (finding that the *expected* price consumers pay under entry regulation is no better than the expected price they pay under unrestricted competition, and therefore regulation is preferred only if consumers are risk-averse).

10. In fact, Title VI of the Communications Act of 1934, which regulates video, limits the obligation to obtain a franchise to those operators that use a "public right-of-way." 47 U.S.C. § 522 (7)(B) (2000). The Act's legislative history further states that "[t]he premise for the exercise of . . . local jurisdiction over cable systems continues to be [the] use of local streets and rights of way." S. REP. NO. 97-518, at 5 (1982).

11. George L. Priest, *The Origins of Utility Regulation and the "Theories of Regulation" Debate*, 36 J.L. & ECON. 289, 306 (1993).

12. *See* Harold Demsetz, *Why Regulate Utilities?*, 11 J.L. & ECON. 55, 62 (1968); Gardner F. Gillespie, *Rights-of-Way Redux: Municipal Fees on Telecommunications Companies and Cable Operators*, 107 DICK. L. REV. 209, 220-21 (2002).

through franchising to only one firm.

Nevertheless, franchise regulation is one method by which a locality can regulate access to the public rights-of-way and impose congestion pricing. A franchise fee would be justified if it were "reasonably calculated to cover the cost that a given use of the public way imposes on either the municipality or the other users of the public way."[13] However, the efficient management of the public ways does not justify the imposition of a franchise fee that exceeds the costs that result from a franchisee's use of the rights-of-way. A franchise fee that merely maximizes revenues for the local government could easily exceed the cost-based charge needed to prevent congestion of the rights-of-way.

Neither does rights-of-way management justify government control over the content, quality, or price of video service, because such regulation would have nothing to do with either transaction costs or congestion. There may be many reasons to impose these types of regulations, but management of public rights-of-way is not one of them.

B. Franchise regulation in practice has harmed consumers

In theory, well-designed franchise regulation might promote consumer welfare under certain circumstances. In practice, franchise regulation has fostered monopoly and raised cable rates, with local governments sharing in the monopoly profits. As Hazlett has noted:

> Municipal governments discovered that they could extract substantial rents by awarding licenses on favorable terms to the applicant. In the 1960s, New York Mayor John Lindsay proclaimed cable franchises "urban oil wells beneath our city streets." This produced a decided bias in favor of monopoly, which would improve expected returns and so raise the "bid" from prospective applicants.[14]

Entry regulation by local franchising authorities is, of course, just one factor that might hamper wireline video competition. A Government Accountability Office (GAO) case study of new competitive broadband service providers (BSPs), which offer both video and Internet service, identified several factors that influence these new entrants' decisions to compete in a given market.[15] Among other factors, the BSPs said they tend to choose cities where local officials actually welcome competition

13. Diginet, Inc. v. W. Union A.T.S., Inc., 958 F.2d 1388, 1399 (7th Cir. 1992).

14. Thomas W. Hazlett, *Cable Television*, 2 HANDBOOK OF TELECOMMUNICATIONS ECONOMICS: TECHNOLOGY EVOLUTION AND THE INTERNET 214-15 (Sumit K. Majumdar et al. eds., Elsevier Science 2006).

15. GOVERNMENT ACCOUNTABILITY OFFICE, TELECOMMUNICATIONS: WIRE-BASED COMPETITION BENEFITED CONSUMERS IN SELECTED MARKETS 20-21 (2004), *available at* http://www.gao.gov/new.items/d04241.pdf.

and make the franchising process easy. Key barriers identified by the competitors include lengthy processing times for franchise applications, franchise fees, the cost of construction permits, and state "level playing field" laws, which require new franchisees to agree to terms and conditions at least as onerous as those imposed on the incumbent.[16] Cities eager to see new competition have approved franchise agreements in as little as 120 days, whereas competitors have abandoned their applications in other cities after waiting two and one-half years.[17] Even seemingly symmetric requirements can actually disadvantage competitors. For example, requiring a competitor to meet the same buildout schedule in the entire service area as the incumbent ignores the fact that the incumbent likely fulfilled this requirement when the metropolitan area was smaller, and then gradually added facilities as population grew.[18] New competitors clearly view restrictive franchising as one significant factor that discourages market entry.

Other potential entrants into the video market—such as telephone companies using fiber optic or DSL, or electric utilities employing broadband over powerlines—are much less likely to face the non-franchise difficulties identified by the BSPs. Phone and power companies are not startups. They already have substantial facilities in place, and they likely have much better access to capital than the BSPs. Phone and power companies can surmount many barriers affecting the BSPs—but the franchising barrier remains.

Franchise regulation has harmed consumer welfare by excluding competitors, forcing cable companies to offer "nonprice concessions" that increase consumer costs, and imposing franchise fees that also increase consumer costs.

1. Anticompetitive exclusion

Entry regulation was not surgically applied to remedy proven market failures, but rather adopted as a general policy almost everywhere. The result was to create market power and entrench cable monopolies.

If entry regulation is a remedy for unsustainable natural monopoly or reduces cable companies' costs, then monopolized video markets should have lower costs, lower prices, and perhaps better quality than competitive markets. Several decades of studies reveal that precisely the opposite is the case.

16. *Id*.
17. *Id.*
18. *Id.* at 25.

TABLE 1: CABLE RATES FOR BASIC, EXPANDED BASIC, AND EQUIPMENT RENTAL

	Monthly Rate of Basic + Expanded Basic + Equip't		Channels		Price Per Channel	
	Non-Compet.	*Wire Compet.*	*Non-Compet.*	*Wire Compet.*	*Non-Compet.*	*Wire Compet.*
2002	$39.97	$34.89	NA	NA	NA	NA
% difference		*-12.71*				
2003	$43.14	$37.22	67.3	71.2	$0.657	$0.528
% difference		*-13.72*		*5.79*		*-19.63*
2004	$45.56	$38.80	70.1	74.9	$0.665	$0.523
% difference		-14.84		6.85		-21.35

Source: *Report On Cable Industry Prices*, *supra* note 3, at attachments 7-9.

One need look no further than the FCC's February 2005 report on cable prices for some highly suggestive evidence. As Table 1 shows, during the past several years, the price of a package including basic, expanded basic, and equipment rental has been between 12 and 15% lower in markets where the FCC has determined the incumbent faces effective competition from another wireline video provider. Since competition also spurs cable companies to include more channels in the expanded basic package, the difference in the price consumers pay per channel is even larger—between 19 and 22%.

Statistics on digital cable, shown in Table 2, tell a similar story. During the past several years, the price of the digital tier has been three to six percent lower in markets with wireline video competition, and the price per channel has been six to 13% lower. In 2004, several other charges were also lower on average in markets with wireline video competition: reconnection ($26.76 vs. $28.71) and installation in an unwired residence ($43.00 vs. $45.19). Only installation in a previously wired residence was less expensive in markets without wireline competition—by 33¢ ($31.57 vs. $31.24).[19]

TABLE 2: DIGITAL CABLE RATES

	Monthly Rate of Digital Tier		Channels		Price Per Channel	
	Non-Compet.	*Wire Compet.*	*Non-Compet.*	*Wire Compet.*	*Non-Compet.*	*Wire Compet.*
2002 *% diff.*	$14.56	$13.68 -6.04	NA	NA	NA	NA
2003 *% diff.*	$15.29	$14.56 *-4.77*	27.3	28.8 *5.49*	$0.686	$0.641 *-6.56*
2004 *% diff.*	$16.09	$15.64 *-2.80*	31.4	33.8 *7.64*	$0.588	$0.513 *-12.76*

Source: *Report on Cable Industry Prices*, *supra* note 3, at attach.12-14.

These average price comparisons may be vulnerable to two criticisms. First, the categories are based on past FCC determinations of whether the incumbent faces effective competition from various sources, including wireline, wireless, and direct broadcast satellite. Incumbents have to petition for these findings, and a finding of effective competition releases the incumbent from regulation of basic cable rates.[20] It is possible, therefore, that some markets where the incumbent faces competition are in the "noncompetitive" category because they have never petitioned for a finding that they face effective competition.

19. *Report on Cable Industry Prices*, *supra* note 3, at attach.11.
20. 47 C.F.R. § 76.905-07 (2005).

Alternatively, the FCC might classify some markets as "competitive" even if the competitor has disappeared. For these reasons, the raw price comparisons may either under- or overstate the effect of wireline video competition on rates.[21]

A more fundamental criticism is that the raw data do not control for other factors affecting cable rates. If, for example, markets with multiple competitors have population patterns or geography that make them less expensive to serve, then those underlying factors might be responsible both for the lower rates and for the presence of competitors. Econometric analyses that control for other factors, however, consistently find that video markets with more competition have lower prices and better service packages.

In April 2005, the GAO released an analysis of 2004 cable rate data that corrected for both potential problems. GAO's econometric analysis found that wireline cable competition reduced cable rates by 15.6%. The cable rate measure in GAO's study was the total price of basic, extended basic, and converter box rental—similar to the figure listed in Table 1 above.[22] GAO omitted franchise areas with competition from a municipal cable company;[23] thus, the analysis avoids confusing the effects of competition with the effects of possible municipal subsidies. GAO's analysis found that private wireline competition had an even bigger effect on prices than the FCC's raw data might indicate. In addition, GAO found that regulation of basic cable rates has no

21. *Report on Cable Industry Prices*, *supra* note 3, at 2. For elaboration of this criticism and the FCC's response, *see* GOVERNMENT ACCOUNTABILITY OFFICE, TELECOMMUNICATIONS: ISSUES RELATED TO COMPETITION AND SUBSCRIBER RATES IN THE CABLE TELEVISION INDUSTRY 16-18, 70-79 (2003), *available at* http://www.gao.gov/new.items/d048.pdf.

22. GOVERNMENT ACCOUNTABILITY OFFICE, TELECOMMUNICATIONS: DIRECT BROADCAST SATELLITE SUBSCRIBERSHIP HAS GROWN RAPIDLY, BUT VARIES ACROSS DIFFERENT TYPES OF MARKETS 31 (2005), *available at* http://www.gao.gov/new.items/d05257.pdf. The results are very similar to those found in previous runs of GAO's model, such as its October 2003 report. GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 21. An earlier version of our analysis reported that GAO found a 16.9% price difference due to wireline cable competition; this resulted from an erroneous interpretation of one of GAO's regression coefficients. We interpreted the coefficient on the competition dummy variable as the percentage price change due to competition. Because the variables in the GAO model were in logarithms, the price effect is actually equal to (exp(-0.1694)-1), or 15.6%. *See* Comments of Jerry Brito & Jerry Ellig to the *Notice of Proposed Rulemaking* in Implementation of Section 621(a)(1) of the Cable Communications Policy Act of 1984 as amended by the Cable Television Consumer Protection and Competition Act of 1992, MB Dkt. No. 05-311 (Feb. 13, 2006), http://gullfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=6518327082. For an explanation of the econometric interpretation issue, *see* Robert Halvorsen & Raymond Palmquist, *The Interpretation of Dummy Variables in Semilogarithmic Equations*, 70 AM. ECON. REV. 474 (1980). We are grateful to George Ford for pointing out the error—which fortunately did not affect our estimate of the total effect on consumer welfare very much.

23. GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 22, at 29.

statistically significant effect on rates,[24] which suggests that rate regulation is largely ineffective at controlling monopoly pricing.[25]

These kinds of results are consistent with findings of numerous earlier studies. A monograph on the economics of cable TV cites 11 different studies or surveys conducted between 1984 and 1992 that find wireline cable competition reduces cable prices by between 8% and 34%.[26] The FCC's own 2002 econometric study found that the presence of wireline video competition reduces cable rates by 5.4%.[27] The seminal empirical studies of cable competition, by Thomas Hazlett, found that in areas with two or more overlapping cable systems, monthly bills for basic cable and HBO were about $1.82 lower than in localities with only one cable franchisee.[28] Once regarded as heresy, the notion that cable competition leads to lower prices must now be accepted as documented fact.

Incumbent cable operators responded to competition with more than just price reductions. Faced with competition from direct broadcast satellite in the mid-1990s, which offered a digital signal, cable operators nearly doubled their bandwidth, from 450 MHz to 750 MHz, and offered their own digital service.[29] When direct broadcast satellite carries local broadcast channels, and hence becomes a closer substitute for cable, cable operators offer about 5% more channels than elsewhere.[30] The FCC data in Tables 1 and 2 demonstrate that cable companies offer more channels, on average, when they face wireline video competition. Consistent with these raw figures, the most recent run of GAO's cable/satellite competition model finds that cable systems tend to offer more channels where satellite has a higher market share and where wireline video competition is present.[31] The GAO case study of

24. *Id.* at 31.

25. Further evidence comes from a 2004 GAO case study that compared six markets having competing broadband service providers with six similar markets lacking such competition. GAO found that in five of the six competitive markets, expanded basic cable rates were lower than in similar markets without such competition. Rate differences ranged from 15 to 41%. Telephone service cost between 4 and 33% less in five of the markets, and about the same in the remaining one. High-speed Internet service cost 20 to 38% less in three of the markets with competition, and about the same in the other three. On average, rates for a package of cable, high-speed Internet, and telephone service were 15% lower in the markets with competition. *See* GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 15, at 12, 15-16.

26. THOMAS W. HAZLETT & MATTHEW L. SPITZER, PUBLIC POLICY TOWARD CABLE TELEVISION: THE ECONOMICS OF RATE CONTROLS 30 (1997).

27. *See Report on Cable Industry Prices*, *supra* note 3, at 29.

28. Hazlett, *Competition vs. Franchise Monopoly in Cable Television*, *supra* note 6, at 80, 91.

29. Hazlett, *supra* note 14, at 208.

30. GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 21, at 59-61.

31. GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 22, at 31. The presence of a wireline video competitor increases the number of channels offered by the incumbent cable company by about eight percent.

broadband service providers, meanwhile, found that cable companies tend to respond to these new competitors by lowering prices, expanding service offerings, and improving customer service.

These findings undercut the natural monopoly justification for entry regulation, which posits that the market can be served at lowest cost by a single firm. They also cast doubt on the "specialized capital" justification. Even when cable was first deployed in major population centers, jurisdictions with open entry policies had rates no higher than state or national averages, and jurisdictions with competing cable systems had rates lower than monopolized jurisdictions. Open entry and competitive jurisdictions often had much higher cable penetration rates, suggesting that cable service was deployed faster or was of higher quality than in monopoly jurisdictions.[32]

Finally, the fact that different scholars using different data and different methods have reached the same conclusion over the course of two decades also undermines any claims that the competition and low prices are transitory, "unsustainable" phenomena. The benefits of video competition are conclusive.

2. Nonprice concessions

Regulatory mandates in franchise agreements increase costs, and possibly prices. Franchises granted by local authorities often include many "nonprice concessions" by the cable operator. These include such things as channels devoted to public, educational, and government use ("PEG" channels), free wiring and connection of local public institutions, community programming capacity that includes studio space and equipment for local government use, institutional networks linking different government facilities such as the fire department and city hall, excess channel capacity, and other perquisites. Such mandates are potentially dangerous for consumers because, unlike franchise fees, they are not effectively regulated by federal legislation. Indeed, even though the 1984 Cable Act now prevents localities from charging franchise fees in excess of five percent, a local franchising authority can now simply demand more in-kind services instead.[33]

Several studies reveal that nonprice concessions significantly raise cable costs. Examining data from the early 1980s, Hazlett found that total annualized costs of uneconomic investments made due to franchising were equal to 16-19% of annual cable revenue. Annualized costs of lobbying for the franchise equaled about 4% of annual

32. Hazlett, *Competition vs. Franchise Monopoly in Cable Television*, *supra* note 6, at 84-87, 90-91.

33. Hazlett, *supra* note 14, at 216

revenues.[34] Similarly, a 1984 survey of cable operators by Mark Zupan showed that nonprice concessions significantly raise cable costs. Nonprice concessions accounted for 26% of building costs and 11% of operating expenses.[35] Zupan's econometric analysis found that the monthly rate for basic cable would have been an average of 49¢, or about 5.2%, lower in the absence of nonprice concessions.[36] Additionally, the survey found that much of the capacity created as a result of the nonprice concessions goes largely unused, and operators indicated that they would never freely invest in such systems.[37] PEG channels, the local community programming very often required by franchisors, have little or no effect on demand for cable. "Televised city council meetings and local high school football games simply do not sell many subscriptions for an operator."[38]

It is especially difficult to discern how much of the cost of nonprice concessions is passed through to consumers, because many of these concessions are fixed and sunk costs. As such, they should have no effect on current cable prices unless the prices are effectively regulated and the regulator permits the firm to pass the costs through to consumers. At the time of Zupan's survey, many localities regulated cable rates. Franchise agreements may well have involved tradeoffs in which the cable firms received the right to charge higher prices if they provided more free or discounted services that local governments wanted. Today, the regulatory situation is different. Since most consumers face deregulated cable prices, cable companies would presumably charge the same profit-maximizing prices regardless of how nonprice concessions affect their fixed or sunk costs. This is just an application of the tried-and-true economic principle that in the absence of price regulation firms tend to set prices based on a comparison of marginal costs and marginal revenues.

There is one circumstance in which nonprice concessions might affect consumer prices by affecting the firm's perceived marginal costs. If local governments require cable companies to provide larger nonprice concessions (or more funding for nonprice concessions) as the number of subscribers or revenues rise, then the cable company is likely to perceive that funding requirement as a marginal cost. In effect, it is a tax that varies with revenues or with the number of subscribers. Comments filed

34. Thomas W. Hazlett, *Private Monopoly and the Public Interest: An Economic Analysis of the Cable Television Franchise*, 134 U. PA. L. REV. 1335, 1401 tbl.3 (1986).

35. Mark A. Zupan, *The Efficacy of Franchise Bidding Schemes in the Case of Cable Television: Some Systematic Evidence*, 32 J.L. & ECON. 401, 405 (1989).

36. *Id*. at 417. Percentage calculated by dividing 49¢/month by the average monthly rate for basic service of $9.35. *Id*. at 442.

37. *Id*. at 405-6.

38. *Id*. at 406.

by nearly 200 local governments in the FCC's video franchising proceeding reveal that many franchising authorities require or authorize cable companies to impose a specific fee on each subscriber each month, usually to support PEG channels.[39] Thus, PEG fees are the most likely nonprice concessions to affect prices paid by consumers.

3. Franchise fees

Franchise regulation also involves fees, the costs of which are passed through to consumers. Federal regulation limits franchise fees to five percent of a cable company's gross revenues from the sale of video services. The five percent franchise fee acts as an excise tax on services sold by companies that hold cable franchises. To the extent that this fee merely reimburses the local government for costs associated with the video provider's use of the public rights-of-way, it provides an accurate price signal that makes cable firms take these costs into account. To the extent that the fee exceeds the actual costs, then it simply forces the price of video service higher and gives the local government a stake in higher prices.

The data on cable rates gathered in FCC surveys do not include the cost of franchise fees.[40] Thus, the maximum five percent fee imposes an additional cost on consumers over and above the price increases identified in the GAO studies.

C. An estimate of the total costs of franchise regulation

Anticompetitive exclusion, cost-increasing mandates, and franchise fees all affect consumer welfare. They do so in two distinct ways. The price increases transfer wealth from consumers to cable firms and local governments. In addition, consumers purchase and use less cable service in response to the price increase. Fewer consumers subscribe to cable, and the consumers in areas without direct cable competition tend to receive a lower-quality package because it has fewer channels. The value consumers forego because less or lower-quality service is purchased is an important, but hidden, cost of regulation.

39. We searched for every comment filed by a city, county, town, village, or township using the FCC's Electronic Comment Filing System, http://gullfoss2.fcc.gov/prod/ecfs/comsrch_v2.cgi. Approximately 175 local entities are represented. The most common form of PEG fee mentioned was a monthly per subscriber charge. In a few cases the fee is expressed as a percentage of gross revenues—as high as three percent in the case of Bowie, Maryland.

40. Telephone Interview with John Scott, Industry Analysis Division, Media Bureau, Federal Communications Commission, in Washington, D.C. (Jan. 27, 2006). This is also implied by the fact that the federal law allows cable operators to list the franchise fee as a separate line item on cable bills. 47 U.S.C. § 542(c) (2000).

1. Price increases and wealth transfers

The price increase transfers money from consumers to cable companies and/or local governments. Economists call this effect the "wealth transfer." It is equal to $\Delta p \cdot q$, where Δp is the price increase caused by regulation and q is the amount of service purchased.

For cable franchising, Δp is the sum of three costs: (a) the price increase that occurs because of market power, (b) the price increase caused by the increased costs created by nonprice concessions demanded by local franchising authorities, and (c) the five percent franchise fee.

a. Price increase due to market power

We can calculate (a) from data and studies that assess the effect of wireline video competition on cable rates. The most recent and careful study appears to be the 2005 GAO study, which uses 2004 data to estimate that wireline video competition reduces monthly cable rates by about 15.6%.[41] In 2004, the monthly rate for basic, expanded basic, and equipment rental in markets without wireline competition was $45.52—virtually identical to the weighted average of $45.56 in all markets the FCC designated as "noncompetitive."[42] A 15.6% reduction equals $7.10 per month.

According to FCC data, 3.09% of cable subscribers are in markets with wireline video competition.[43] Total cable subscribership stood at 66.1 million in 2004.[44] Therefore, approximately 2 million cable subscribers were in markets with wireline video competition, leaving about 64 million in markets without wireline video competition. If these 64 million consumers paid an average of $7.10 more per month than they would have paid in the presence of wireline video competition, the

41. GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 22, at 31. GAO's statistical approach draws upon, and is consistent with, best practices in the scholarly literature.

42. Calculated from figures in the *Report on Cable Industry Prices*, *supra* note 3, at attach. 1, and subscribership information in the Federal Communications Commission's Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, *Twelfth Annual Report*, 21 FCC Rcd. 2,503, tbl.B-1 (2005) [hereinafter CABLE COMPETITION REPORT]. Other markets the FCC deemed competitive were those where the incumbent was found to face adequate competition from DBS or wireless cable, or where the incumbent had a penetration rate below a designated threshold. The weighted average price for all of these markets lacking wireline competition is about the same as in noncompetitive markets because prices in markets with competition from wireless cable are actually higher than prices in noncompetitive markets.

Since the FCC averages may suffer from inaccuracies identified in *supra* note 21 a more accurate calculation would use averages for noncompetitive and wireline competition markets derived from the GAO's (2005) data set. Unfortunately, GAO's data set includes some proprietary data that are not available to the public, so the FCC figures are the best available to us.

43. *Report on Cable Industry Prices*, *supra* note 3, at attach.1.

44. CABLE COMPETITION REPORT, supra note 42, at app.B, tbl.B-1.

wealth transfer from the price increase on basic, extended basic, and equipment rental totaled $5.5 billion in 2004.

FCC data also permit a rough estimate of the wealth transfer that occurs because incumbents who do not face wireline video competition can charge higher prices for digital cable. The weighted average price of the digital tier in markets lacking wireline video competition equals $16.06 per month, versus $15.64 in the markets with wireline video competition. The $5.00/year difference, multiplied by an estimated 22.5 million digital subscribers, yields a wealth transfer in 2004 of $113 million.[45]

We have found no data from recent years that would let us assess whether franchising restrictions allow incumbent cable operators to charge higher prices for premium channels. To the extent that they can do so, our calculations understate the effects of market power on prices paid by consumers.

b. Nonprice concessions

The cost of nonprice concessions is more difficult to peg, as the FCC does not systematically gather data on the costs, and few studies examine their effect on rates. Earlier studies identified very large costs associated with nonprice concessions, especially uneconomical investments.[46] One systematic survey, conducted by Mark Zupan in 1984, suggests that nonprice concessions equal between one percent and 6.45% of costs.[47]

Another clue about the cost of nonprice concessions comes from Comcast's assertion that it spends $100 million annually to support PEG channels.[48] According to Comcast's 2004 annual report, the company

45. Calculated from data on total subscribership, digital subscribership, and digital tier price in REPORT ON CABLE INDUSTRY PRICES, supra note 22, at attach. 12, 16, and CABLE COMPETITION REPORT, supra note 42, at app.B, tbl.B-1. The price difference for digital is based on a comparison of raw averages compiled by the FCC, not econometric analysis that controls for other factors affecting rate differences. Nevertheless, GAO's statistical analysis of basic plus extended basic rates finds that competition led to a 2004 rate differential (15.6%) slightly larger than that identified in the FCC's comparisons of average price data in Table 1 (14.82%). If the same relationship exists between raw averages and the results that an econometric analysis of digital cable would find, our calculation may slightly understate the wealth transfer.

46. Hazlett, *supra* note 34.

47. Zupan classifies franchise fees as nonprice concessions; the figures cited above omit franchise fees. Zupan lists a category of "other" operating costs associated with franchising that are equal to about 1.1% of revenues from basic service. An additional category of "non-operating" costs associated with franchising amount to about 2.8% of revenues from basic service. Another table in Zupan's study calculates that operating costs associated with nonprice concessions account for about 6.45% of costs. Figures are calculated from data in Zupan, *supra* note 35, at 406, 442-43.

48. CABLE COMPETITION REPORT, *supra* note 42, at ¶ 136.

had 21.5 million cable subscribers in that year[49], which implies an expenditure on PEG channels equal to $4.65 per subscriber. That equals 38.75 cents per subscriber per month, or just under one percent of the price of basic, extended basic, and equipment rental.

In response to the FCC rulemaking, about 175 cities, counties, and other local governments filed comments describing their franchising processes.[50] Approximately 40 mentioned that they assess a fee on cable bills to support the operating costs of PEG channels (and sometimes other public access mandates). These fees ranged between 5 cents and $1.25 per subscriber per month. The fees identified by larger cities tended to be between 40¢ and $1.00. A few local authorities state the PEG fee as a percentage of gross revenues – in one case as high as three percent. Numerous other local franchising authorities stated that the cable company supported PEG channels and other government-mandated services through mandatory or voluntary contributions of a specified dollar amount. Since they did not provide subscribership numbers, it is not possible to convert these dollar amounts into per-subscriber figures. PEG channels, of course, are not the sole form of nonprice concession.

It is clear that the costs of nonprice concessions are substantial, but it is unclear how much of these costs are passed on to consumers. We conservatively assume that nonprice concessions add one percent per year to the price consumers pay for cable, which is consistent with the Comcast figures and the lower range of the PEG fees in larger cities. As noted above, the PEG fee on cable bills is the cost most likely to be passed on to consumers, because it is the type of PEG cost that cable operators are most likely to perceive as an increase in marginal cost. A one percent PEG fee would raise approximately $350 million from cable subscribers in markets that lack wireline video competition.[51] An additional $16 million comes from the 2 million cable subscribers in markets with wireline video competition and the 1.4 million BSP subscribers, which the FCC does not include in its count of cable subscribers.

c. Franchise fee

The franchise fee applies to all cable consumers, not just those in the markets that lack wireline video competition. Formally, cable companies pay the fee, but they usually add a separate charge for the fee

49. COMCAST, 2004 ANNUAL REPORT 22 (2004), *available at* http://ccbn.mobular.net/ccbn/7/981/1039.

50. Method used for gathering these data is described *supra* note 39 and accompanying text.

51. A one percent PEG fee times a $45.52 average monthly cable bill equals a price increase of 46¢/month, or $5.52 per year. Multiplying this figure times 64 million subscribers yields $350 million/year.

onto the consumer's bill. The add-on by itself, however, does not tell us whether the total price paid by the consumer actually rises by an amount equal to the fee. One of the most well-known tenets of the economics of taxation is that the party that formally "pays" a tax does not necessarily bear the burden of the tax. The incidence of the tax—who really pays—depends on the elasticities of supply and demand, as well as the competitiveness of the market.

As a percentage of gross revenues, the franchise fee is a product-specific *ad valorem* tax. Economic theory shows that when a product is supplied in a competitive market at constant marginal cost, a tax on that product is fully passed through to consumers.[52] If marginal cost is not constant, then the extent of pass-through depends on the relative elasticities of supply and demand.[53] There is little reason to believe that a cable company's supply curve is not highly elastic; indeed, in the short run marginal cost may even be falling due to economies of density. Thus, cable companies in competitive markets are likely to pass the costs of the franchise fee through to consumers. If the firm has some market power—which may be the case in markets with two cable companies and is surely the case in markets with only one cable company—then the tax incidence is less clear. Economic theory suggests that a firm with market power could pass all or only some of the cost through to consumers – or it may even be able to raise prices by more than the amount of the tax.[54] The actual result depends on the behavior of costs, characteristics of consumer demand, and the competitiveness of the market. Thus, whether the cable companies with market power pass the entire franchise fee through to consumers is an empirical question.

Most empirical studies of cable markets report results consistent with a complete pass-through of the franchise fee to consumers. Several of the most recent studies find that the franchise fee has no statistically significant effect on cable prices.[55] This finding is consistent with full

52. *See*, *e.g.*, EDGAR BROWNING & JACQUELINE BROWNING, PUBLIC FINANCE AND THE PRICE SYSTEM (1979).

53. *See* John F. Walker, *Do Economists Ever Agree? The Case of the Teaching of Excise Tax: Shifting and Incidence,* 27 NAT. TAX. J. 351 (1974).

54. *See* Simon P. Anderson, et al., *Tax Incidence in Differentiated Product Oligopoly*, 81 J. PUB. ECON. 173 (2001); Paul G. Barnett, et al., *Oligopoly Structure and the Incidence of Cigarette Excise Taxes*, 57 J. PUB. ECON. 457 (1995); Jeremy I. Bulow & Paul Pfleiderer, *A Note on the Effect of Cost Changes on Prices*, 91 J. POL. ECON. 182 (1983).

55. T. Randolph Beard, et al., *Fragmented Duopoly: A Conceptual and Empirical Investigation* 78 J. BUS. 2377, 2390 (2005) (1991-92 data); Richard O. Beil, Jr., et al., *Competition and the Price of Municipal Cable Television Services: An Empirical Study*, 6 J. REG. ECON. 401, 410 (1993) (1989 data); Austan Goolsbee & Amil Petrin, *The Consumer Gains from Direct Broadcast Satellites and the Competition with Cable TV,* 72 ECONOMETRICA 251, 372 (2004) (2001 price data).

One study that finds franchise fees have a statistically significant effect on basic cable prices is John W. Mayo & Yasuji Otsuka, *Demand, Price Regulation, and Regulation:*

pass-through of the costs to consumers, because the cable rate data used in these studies does not appear to include franchise fees; companies add the franchise fees onto the customer's bill along with taxes and other regulatory charges. If cable companies were not fully passing through the franchise fee to consumers, then a higher franchise fee would be associated with lower cable rates, since the company would reduce the price of cable somewhat to compensate for the franchise fee.[56]

Prior to the 1992 Cable Act, which capped franchise fees at five percent, franchise fees ranged from zero to as high as nine percent.[57] The Cable Act appears to have made franchise fees much more uniform. Out of approximately 175 local governments that filed comments in the FCC's video franchising proceeding, only three reported franchise fees substantially different from five percent. Montrose, CO, White, SD, and Esopus, NY each charge three percent.[58] Therefore, we assume a franchise fee equal to five percent of gross cable revenues.

If cable operators did not have to pay a five percent franchise fee, and if competition forced them to pass this cost saving through to consumers, then the final price of basic, extended basic, and equipment rental is $2.28 per month higher in markets without wireline video competition and $1.94 higher in markets with wireline video competition.[59] The fee, multiplied by 64 million subscribers in markets

Evidence from the Cable TV Industry, 22 RAND J. ECON. 396, 408 (1991). Using data from the early 1980s, they find that a one percent increase in the franchise fee is associated with an 8.1 cent/month increase in basic cable rates, which is approximately a one percent increase. They do not specify whether their cable rate data are pre- or post-fee prices. If post-fee, their result suggests 100% passthrough of the cost of franchise fees to consumers. If pre-fee, their result suggests that the franchise fee prompts cable companies to increase prices by more than the amount of the fee. However, a study by one of the same authors using the same data finds that the effect of franchise fees on basic cable prices disappears after controlling for the quality of service. *See* Yasuji Otsuka, *A Welfare Analysis of Local Franchise and Other Types of Regulation: Evidence from the Cable TV Industry*, 11 J. REG. ECON. 157, 176 (1997).

The other principal study that finds franchise fees may have a statistically significant effect on cable prices is Zupan's empirical study, based on 1984 data gathered via a telephone survey. Zupan appears to include franchise fees in the cable price. He finds that basic cable rates would have been 49¢ (or 5.2%) lower in the absence of nonprice concessions including franchise fees. Zupan, *supra* note 35, at 417. The costs most likely to affect cable rates would be the costs that are not fixed: franchise fees and "other operating costs" associated with franchising. His data imply an average franchise fee of about 3.1% of gross revenues and "other operating costs" of franchising equal to 1.1% of the price of basic service, for a total of 4.2%. *Id*. at 442-43. Zupan's price effect, therefore, implies that the franchise fee and increased operating costs associated with franchising are fully passed through to consumers.

56. We cannot, however, be 100% certain that the fee is fully passed through, because the studies might also find no effect if franchise fees are relatively uniform across jurisdictions.

57. *See*, *e.g.*, Mayo & Otsuka, *supra* note 55, at 400.

58. Method used for gathering these data is described in *supra* note 39.

59. In an earlier version of our analysis, our calculation assumed that the observed prices of cable service equals the price without the fee times 1.05. Hence, we calculated that the price without the fee would equal the observed price divided by 1.05, which is equivalent

without wireline video competition, yields an annual wealth transfer of $1.75 billion. We multiply the $1.94 fee times 3.4 million, which represents the 2 million cable subscribers in markets with wireline video competition plus 1.4 million BSP subscribers, which are not included in the FCC's count of cable subscribers. The wealth transfer from the subscribers in these more competitive markets equals $79 million.

These calculations show the wealth transfer just for basic, extended basic, and equipment rental. The franchise fee, however, applies to cable companies' gross video service revenues, which include premium channels. The National Cable & Telecommunications Association (NCTA) estimates that cable companies paid $2.4 billion in franchise fees in 2004.[60] We use this figure as our estimate of franchise fees paid by the cable companies that do not face wireline video competition.

d. Total wealth transfer

Table 3 shows the total wealth transfers in both types of markets. For each type of market, the figures in each row are cumulative, adding the effect of the new factor identified in each row. (The one exception is the digital price change and the number of digital subscribers; those

TABLE 3: WEALTH TRANSFERS

Effect	Monthly Price Change	Subscribers	Wealth Transfer
Markets without wireline competition			
Market Power – Basic, extended, equipment	$7.10	64 mil.	$5.5 bil.
+ Nonprice concessions	$7.56	64 mil.	$5.8 bil.
+ Franchise fees	$9.83	64 mil.	$8.2 bil.
+ Market Power – Digital	$5.00 (digital)	22.5 mil. (digital)	$8.3 bil.
Markets with wireline competition			
Nonprice concessions	$0.39	3.4 million	$16 mil.
+ Franchise fees	$2.33	3.4 million	$96 mil.
TOTAL ALL MARKETS	N.A.	67.4 MIL.	$8.4 BIL.

to multiplying the observed price by .952. We have since learned that the FCC cable rate data do not include franchise fees, so pass-through of a five percent fee would raise the price to the consumer by five percent.

60. NATIONAL CABLE & TELECOMMUNICATIONS ASSOCIATION, 2005 MID-YEAR INDUSTRY OVERVIEW 22 (2005), *available at* http://i.ncta.com/ncta_com/PDFs/CableMid-YearOverview05.pdf.

figures are for digital only.) By far the largest effect stems from market power, which leads to a $5.5 billion increase in consumer costs. Nonprice conessions and franchise fees raise the total wealth transfer to $8.4 billion. Most of these costs occur in the markets lacking wireline video competition, simply because the vast majority of cable subscribers are located in these markets.

2. Forgone consumer benefits

In addition to redistributing money from consumers to cable companies and local governments, the price increase caused by franchise regulation leads to changes in consumer behavior. Consumers are worse off when they purchase less of a service because prices are higher than they would otherwise be. Theoretically, their loss can be measured by the difference between the value of the service to them and the price they would have paid. Economists call this difference the "consumer surplus" forgone as a result of the price increase.

In cable markets, franchise regulation leads to forgone consumer surplus in two ways. First, price increases for cable service lead to lower subscription levels. Second, the absence of wireline video competition reduces quality by reducing the number of channels the cable operator offers as part of its extended basic package.

In general terms, the value of the forgone consumer surplus can be calculated as $.5 \cdot \Delta p \cdot \Delta q$.[61] The term Δp refers to the price increase caused by franchise regulation, and Δq is the reduction in quantity sold due to the price increase. In other words, the forgone consumer surplus equals approximately one-half of the change in price induced by regulation times the change in quantity induced by the price change.

The trickiest aspect of these calculations—aside from actually getting the relevant data—is ascertaining how much of a change in quantity occurs as a result of a regulation-induced price change. The change in quantity can be calculated from the change in price with the aid of an estimate of the price elasticity of demand. The price elasticity of demand measures how responsive quantity is to price. It is equal to the percentage change in quantity divided by the percentage change in price. The elasticity of demand is defined as $(\Delta q/q)/(\Delta p/p)$. If one has an estimate of the elasticity and also the values of p, Δp, and q, then one can solve algebraically for Δq and estimate the forgone consumer surplus.

Virtually every study of cable television subscription demand finds that demand is very responsive to price. During the past 25 years, studies have produced demand elasticity estimates ranging from -1.5 to as high

61. See Jerry Hausman & Howard Shelanski, *Economic Welfare and Telecommunications Regulation: The E-Rate Policy for Universal-Service Subsidies*, 16 YALE J. ON REG. 19, 40 (1999).

as -5.9. Most fall in the range between -2.4 and -3.[62] The most recent study, published by GAO in 2005, found an elasticity of -2.63, which is very close to the -2.7 figure calculated by Hazlett using data on the cable industry's 2001 cash flow margin.[63] We assume a demand elasticity equal to -2.

All of the relevant data on monthly cable rates and subscribership can be found in either FCC reports or independent scholarly studies. Unfortunately, the available data cover only basic, extended basic, and equipment rental—the "monthly cable rate" discussed in FCC surveys and the GAO studies. Our estimate will therefore understate the forgone consumer surplus, perhaps by a great deal, because it will not include any forgone consumer value due to reduced purchases of digital cable or premium channels that may result from franchise regulation.

The forgone consumer surplus must be calculated separately for markets that have wireline video competition and markets that lack wireline video competition. For the markets that lack wireline video competition, the Δp that affects cable subscriptions is the sum of three costs: (a) the price increase that occurs because franchising gives incumbent cable companies market power, (b) the cost of nonprice concessions, and (c) the five percent franchise fee.

The absence of wireline video competition also affects quality by reducing the number of channels offered as part of the extended basic package. Quality affects only the forgone consumer surplus, not the wealth transfers. To estimate the size of forgone consumer surplus due to fewer channels in markets that lack wireline video competition, we start by comparing the average price per channel in markets with and without wireline video competition, using FCC data from Table 1. The difference between these prices, multiplied by 12 months, is our Δp per channel per year. The lower price per channel in competitive markets is associated with a larger number of channels in the extended basic package, and so the difference between the number of channels in each market provides our Δq for channels. The formula $.5 \cdot \Delta p \cdot \Delta q$ gives us the forgone consumer surplus due to quality reduction for an "average" consumer in markets that lack wireline video competition. Multiplying this figure times the predicted number of subscribers in such markets

62. GEORGE S. FORD & THOMAS M. KOUTSKY, FRANCHISE FEE REVENUES AFTER VIDEO COMPETITION: THE "COMPETITION DIVIDEND" FOR LOCAL GOVERNMENTS 8 (Phoenix Policy Center, Bulletin No. 12, Nov. 2005), *available at* http://www.phoenix-center.org/PolicyBulletin/PCPB13Final.pdf. The FCC's 2002 econometric analysis found an elasticity of -2.19. *See Report on Cable Industry Prices*, *supra* note 3, at 29.

63. *See* GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 22, at 31; Hazlett, *supra* note 14, at 211.

TABLE 4: FORGONE CONSUMER SURPLUS AND TOTAL CONSUMER COST

Effect	Δ in no. of subscribers	Forgone consumer surplus	Wealth Transfer	Total consumer cost
Markets without wireline competition				
Market Power – Basic, extended, equipment	20 mil.	$850 mil.	$5.5 bil.	$6.3 bil.
+ Nonprice concessions	21 mil.	$964 mil.	$5.8 bil.	$6.8 bil.
+ Franchise fees	28 mil.	$1.6 bil.	$8.2 bil.	$9.8 bil.
+ Market Power – Digital	NA	$1.6 bil.	$8.3 bil.	$10 bil.
+Quality effect	4.8 (channels)	$2 bil.	$8.3 bil.	$10.3 bil.
Markets with wireline competition				
Nonprice concessions	69,000	$160,000	$16 mil.	$16.2 mil.
+ Franchise fees	413,000	$5.8 mil.	$96 mil.	$102 mil.
TOTAL ALL MARTKETS	28.1 MIL.	$2 BIL.	$8.4 BIL.	$10.4 BIL.

provides an estimate of the total consumer surplus forgone due to the lower number of channels in the markets with less competition—about $375 million annually.[64]

For markets that have wireline video competition, Δp includes only the cost of nonprice concessions and the franchise fee. There is no forgone consumer surplus due to the quality effect, because these competitive markets provide the quality baseline against which the less competitive markets are compared.

Table 4 shows the forgone consumer surplus, wealth transfer, and total cost to consumers that result from various aspects of franchise regulation. As in Table 3, the figures in each row for each type of market are cumulative, with the exception of the change in quantity numbers for digital and channels. Inclusion of the forgone consumer surplus raises the total cost to consumers substantially—by about $2 billion.

3. Caveats and sensitivity analyses

Table 5 presents sensitivity analyses showing how the results change if various assumptions change. Dollar figures are carried out to more decimal places in this table because some of the differences in results that stem from different assumptions are relatively small. Estimates of forgone consumer surplus depend on the assumed elasticity of demand for cable service. The total wealth transfer remains unchanged, since it results from the increased prices paid by existing

64. This is a very rough, back-of-the-envelope calculation. It may be a conservative estimate, for several reasons. First, GAO's model finds that the presence of wireline video competition is associated with an 8.4% increase in the number of cable channels, which works out to an increase of 5.9 channels instead of the 4.8 channels implied by the FCC data in Table 1. *See* GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 22, at 31. Second, previous analyses of the value of additional cable channels find that one additional channel is worth about $1.00 per month (on average) to consumers. *See* ROBERT W. CRANDALL AND HAROLD FURCHTGOTT-ROTH, CABLE TV: REGULATION OR COMPETITION? 56 (1996). If wireline video competition increases the average number of channels by 4.8, that makes the average consumer better off by $4.80 x 12 months = $57.60 per year, for a total of $5.2 billion annually when summed over the predicted number of cable customers. Crandall and Furtchgott-Roth's study, however, uses data from 1992, and the media number of channels in the cable systems in their sample appears to be about 32. *Id.*at tbl.B-1 (summing the mean values of BASAT, the number of satellite-transmitted channels offered on the cable system, and OFFAIR, the number of broadcast and microwave channels offered on the cable system). Since channel capacity has expanded greatly since then, the marginal value to consumers of additional channels may be lower now. Consistent with this hypothesis, studies attempting to measure the marginal value of particular channels find that this value is statistically indistinguishable from zero for many channels. *See, e.g.,* Noel D. Uri & Keith Brown, *Cable Service and Its Implicit Marginal Valuation*, 16 TECH. ANAL. & STR. MGM'T. 539 (2004); Diane Bruce Anstine, *How Much Will Consumers Pay? A Hedonic Analysis of the Cable Television Industry*, 19 REV. INDUS. ORG. 129 (2001).

subscribers. When the elasticity of demand ranges from -1.5 to -2.5, the forgone consumer surplus varies from $1.58 billion to $2.45 billion, and so the total cost to consumers varies from $9.99 billion to $10.87 billion.

TABLE 5: SENSITIVITY ANALYSES

	Δ in no. of subscribers	Forgone consumer surplus	Wealth Transfer	Total consumer cost
Baseline	28.1 mil.	$2.01 bil.	$8.42 bil.	$10.43 bil.
Change in assumption				
Elasticity = -1.5	21.1 mil.	$1.58 bil.	$8.42 bil.	$9.99 bil.
Elasticity = -2.5	35.1 mil.	$2.45 bil.	$8.42 bil.	$10.87 bil.
Mutatis mutandis				
11.5% price effect	32.1 mil.	$1.91 bil.	$7.62 bil.	$9.53 bil.
All MVPD subscribers				
11.5% price effect	30.1 mil.	$1.95 bil.	$8.48 bil.	$10.43 bil.

Regardless of the elasticity, the total costs to consumers of video franchising are large.

Another key variable is the size of the price effect from wireline video competition. The 15.6% figure we use is derived from the coefficient on the wireline competition variable in the cable price equation in GAO's 2005 study. In economic terminology, this the "ceteris paribus" effect of the price change, holding all other factors constant. However, the GAO model involves multiple equations, and the dependent variables predicted by each equation also appear as independent variables in the cable price equation.[65] In addition to its direct effect on cable prices, wireline video competition affects the number of cable subscribers, the number of cable channels, and direct broadcast satellite penetration, and these in turn affect cable prices. Thus, wireline video competition has both direct and indirect effects on cable prices. The net effect of the price change after all factors adjust—what economists call the "mutatis mutandis" effect—may be different from the ceteris paribus effect. The direct effect is a 15.6% reduction. After accounting for all of the indirect effects, wireline video competition reduces cable prices by about 11.5%[66]—a figure that implies smaller wealth transfers and deadweight losses than we calculated.

It would be a mistake, however, to simply substitute 11.5% for

65. The generic problem of interpreting coefficients in multi-equation systems is addressed in George S. Ford & John D. Jackson, *On the Interpretation of Policy Effects from Estimates of Simultaneous Systems of Equations*, 30 APPLIED ECONOMICS 995 (1998).

66. Ford & Koutsky, *supra* note 62, at 10.

15.6% in our calculations, because the resulting figures would dramatically under-estimate the full effects of wireline competition. Wireline competition has an indirect effect on cable prices through its effects on the number of cable subscribers, the number of cable channels, and direct broadcast satellite penetration. This price effect, in turn, has an effect on the number of cable subscribers. In addition, wireline competition has other, indirect effects on the number of cable subscribers—most importantly via its effect on direct broadcast satellite penetration. GAO's model implies that direct broadcast satellite penetration declines by about 40% in the presence of wireline video competition,[67] presumably because the lower price makes cable a more attractive option compared to satellite. These satellite customers shift to cable. Therefore, a complete calculation of competition's effect on the number of cable subscribers must include both the price effect and the effect of reduced satellite subscription. We use this net effect of competition on cable subscribership as our Δq. Table 5 shows that, for a demand elasticity equal to -2, the mutatis mutandis calculation leads to a relatively small change in the results. Compared to the ceteris paribus calculation, the wealth transfer under the mutatis mutandis calculation is about $800 million less, the forgone consumer surplus is $100 million less, and the total cost to consumers is $900 million less. Obviously, the cost of video franchising is still substantial.

One objection to both the ceteris paribus and the mutatis mutandis calculations is that they assume satellite providers will leave their prices unchanged and simply allow cable competition to erode their market share. This may be a reasonable assumption under current arrangements, where only three percent of cable subscribers are in markets with direct wireline competition. Satellite providers likely regard the price of cable in markets without wireline competition as the principal price they compete against in their nationwide pricing plans. A substantial increase in wireline video competition would likely change the competitive dynamic and prompt satellite companies to lower their prices in order to retain subscribers they would otherwise lose.

The GAO model does not permit us to examine the effects of satellite price reductions in response to cable price reductions, because the price of satellite service is not a variable in the model. Since it is a cross-sectional model (all data come from the same time period) and satellite companies set nationwide prices, there is no variation in satellite prices that could be incorporated into the model. However, we can roughly approximate the effects of satellite price reductions by treating satellite subscribers as if they were customers in cable markets that lack wireline competition. This implicitly assumes that satellite providers

67. *Id.*

lower their prices to the same extent that cable companies do in response to increased competition. This is an admittedly arbitrary assumption, but arguably more realistic than assuming that satellite firms do not lower their prices at all.

The final entry in Table 5 shows the results when we add satellite subscribers to cable subscribers and then perform the calculations. The results are virtually the same as our original calculations. More consumers would remain satellite subscribers, but they would benefit from lower prices.

Another "reality check" on our calculations involves comparing our projections of subscribership under ubiquitous wireline video competition to the total number of households and housing units in the nation. The Census Bureau estimates that there were 112 million households in 2004.[68] A single household may, of course, have more than one cable subscription, either because some family members subscribe separately or because the household has more than one residence. The Census Bureau estimates that there were about 121 million housing units in the United States in 2003, the most recent figure available.[69] Our calculations imply that ubiquitous wireline video competition would increase total cable plus broadband service provider subscriptions from 67 million to between 89 and 103 million, depending on the elasticity of demand. The higher estimate implies close to universal cable subscription.

4. Comparison to previous studies

We know of three other economic studies that have estimated the effects of widespread cable competition on consumers: Thomas Hazlett (2005), George Ford and Thomas Koutsky (2005), and Robert W. Crandall and Robert Litan (2006). The first two studies calculate only the effects of widespread wireline video competition on consumer welfare via price reductions, though Hazlett offers ample documentation of the inefficiencies associated with quality differences, nonprice concessions and franchise fees.[70] Crandall and Litan also include the effects of improved quality.

The Hazlett study develops a model in which market concentration (as measured by the Herfindahl-Herschman Index (HHI), a commonly-used measure of concentration) affects prices, and competitive entry

68. U.S. CENSUS BUREAU, CURRENT POPULATION SURVEY, 2004 ANNUAL SOCIAL & ECONOMIC SUPPLEMENT (2004), *available at* http://www.census.gov/population/socdemo/hh-fam/cps2004/tabH1-all.csv.

69. U.S. CENSUS BUREAU, AMERICAN HOUSING SURVEY FOR THE UNITED STATES (2003), *available at* http://www.census.gov/hhes/www/housing/ahs/ahs03/tab1a1.htm (last visited August 2006).

70. Hazlett, *supra* note 1, at 12-36.

affects the HHI. National data on market shares of MVPD providers are combined with plausible estimates of demand elasticity. Hazlett estimates that widespread wireline video competition would create approximately $9 billion in consumer benefits annually. About $3 billion of this amount is a pure efficiency gain, rather than a transfer from cable companies to consumers.[71]

Ford and Koutsky estimate the cost to consumers of a one-year delay in competitive wireline video entry. They develop a model of the likely speed and extent of competitive entry over time, then calculate the present value of the reduction in consumer surplus that results from a one-year delay. Employing GAO's estimated 15% price reduction from wireline video competition and a demand elasticity of -1.5, Ford and Koutsky find that a one-year delay would reduce this net present value by $8.2 billion.[72]

Crandall and Litan rely on elasticity estimates and regression coefficients estimated in several academic studies, rather than the GAO study. They calculate that introducing wireline video competition in markets that currently lack such competition would initially reduce prices by 18.4%.[73] Improvements in quality (the number of channels) would reduce the price savings somewhat by increasing the demand for video service, but also increase consumer value. For a demand elasticity between -1.5 and -2, they conclude that competition would increase consumer surplus by between $7.46 billion and $13.99 billion annually.[74]

Like our estimates, the Hazlett and Crandall/Litan studies are "comparative static" analyses that assesses the effect of competition by comparing actual cable prices with those that would exist in a counterfactual case at a single point in time, after all wireline entry occurs and all market adjustments occur. Ford and Koutsky's estimate, on the other hand, assumes that entry occurs gradually over time. Since they model the effects of entry over multiple years, they need to calculate the net present value of consumer benefits over a multi-year time horizon in order to identify the full effects of a one-year delay.

At $6.3 billion, our estimate of the market power effect is somewhat lower than in any of these other studies, but still in the same neighborhood. We take some comfort in the fact that three different studies employing different models have estimated consumer benefits

71. *Id.* at 65-66.

72. George S. Ford & Thomas M Koutsky, *In Delay There is No Plenty: The Consumer Welfare Cost of Franchise Reform Delay* 1 (Phoenix Policy Ctr., Policy Bulletin No. 13, Jan. 2006), *available at* http://www.phoenix-center.org/PolicyBulletin/PCPB13Final.pdf.

73. ROBERT W. CRANDALL AND ROBERT LITAN, CRITERION ECONOMICS, THE BENEFITS OF NEW WIRELINE VIDEO COMPETITION FOR CONSUMERS AND LOCAL GOVERNEMENTS 16 (2006).

74. *Id.* at 20.

from entry that are the same order of magnitude as ours. Our unique contribution lies in the inclusion of other costs of franchising, such as its effect on quality (number of channels), nonprice concessions, and franchise fees.

II. THE FCC'S OPTIONS

The FCC might address the anticompetitive effects of local franchising in two ways. First, it could declare that local telephone companies (telcos), which are now entering the video market, are not subject to the regulations that apply to cable operators and therefore need not acquire franchises. Second, the FCC could preempt local franchising laws to the extent that they unreasonably deny franchises to new entrants.

A. Exempting telcos from cable franchise regulations

Title VI of the Communications Act of 1934 governs cable communications.[75] However, what the average consumer understands simply as "cable TV" is subdivided by the statute into a series of components. The Act applies different regulatory treatment to each of these components. Therefore, how a new service is classified—that is, how it is found to fit within the existing statutory definitions—determines the regulatory obligations that apply. The FCC is effectively the ultimate arbiter of how a new service is classified and thus regulated.[76]

Pay television services are provided by what the statute calls "multichannel video programming distributors" (MVPDs). These include cable television operators, direct broadcast satellite service providers, "wireless cable" providers, and generally any other entity that "makes available for purchase, by subscribers or customers, multiple channels of video programming."[77] Any telco that makes a video offering will be considered an MVPD.[78]

All MVPDs are subjected by the Act to a number of regulations. These include closed captioning mandates,[79] retransmission consent

75. 47 U.S.C. § 521 (2000).

76. 47 U.S.C. § 151 (2000). This is doubly true after the Supreme Court held in *Brand X* that an agency has the ultimate interpretative authority over the statute it administers if that statute is ambiguous, even when a court has previously interpreted the same statute. *See* Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Servs., 545 U.S. 967 (2005).

77. 47 U.S.C. § 522(13) (2000).

78. In a filing arguing that its video offering is not subject to franchise regulation, SBC (now AT&T) nevertheless accepts that it will be subject to regulations that apply to MVPDs. *See* Comments of SBC Commc'ns Inc. to the *Notice of Proposed Rulemaking* in IP-Enabled Services, WC Dkt. No. 04-36 13 (Sept. 14, 2005) [hereinafter *SBC Memo*], http://gullfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=6518157935.

79. 47 C.F.R. § 79.1 (2005).

rules,[80] and equal employment opportunity standards[81] among others. However, not all MVPDs are subject to franchising regulations. Only "cable operators," a subset of all MVPDs, must acquire a local franchise before they can provide service.[82] They must also pay franchise fees and meet other franchise obligations.[83] Therefore, if the FCC finds that telcos offering video service do not fit the statutory classification of "cable operators," they will not be obligated to acquire a local franchise before they are allowed to provide service.

A "cable operator" is defined by the Act as someone who provides "cable service" over a "cable system."[84] Therefore, if a telco does not provide "cable service," or if it does but not over a "cable system," then it will not be considered a "cable operator" and will thus not be subject to franchise regulations under Title VI.

Additionally, some have suggested that, under the statute, telcos can only offer video services in a few enumerated ways.[85] Part V of Title VI is entitled, "Video Programming Services Provided by Telephone Companies." It states in section 651,

> To the extent that a common carrier is providing video programming to its subscribers in any manner other than [via radio under Title III or as a common carrier under Title II] . . ., such carrier shall be subject to the requirements of [Title VI], unless such programming is provided by means of an open video system[.][86]

The claim is that, putting aside radio and common carriage delivery, which the telcos do not plan to employ, the only two ways they may offer video is as a cable operator or as an open video system (OVS).[87] The FCC expressed a similar point of view when it recently stated,

80. 47 U.S.C. § 325 (2000).

81. 47 U.S.C. § 554(h)(1) (2000).

82. 47 U.S.C. § 541(b) (2000).

83. *Id*.

84. 47 U.S.C. § 522(5) (2000).

85. *See* Comments of the National Cable & Telecommunications Association to the *Notice of Proposed Rulemaking* in IP-Enabled Services, WC Docket No. 04-36 6-7 (Sept. 9, 2005) ("The 1996 Act offered phone companies four ways in which to enter the cable business. Telcos may provide transmission of video programming [as a common carrier, via radio, or via OVS.] . . . Finally, the statute made clear, by adding Section 651(a)(3)(A) to the Communications Act, . . . that the telcos' only other option was to provide video programming as a cable operator subject to Title VI.") [hereinafter *NCTA Memo*], http://gullfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=6518156130.

86. 47 U.S.C. § 571(a)(3)(A) (2000).

87. See *NCTA Memo*, *supra* note 85, at 6-7. An open video system (OVS) is a hybrid classification, created by the 1996 Telecom Act and meant to replace "video dialtone,' which combines elements of common carrier and cable regulation. *See* Kimberly Auerbach, *OVS: A Platform Worth Investing In?*, 5 MEDIA L. & POL'Y 15 (1996).

> The Communications Act provides new entrants four options for entry into the MVPD market. They can provide video programming to subscribers via radio communication, a cable system or an open video system, or they can provide transmission of video programming on a common carrier basis. Any new entrant opting to offer "cable service" as a "cable operator" becomes subject to the requirements of Title VI [and its franchising regulations].[88]

It should first be noted that section 651 is only operable "[t]o the extent that a common carrier is providing video programming." If the FCC finds that telco offerings are not "video programming" as defined in the Act, then section 652 does not apply. Secondly, even if a telco is offering video programming, the binary choice posed by section 651 is not between OVS and "cable operator" status, but between OVS and "being subject to the requirements of [Title VI]."[89] As we have seen, if telcos offer video programming, they will be subject to the Title VI regulations that apply to all MVPDs. It does not follow, however, that simply because Title VI applies to telcos that they must necessarily be cable operators. Therefore, nothing in section 651 obliges the FCC to regulate telcos that provide video programming as cable operators subject to franchise regulations.

B. FCC preemption of local franchising rules

The second way the FCC could address the problem of franchising is by preempting local franchising laws to the extent that they unreasonably deny franchises to new entrants. Section 621 of the Communications Act prohibits operators from offering cable service without a franchise.[90] It also gives local franchising authorities (LFAs) the power to grant those franchises.[91] However, the Act goes on to state in section 621(a)(1) that an LFA "may not grant an exclusive franchise and may not unreasonably refuse to award an additional competitive franchise."[92] The only remedy provided by the Act for parties who feel they have been unreasonably denied a franchise is review by a court.[93]

88. *See* Implementation of Section 621(a)(1) of the Cable Communications Policy Act of 1984 as amended by the Cable Television Consumer Protection and Competition Act of 1992, *Order*, 21 FCC Rcd. 2,293, ¶ 2 (2005) [hereinafter *Franchising NPRM*].

89. 47 U.S.C. § 571(a)(3)(A) (2000). The legislative history shows no intent of creating a binary choice between OVS and cable operator. H.R. REP. NO. 104-458, at 172 (1996) (Conf. Rep.).

90. 47 U.S.C. § 541 (2000).

91. *Id*.

92. 47 U.S.C. § 541(a)(1) (2000).

93. 47 U.S.C. §§ 541(a)(1), 555 (2000). It should be noted that simply because the Act makes a remedy available to would-be franchisors, it does not follow that Commission enforcement of the section is precluded. *See infra,* note 105 and accompanying text.

The FCC recently began a rulemaking that, if adopted, would allow it to preempt "any law or regulation of a State or LFA that causes an unreasonable refusal to award a competitive franchise in contravention of section 621(a)."[94] In effect, the FCC would strike down local laws that would, in its judgment, inevitably result in unreasonable denial of franchises. Because the salient economic justifications for franchising are (1) the regulation of natural monopoly, (2) the protection of "specialized capital," or (3) the management of the public rights-of-way, any local franchising laws or regulations that are inconsistent with these goals, or with some other statutorily granted power, would be good candidates for preemption.

1. The FCC's preemption authority

The FCC has several sources of authority to preempt local franchising rules that hinder competition. First, Congress has explicitly delegated preemption power to the FCC in section 636(c), which states that "any provision of law of any State, political subdivision, or agency thereof, or franchising authority, or any provision of any franchise granted by such authority, which is inconsistent with this Act shall be deemed to be preempted and superseded."[95] Therefore, to the extent that local franchising laws and regulations act to "unreasonably refuse" competitive franchises,[96] they are preempted by section 636(c). The FCC need only determine which local franchising rules are offending and preempt them subject to its section 1 charge to "execute and enforce the provisions of [the Act]."[97]

Secondly, even if the Commission did not have an express delegation of preemption power, the Supreme Court has held that "'a federal agency acting within the scope of its congressionally delegated authority may pre-empt state regulation' and hence render unenforceable state or local laws that are otherwise not inconsistent with federal law."[98] As the Supreme Court explained last year in its *Brand X* decision, "Congress has delegated to the Commission the authority to 'execute and enforce' the Communications Act, § 151, and to 'prescribe such rules

94. *Franchising NPRM*, *supra* note 88, at ¶ 15.

95. 47 U.S.C. § 556(c) (2000).

96. 47 U.S.C. § 541(a)(1) (2000).

97. 47 U.S.C. § 151 (2000).

98. City of New York v. FCC, 486 U.S. 57, 63-64 (1988) (quoting Louisiana Public Serv. Comm'n v. FCC, 476 U.S. 355, 369 (1986)). The Court concluded that in cases involving preemption by federal regulation, "a 'narrow focus on Congress' intent to supersede state law [is] misdirected,' for '[a] preemptive regulation's force does not depend on express congressional authorization to displace state law.'" *Id*. at 64 (quoting Fidelity Federal Sav. and Loan Ass'n v. de la Cuesta, 458 U.S. 141, 154 (1982). *See also* Capital Cities v. Crisp, 467 U.S. 691 (1984) (holding that regulations have no less preemptive effect than federal statutes when Congress has authorized the regulator to exercise its discretion).

and regulations as may be necessary in the public interest to carry out the provisions' of the Act, § 201(b). These provisions give the Commission the authority to promulgate binding legal rules[.]"[99] Additionally, the FCC has specifically been found to have authority to interpret section 621 and regulate pursuant to it.[100]

In preempting local rules that result in unreasonable denials of competitive franchises, the FCC would be acting consistent with the Act and within its delegated authority. The 1984 Cable Act created section 621, which then read, "A franchising authority may award, in accordance with the provisions of this title, 1 or more franchises within its jurisdiction."[101] The 1992 Cable Act amended the section by adding the limitation: "except that a franchising authority may not grant an exclusive franchise and may not unreasonably refuse to award an additional competitive franchise."[102] The legislative history explains that the purpose of this preemption of local prerogative was to promote competition among two or more cable systems in local franchise areas.[103] If the FCC finds that localities have enacted laws or rules that result in the unreasonable denial of competitive franchises, then it may preempt those laws in order to give effect to Title VI's purpose, stated in section 601, to "promote competition in cable communications and minimize unnecessary regulation that would impose an undue economic burden on cable systems."[104]

Unlike applicants who must wait to be "denied [a franchise] by a final decision" of the LFA before they can appeal in court, the FCC need not wait for such a final decision before it can enforce the prohibition on unreasonable refusals. The "final decision" language in section 621(a)(1) applies only to applicants, not the Commission. On the contrary, the Commission is charged with executing and enforcing the provisions of the Act.[105] That includes section 621(a)(1)'s provision that LFAs "may not unreasonably refuse to award an additional competitive franchise."[106] *Refusing to award* a franchise is not the same thing as *denying* a franchise. The latter implies an affirmative act turning down the request, while the former can be achieved by omission. An LFA can fail to make

99. *Brand X Internet Servs.*, 125 S.Ct. at 2699.

100. City of Chicago v. FCC, 199 F.3d 424 (7th Cir. 1999) (holding that FCC has regulatory the authority to interpret § 621 and regulate subject to it).

101. Cable Communications Policy Act of 1984, Pub. L. No. 98-549, 98 Stat. 2779.

102. 47 U.S.C. § 541(a)(1) (2000).

103. S. REP. NO. 102-92, at 14 (1991) ("[I]t is clear that there are benefits from competition between two cable systems. Thus, the Committee believes that local franchising authorities should be encouraged to award second franchises. Accordingly, S. 12 as reported, prohibits local franchising authorities from unreasonably refusing to grant second franchises.")

104. 47 U.S.C. § 521(6) (2000).

105. 47 U.S.C. § 151 (2000).

106. 47 U.S.C. § 541(a)(1) (2000).

a final decision and still be said to have refused to award a franchise if it simply never makes a decision or takes so long to do so that it becomes a moot point. Additionally, an LFA can be said to have refused to award a franchise if the terms it sets out are so onerous that a new entrant could not possibly meet them. Therefore, the Commission has the authority to enforce section 621(a)(1) by preempting state and local policies and practices that result in *de facto* refusals to award competitive franchises.

Another source of FCC preemption authority can be found in section 703 of the 1996 Telecommunications Act, which mandates the FCC and the states to "encourage the deployment . . . of advanced telecommunications capability to all Americans . . . by utilizing, . . . regulatory forbearance, measures that promote competition in the local telecommunications market, or other regulating methods that remove barriers to infrastructure investment."[107] As Levin and Meisel explain, "[n]o discussion of cable television and telecommunications can take place without reference to broadband" because both cable and telephone companies are converging in their plans to offer similar and competing broadband services.[108] To the extent that current franchising policies and practices are retarding the deployment of advanced telecommunications service, the FCC has the authority to preempt those policies and practices. Additionally, competition is the purpose of Title VI as stated explicitly in section 601, and given effect by section 621(a)(1). Therefore, policies and practices that act as anticompetitive barriers to entry, and that lack countervailing effects to offset the harm of lost competition, may be preempted in order to fulfill that purpose.

The FCC also has the authority to adopt rules to implement section 621(a)(1). As noted above, section one of the Act gives the Commission authority "to execute and enforce the provisions" of the Act, and according to the Supreme Court, this includes the authority to "promulgate binding legal rules[.]"[109] Section four of the Act further states that "[t]he Commission may perform any and all acts, make such rules and regulations, and issue such orders, not inconsistent with this Act, as may be necessary in the execution of its functions."[110]

2. Limitations to FCC authority

The FCC may not preempt local laws or rules explicitly sanctioned by the Act or consistent with the express provisions of the Act.[111] For

107. Telecommunications Act of 1996 § 706, 47 U.S.C. § 157 (2004).

108. Stanford L. Levin & John B. Meisel, *Cable Television and Competition: Theory, Evidence and Policy*, 15 TELECOMM. POL'Y 519, 519-20 (1991).

109. *Brand X Internet Servs.*, 125 S.Ct. at 2699.

110. 47 U.S.C. § 154(i) (2000).

111. 47 U.S.C. § 556(a) (2000) ("Nothing in this title shall be construed to affect any authority of any [locality] regarding matters of public health, safety, and welfare, to the extent

example, the Act gives LFAs the power to require as part of the franchising process that a certain amount of a cable operator's channel capacity be dedicated to public, educational, and government (PEG) use.[112] Therefore, the FCC may not preempt local policies that require cable operators to dedicate channel capacity to PEG channels, even if such a requirement results in the denial of a competitive franchise. Other nonprice concessions that the Act allows LFAs to require as conditions for franchising include facilities and financial support for the operation of PEG channels,[113] the creation and maintenance of an institutional network,[114] and assurances that the would-be franchisee is financially and technically qualified to operate a cable system.[115]

However, if the statutory power to impose certain conditions on franchises is exercised in such a way that results in the *unreasonable* denial of franchises, then the Commission may preempt consistent with the Act. For example, in accordance with its statutory power to require channel capacity for PEG channels, an LFA might condition a franchise on a cable system dedicating 50% of its capacity to PEG channels. While the Act does not cap the number of PEG channels an LFA may require, some amounts will no doubt rise to the level of unreasonable and will act as a *de facto* unreasonable denial of a franchise in contravention of section 621(a)(1). Using its authority to interpret section 621, the FCC may determine what qualifies as unreasonable.[116]

Legislative history lends support to this interpretation. Examples of reasonable grounds on which a competitive franchise could be denied were considered and excluded from the 1992 Cable Act. The House version of section 621 included a list of examples of reasonable bases on which a franchise could be denied,[117] but they were removed from the final bill. The list included "inadequate assurance that the cable operator will provide adequate [PEG] channel capacity, facilities, or financial support," "inadequate assurance that the cable operator will, within a reasonable period of time, provide universal service throughout the entire franchise area," and "inadequate assurance that the cable operator has the

consistent with the express provisions of this title.").

112. 47 U.S.C. § 531 (2000). LFAs must nevertheless establish procedures under which the cable operator may utilize unused PEG channel capacity for other services. 47 U.S.C. § 531(d)(1).

113. 47 U.S.C. § 541(a)(4)(B) (2000).

114. 47 U.S.C. § 541(b)(3)(D) (2000). Zupan has reported that institutional networks go largely unused and quotes on cable operator who describes them as "just an expensive toy for the local politicians that was necessary to win the franchise." Zupan, *supra* note 35, at 405.

115. 47 U.S.C. § 541(a)(4)(C) (2000).

116. The FCC has authority to interpret § 621. City of Chicago v. FCC, 199 F.3d 424 (7th Cir. 1999) (holding that FCC has regulatory the authority to interpret § 621 and regulate subject to it). *See also* Nat'l Cable & Tel. Ass'n v. FCC, 33 F.3d 66 (D.C. Cir. 1994) (upholding an FCC interpretation of § 621(b)(1)).

117. H.R. REP. NO. 102-628, at 9 (1992).

financial, technical, or legal qualifications to provide cable service."[118] The Senate version of section 621 included the provision that "refusal to award a second franchise on the grounds of technical infeasibility shall be deemed not to be unreasonable."[119] That clause was also excluded from the final Act. Because specific examples of reasonable grounds on which a franchise could be denied were considered and omitted by Congress, there is reason to believe that its final intent was to leave reasonableness up to agency and court interpretation.

3. What qualifies as an "unreasonable refusal"?

At least broadly, it is not difficult to identify the types of LFA policies and practices that would result in *de facto* refusals to grant competitive franchises. As we saw earlier, Congress chose not to explain what would qualify as an unreasonable refusal of a franchise. We do know, however, that a franchise refusal that would have the effect of subverting Title VI's stated purpose to "promote competition in cable communications and minimize unnecessary regulation that would impose an undue economic burden on cable systems"[120] would necessarily be unreasonable.

Given the pro-competitive goals of the Communications Act, and Title VI specifically, refusal of a competitive franchise would be reasonable only if it was justified as a step taken to enhance consumer welfare by limiting entry. As Part I explained, the only plausible rationales for limiting entry are regulating unsustainable natural monopolies and facilitating investment in "specialized capital." However, as we have seen, two decades of research and historical data show conclusively that competition consistently leads to lower prices and improved quality. It would therefore be unreasonable to refuse a competitive franchise on those grounds. Additionally, to effectively manage the public rights-of-way a locality does not need to limit entry, so that refusal on that ground would be unreasonable as well. All other rationales for limiting entry serve only to protect an incumbent from competition and are thus unreasonable.

a. Rights-of-way

Local control of the public rights-of-way has traditionally been the source of authority that has allowed LFAs to control entry into the cable market through franchising.[121] Today, the source of LFA franchising

118. *Id*.
119. S. REP. NO. 102-92, at 112 (1991).
120. 47 U.S.C. § 521(6) (2000).
121. Hazlett, *supra* note 14, at 214.

power is the express grant of that authority by Title VI of the Communications Act.[122] The Act stipulates that an award of a franchise "shall be construed to authorize the construction of a cable system over public rights of way[.]"[123] Therefore, it would be reasonable to refuse a franchise on rights-of-way grounds only when the public rights-of-way could not support construction of a second cable system. That, however, is not a credible concern.

First, in the rare case that underground and aerial utility ducts are at capacity, they can always be expanded. As Hazlett and Ford note, "The [only] policy question is: who pays?"[124] The answer to crowding is not to limit entry, but to allocate space through a congestion price mechanism. Second, management of public inconvenience caused by construction cannot reasonably require the denial of a franchise. Today, utility companies, including telcos, are subject to regulations of general applicability controlling construction on public ways. Through such regulations utilities are made to internalize the costs they impose on the public, and localities are allowed to recover the cost of policing compliance and making repairs.[125] Telcos already have access to the public rights-of-way that they would use to provide video services and, in fact, they already provide other broadband services over these same facilities. Therefore, refusal of a franchise on rights-of-way grounds would be unreasonable.[126]

b. Unsustainable natural monopoly and "specialized capital"

The history of overbuilding in the cable industry gives lie to the notion that cable television is a natural monopoly. So does intermodal competition from DBS. As Hazlett points out, "while overbuilding an existing cable system can lower the profitability of the incumbent operator, it unambiguously improves the position of consumers who face prices determined not by historical costs, but by the interplay of supply and demand."[127] The economics literature shows that franchising has not been employed to remedy unsustainable natural monopoly or a

122. 47 U.S.C. § 621(a)(1) (2000). *See supra*, note 10.

123. 47 U.S.C. § 621(a)(2) (2000).

124. Thomas W. Hazlett & George S. Ford, *The Fallacy of Regulatory Symmetry: An Economic Analysis of the 'Level Playing Field' in Cable TV Franchising Statutes*, 3 BUS. & POL. 21, 30 (2001).

125. Gillespie, *supra* note 12, at 215-16.

126. It should be noted that the Act provides for the regulation of access to, and rates for, rights-of-way owned by utilities. 47 U.S.C. § 224 (2000). To the extent that franchise fees are used to recover the costs of using rights-of-way, they would only be justified to recover the costs imposed on the locality.

127. Thomas W. Hazlett, *Duopolistic Competition in Cable Television: Implications for Public Policy*, 7 YALE J. ON REG. 65, 69 (1990).

"specialized capital" problem, but instead has entrenched local cable monopolies.[128] Posner has explained that, through franchising, local authorities seek to obtain the monopoly rents for themselves.[129] This is apparent in the nonprice concessions LFAs extract from franchisees that have nothing to do with addressing any such problems.[130]

Competition in the cable industry is the clear policy of both Congress and the FCC. Therefore, unless an LFA can show that the cable system in its jurisdiction is an unsustainable natural monopoly or faces a "specialized capital" problem, it cannot reasonably refuse a second franchise on those grounds. Baumol et al. explain that while preventing entry is one way to address an unsustainable monopoly problem,

> [O]ne must proceed with caution. As long as any doubt remains about the unavailability of sustainable solutions, one must hesitate before bowing to the pressures for the encouragement of barriers to entry. It is understandable and natural for the incumbent firms in an industry who are fearful of enhanced competitive pressures to seek the erection or toleration of protective umbrellas against entry. But those who have the task of protecting the interests of society must resist such demands until the evidence for them is all but incontrovertible. We have seen again and again the sorts of benefits that unrestricted freedom of entry can bring. It is dangerous to risk those benefits on the basis of imperfect evidence indicating that, in a particular case, the market mechanism is likely to function badly.[131]

While it is theoretically possible that an LFA could reasonably refuse a second franchise in order to address a natural monopoly concern, in practice the rationale is very limited—especially without effective rate regulation. Historical evidence and academic research show that it is only in the rare case, if ever, that preventing the entry of a competitive cable system would increase consumer welfare. As a result, the default

128. *See supra* Section II.B.

129. Richard A. Posner, *The Appropriate Scope of Regulation in the Cable Television Industry*, 3 BELL J. OF ECON. & MGMT. SCIENCE 98, 113 (1972).

130. In a recent filing with the FCC, AT&T complained about the concessions localities attempt to extract from would-be entrants. "One city required a multi-stage application process with public hearings, an additional 2% of gross sales tax on top of the five percent franchise fee, a $500,000 payment for local producers, a set-aside of *10%* of the channel capacity for a local public access corporation and a substantial payment to support the corporation. . . . One city had the audacity to demand that Ameritech pay for a new recreation center and pool." Comments of AT&T Inc. to *Notice of Proposed Rulemaking* in Implementation of Section 621(a)(1) of the Cable Communications Policy Act of 1984 as amended by the Cable Television Protection and Competition Act of 1992, MB Dkt. No. 05-311, 24 (Feb. 13, 2006), http://gullfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=6518328493.

131. WILLIAM J. BAUMOL ET AL., CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE, 472-73 (1982).

bias should be to doubt the reasonableness of franchise refusals in the absence of great evidence to the contrary.

c. "Level playing field" laws and other barriers to entry

Given Congress's and the Commission's paramount goals of encouraging competition and broadband deployment, all LFA practices and policies that produce barriers to entry should be preempted because they result in *de facto* unreasonable franchise refusals. Many state "level playing field" (LPF) laws are a case in point. They were enacted to ensure regulatory parity between incumbents and new entrants in the cable market by imposing on new cable systems franchise terms at least as burdensome as those shouldered by the incumbent. However, these laws have no other effect than to protect incumbents from competition. As Hazlett and Ford have shown, "rules that ostensibly mandate fairness can create barriers to entry."[132]

LPF laws create *de facto* franchise refusal in several ways. First, LPF laws often require new entrants to match the capital expenditures of incumbents, with the result that "incumbents and franchise authorities can force entrants to incur sunk costs considerably in excess of what free market conditions would imply."[133] This means that while a second cable operator will have to make the same unrecoverable investment previously made by the incumbent, it will not have the benefit a monopoly over which to amortize it. Because the new system will have to compete against the incumbent, it can expect revenue from fewer subscribers and at lower rates than the incumbent previously enjoyed. In addition, capital expenditure requirements ignore the possibility that new technology may allow some new entrants to build their systems at a lower inflation-adjusted cost than the incumbent. Would-be new entrants will therefore often find the large up front investment required by LPF laws to be a prohibitive barrier to entry.[134]

Another way that LPF laws present a barrier to entry is by requiring that competitors match the entire area served by the incumbent. Such an obligation prevents new entrants from competing in just a subset of the jurisdiction.[135] This keeps out competitors that might find it cost-effective to compete only partially with the incumbent, or to phase in its service by serving the most lucrative customers first. By foreclosing competition, the obligation precludes subscribers in the potentially

132. Hazlett & Ford, *supra* note 124, at 22.

133. *Id*. at 25.

134. *Id*.

135. Although an LFA may require it, there is nothing in Title VI that requires a new entrant to serve an entire jurisdiction. For example, Texas's statewide franchising system allows for "service area footprint[s]" smaller than the municipality in which they are located. TEX. UTIL. CODE ANN. § 66.003 (b)(4) (Vernon 2005).

competitive areas from enjoying lower rates.

A common justification for requiring new entrants to serve all markets served by an incumbent firm is that "cream-skimming" in the most lucrative markets would erode the profits that subsidize prices in less lucrative markets. The less lucrative markets may be higher cost, or they may consist of consumers who buy only a basic service package. According to this theory, if the new entrant takes the "cream," the incumbent will have to raise prices to its remaining customers, or perhaps even discontinue service to the unprofitable customers.

Whatever the merits of the cream-skimming argument in theory, there are several practical reasons that it is not applicable to contemporary cable markets.

First, the cream-skimming theory requires that some customers pay prices that are below the incremental cost of serving them. These are the customers in danger of paying higher prices or losing service if the incumbent loses some of its profits from the more lucrative customers. It is by no means clear, however, that cable companies currently sell service to any subscribers at prices that fail to cover the incremental costs of serving those subscribers. As long as prices cover the incremental costs of serving a subscriber or a group of subscribers, they make a contribution to covering the fixed costs of the cable system. These customers may be *less* profitable than other customers, but they are not *un*profitable. As a result, there is no reason for the cable company to stop serving them just because it loses some of its more profitable customers. Indeed, if the less profitable customers are willing to pay a price that covers the incremental cost of serving them, then there is no reason that new entrants would not also eventually extend service to them, and competition would likely lower their cable rates too.

Second, the theory that the incumbent deprived of the "cream" will raise prices to other customers makes sense only if regulation effectively constrains the prices these customers pay. An incumbent unconstrained by regulation will charge whatever price it believes the market will bear (taking into account concerns such as its reputation for fair dealing and the possibility that a higher price might attract competition). Such an incumbent is already charging its customers the most profitable price. A cable incumbent that lost customers to competition and then tried to increase prices on remaining customers would see its profits fall even further. Given the extensive evidence that cable rate regulation has little effect on cable rates, it is unlikely that cable companies are using profits from lucrative markets to subsidize the prices paid by customers in less profitable markets. Therefore, no consumers are harmed if new competitors are permitted to serve only part of the incumbent cable company's customers. Because noncompetitive portions of the jurisdiction will not see higher rates as a result of competition elsewhere,

there is no reasonable justification for forcing new competitors to serve the incumbent's entire territory.

New entrants are also sometimes required to *quickly* serve the entire area that an incumbent has built out over many years—and without the benefit of a monopoly position.[136] This can serve as a barrier to entry because it reduces the time a new entrant has to become profitable. However, Title VI requires that franchise authorities allow new entrants "a reasonable period of time to become capable of providing cable service to all households in the franchise area."[137] The legislative history of this provision states that its purpose is to ensure that section 621(a)(1)'s prohibition on unreasonable refusals of competitive franchises not be thwarted.[138] Therefore, to the extent that LPF laws and LFA policies mandate build-out schedules that are unreasonable and serve as barriers to competitive entry, they frustrate the Act's goal of competition as well as its clear directive to grant competitors time to deploy their services.

Another local practice that raises a competitor's cost of entry is long delay by LFAs in approving a second franchise.[139] Delays allow the incumbent to prepare itself for aggressive and targeted competition based on what it has learned of the new competitor's plans from the public franchise proceedings.[140] They also make it difficult for competitors to secure capital investment, programming or subscribers. While certainly not codified anywhere, delays are a feature of LPF laws, which often require LFAs to duly consider a laundry list of factors and conduct in-depth studies before a competitive franchise can be granted. In some cases entrepreneurial firms have had to abandon their quest for a competitive franchise after years of delays. Because interminable delays are barriers to entry, they can amount to *de facto* unreasonable refusals.

Finally, nonprice concessions demanded by LFAs are what Posner has termed taxation by regulation.[141] By threatening to withhold a

136. It should be noted that such a requirement places an onerous obligation on the new entrant that the incumbent never faced, giving lie to the idea that "level playing field" laws create parity.

137. 47 U.S.C. § 541(a)(4)(A) (2000).

138. S. REP. NO. 102-92, at 91 (1991). The report goes on to state, "The provision requires local franchising authorities to grant the second or third cable system in a community sufficient time actually to construct its system and provide service. For purposes of this section, a reasonable period of time would include a period of time comparable to that taken for the incumbent cable operator to construct its cable system for a comparably sized franchise area." *Id*.

139. The GAO has reported that delays have caused some potential entrants to "withdraw their applications and seek more receptive markets." GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 15, at 21.

140. Thomas W. Hazlett, *Predation in Local Cable TV Markets*, 40 ANTITRUST BULL. 609, 616-17 (1995).

141. Richard A. Posner, *Taxation by Regulation*, 2 BELL J. OF ECON. & MGT. SCIENCE

franchise, local authorities can extract an in-kind tax from prospective cable operators. Nonprice concessions can serve as anti-competitive barriers to entry not only because they can be individually onerous in each locality, but because competitors whose successful business plan depends on rolling out service regionally or nationally will have to negotiate and deliver thousands of such concessions.[142] Nevertheless, Title VI expressly permits some of these types of concessions if they are related to the provision of PEG channels or the establishment or operation of a cable system.[143] However, many requested nonprice concessions seem to be of dubious authority and likely serve only as barriers to entry. As the *Wall Street Journal* recently reported,

> Budget-strapped local officials, who have the final say over granting cable-TV-service franchises, are greeting [Verizon] with expensive and detailed demands. In New York State, Verizon faces requests for seed money for wildflowers and a video hookup for Christmas celebrations. Arlington County, Va., wants fiber strung to all its traffic lights so it can remotely monitor traffic flow. Holliston, Mass., is seeking free television for every house of worship and a 10% video discount for all senior citizens. Others want high-speed Internet for sewage facilities and junk yards, flower baskets for light poles, cameras mounted on stop lights and Internet connections for poor elementary students.[144]

The legislative history of Title VI shows that section 624, in which LFAs find their authority to require nonprice concessions unrelated to PEG channels, "is intended to provide procedures for and impose limitations on a franchising authority regarding the establishment of requirements related to services, facility, and equipment provided by a cable operator."[145] It goes on to say that an LFA "cannot enforce or impose requirements for services, facilities or equipment which are not related to the operation of a cable system."[146] Therefore, nonprice concessions extracted by LFAs that are not directly related to the establishment or operation of a cable system are not permitted by the Act

22 (1971).

142. *SBC Memo*, *supra* note 78, at 9 (explaining that developing region-wide networks are necessary to achieve economies of scale).

143. LFAs have the authority to require "services, facilities, or equipment" related to use of PEG channel capacity. *See* 47 U.S.C. §§ 531(c), 541(A)(4) (2000). This allows LFAs to require in-kind benefits such as cameras, studios, and other production facilities. LFAs also have the authority to require facilities and equipment "to the extent related to the establishment or operation of a cable system…." 47 U.S.C. § 544(b) (2000).

144. Dionne Searcey, *As Verizon Enters Cable Business, It Faces Local Static; Telecom Giant Gets Demands as it Negotiates TV Deals*, WALL ST. J., Oct. 28, 2005, at A1.

145. H.R. REP. NO. 98-934, at 68 (1984).

146. *Id*.

and certainly contribute to unreasonable refusals of franchises.

C. The FCC should issue rules preempting local barriers to entry

As explained above, the FCC has the authority to adopt rules to implement section 621(a)(1), and it should exercise that authority. By clarifying what state and LFA policies result in *de facto* unreasonable franchise refusals it can give effect to Congress's intent to prohibit such practices. It should also identify local practices that not only result in unreasonable franchise refusals, but are also expressly forbidden by Title VI.

Only by issuing rules—as opposed to simply nonbinding guidelines—can the Commission ensure that section 621(a)(1) is enforced, and enforced consistently. If the Commission were merely to issue guidelines, nothing much would change. Dissatisfied would-be franchisees would still have to wait for a final LFA decision—perhaps after long delays—before they could litigate a refusal. Additionally, guidelines alone would not address policies that discourage potential new entrants from ever attempting to seek a franchise.

Because unreasonable delays in awarding a franchise can amount to a *de facto* unreasonable refusal, the Commission should set the maximum amount of time an LFA may take to make a decision after a franchise application is filed. While the appropriate amount of time to be set should be studied carefully, it ought to be noted that a GAO study on wireline competition reports that LFAs receptive to competition have issued franchises in 120 days.[147] Similarly, Title VI requires LFAs to decide within 120 days whether to approve the sale or transfer of a cable system.[148]

If a final decision is not reached within the allotted time, the franchise should be deemed granted on a set of default terms. These default terms should also be the subject of close study, but two possibilities suggest themselves. First, default terms for a new franchise could be the same terms as those of the incumbent, but only as they apply to the franchise fee and PEG channel capacity. Alternatively, default terms could simply be set as the maximum franchise fee of five percent and a predefined PEG channel capacity.[149]

If it refuses to award a competitive franchise, an LFA should be required to explain in writing why its refusal is not unreasonable.[150] It is

147. GOVERNMENT ACCOUNTABILITY OFFICE, *supra*, note 15 at 20-21.

148. 47 U.S.C. § 541 (2000).

149. For example, Texas's statewide franchising law requires franchisees to provide "(1) up to three PEG channels for a municipality with a population of at least 50,000; and (2) up to two PEG channels for a municipality with a population of less than 50,000." TEX. UTIL. CODE ANN. § 66.009(c) (Vernon 2005).

150. Today, federal law requires local zoning authority decisions to deny placement of

important that LFAs be required to provide not just theoretical or anecdotal support for their refusal, but systematic empirical proof to show why entry should be restricted. Former FTC Chairman Tim Muris has explained the vital need for empirical evidence in FTC rulemakings, and the same logic applies here,

> Theories alone are not enough....for creative theoreticians can fashion a convincing rationale for nearly any scheme. Thus, a proposal should not become a rule until systematic evidence has been collected to test its factual premises. Anecdotes, the commission's own expertise, and the testimony of experts can rarely, if ever, provide the necessary confirmation. Such evidence may be consistent with the theory, but cannot test it. And an untested theory should not be imposed on society at large.[151]

Given that competition is at the heart of Title VI, that the purpose of section 621(a)(1) is to promote competitive entry in the video market, and that historical data and academic research have repeatedly shown that there is no plausible economic justification for restricting entry into local video markets—except to create monopoly—a high standard of proof is warranted.

The Commission should issue a definition of reasonableness that excludes monopoly, "special capital," and rights-of-way rationales unless they can be shown conclusively and empirically by the LFA. If an LFA wished to cite unsustainable natural monopoly as a reason for refusing a franchise, it should have to prove that its jurisdiction is subject to such conditions. If an LFA were to cite rights-of-way concerns as a reason for denying a franchise, it should have to show why local ordinances regulating the use and occupation of public ways would not suffice to address those concerns. Additionally, if a franchise applicant already has access to the rights-of-way, that rationale should be unavailable to the LFA.[152]

A potential entrant that is nevertheless refused a competitive franchise would still have the option, per statute, to appeal the decision in

mobile phone towers and other facilities "shall be in writing and supported by substantial evidence contained in a written record." 47 U.S.C. § 332(b)(7)(B)(iii) (2000).

151. Timothy J. Muris, *Rules Without Reason: The Case of the FTC*, 6 REGULATION 20, 26 (1982).

152. As Copple has pointed out, courts in the 1960s that considered the question of whether telcos had to acquire a franchise before they could offer cable service "uniformly held that because the telephone companies had already been granted a franchise (either by state or local authorities) to erect utility poles and string wire, the transmission of cable signals did not constitute an additional use of the public ways requiring a separate franchise." Robert F. Copple, *Cable Television and the Allocation of Regulatory Power: A Study of Government Demarcation and Roles*, 44 FED. COMM. L.J. 1, 21 (1991).

court.[153] If the Commission adopts rules enforcing section 621(a)(1), however, a court will be able to gauge an LFA's actions against the FCC interpretation of "reasonableness" in that section. Also, if the time an LFA may take in rendering franchise decisions is capped, appealing a "final decision" as the statute requires will become a much more practicable option for potential new entrants that are refused a franchise.

State "level playing field" laws serve no purpose other than to erect barriers to entry that protect incumbents from competition. As a result, they are in contravention of Title VI's purpose to "promote competition in cable communications[.]"[154] Also, as shown above, the roadblocks posed by LPF laws result in *de facto* franchise refusals that are unreasonable because they limit competition without producing any offsetting increase in consumer welfare. The aspects of these laws discussed above should therefore be preempted by the FCC as inconsistent with the spirit and letter of Title VI.

Section 621(a)(4)(A) requires that LFAs give a new franchisee "a reasonable period of time" to build out its system.[155] The FCC should define what is reasonable in this context as well. One measure of reasonableness is the time the incumbent took to complete the same buildout. However, in setting guidelines for that comparison, the FCC should take the lead of courts that have interpreted the parity requirements of "level playing field" laws. Courts that have looked at the issue have uniformly held that a reasonable buildout time for a new cable system:[156]

1. should be judged by looking at the buildout requirement in the incumbent's original franchise—when the incumbent's situation more closely resembled the entrant's current situation—not its renewal franchise.

153. 47 U.S.C §§ 541, 555 (2000).

154. 47 U.S.C. § 521(6) (2000).

155. 47 U.S.C. § 541(a)(4)(A) (2000).

156. *See* David P. Kerr, *Local Cable Overbuilding Issues: The Search for a Level Playing Field*, presented to the Law Seminars International Fourth Annual Local Telecommunication Infrastructure seminar, Aug. 24, 2001, *at* http://www.watoa.org/Level_Playing_Field.pdf (last visited Feb. 8, 2006); United Cable Television Servs. Corp. v. Dep't of Pub. Util. Control, 663 A.2d 1011 (1995) (stating that a comparison between an incumbent and a new entrant is properly made based on the "entire package of terms and conditions required of both cable providers[.]"); Cable Sys. of Southern Connecticut, Ltd. v. Connecticut DPUC, 1996 WL 661818 (Conn. Super. Ct. 1996) (differentiating a new buildout from an incumbent's system upgrade); Comcast Cablevision of New Haven, Inc. v. Connecticut DPUC, 1996 WL 661805 (Conn. Super. Ct. 1996) (comparing a new entrant's buildout schedule to the actual buildout schedule of the incumbent and its predecessors in interest and taking into consideration the benefits of incumbency); New England Cable Television Ass'n, Inc. v. Dept. of Pub. Util. Control, 717 A.2d 1276 (Conn. 1998) (holding that the comparison to be made is to the incumbent's original franchise and its actual performance).

2. should be based on the actual time that the incumbent took to complete its buildout, not on the buildout requirement listed in the franchise agreement.
3. should never be compared to the time an incumbent takes to simply upgrade an existing system.
4. should take into account the risks associated with new entry against an entrenched competitor, as well as the benefits of incumbency.

Although LFAs often require it, nothing in Title VI obligates new entrants to serve the entire area within an LFA's jurisdiction. As we have seen, restricting partial entry only serves as a barrier to entry that hinders competition. Therefore, the FCC should preempt such franchise terms.[157] Similarly, franchise terms that require new entrants to build out unprofitable or sparsely populated areas first, before they can wire other areas, only serve to raise the costs of entry and should also be preempted.

Finally, the FCC should address the barrier to competitive entry posed by the unreasonable nonprice concessions that are often demanded by LFA's. It should issue rules interpreting narrowly the sections of Title VI that allow LFAs to require such concessions. Congress, after all, intended to limit the authority of LFAs to require in-kind contributions not directly related to the operation of PEG channels or the cable system.[158] A reasonable nonprice concession consistent with Title VI must be related to an essential aspect of providing cable service and PEG channels, and cannot include items that are merely tangential to that purpose.

III. LEGISLATIVE OPTIONS

More comprehensive reform of the franchising process can only be achieved through legislation. The most direct way to address the franchising barrier to entry would be for Congress to amend Title VI itself. States, however, can address the balkanized nature of franchising by consolidating and streamlining the process on a statewide level.

157. Allowing partial entry is not inconsistent with section 621(a)(3), which prohibits cable systems from discriminating among subscribers based on income. 47 U.S.C. § 541(a)(3) (2000). LFAs can allow partial entry and still ensure that cable systems do not deny service to potential subscribers solely based on "the income of the residents of the local area in which the group resides." *Id*. For example, Texas's statewide franchising system allows for "service area footprint[s]" smaller than the municipality in which they are located. TEX. UTIL. CODE ANN. § 66.003(b)(4) (Vernon 2005).

158. *See supra* text accompanying note 143.

A. Statewide franchising

As we have seen, the anticompetitive aspects of franchising that should be reformed include municipal delays in granting a franchise, unreasonable nonprice concessions and buildout obligations, and "level playing field" requirements. The purpose of any state law that seeks to address these problems should therefore be to create an environment that is as close as possible to open entry. In 2005, Texas enacted a statewide franchising law that streamlines the franchising process and removes many of the barriers to entry common in traditional municipal franchising.[159] That law can serve as a model for state franchising reform.[160]

The Texas law strips municipalities of their franchising authority and vests it in the state public utility commission.[161] To acquire a franchise, a new entrant only needs to file an affidavit with the commission agreeing to comply with state and federal laws and regulations, including local rights-of-way rules.[162] It must also provide other ministerial information, such as specifying the area of a municipality that it will serve, its place of business, and the name of its officers.[163] If the affidavit is filed correctly, the entrant is automatically awarded a franchise,[164] and the state commission must grant the franchise within 17 business days of the filing.[165]

A statewide franchise allows a new entrant to offer service and make use of the public rights-of-way.[166] Municipalities retain the ability to manage their public rights-of-way, but they must do so through regulations that are nondiscriminatory and competitively neutral.[167] New entrants may not be required to build out their networks in any particular manner,[168] and partial entry of a municipality is allowed.[169]

159. TEX. UTIL. CODE ANN. § 66.001 (Vernon 2005).

160. Other states have also recently enacted statutes to address cable franchising. Unlike Texas, Virginia did not enact a statewide franchise. Instead, video providers may opt for a standardized state franchise only if franchise negotiations with a locality go on for more than 45 days without agreement. VA. CODE ANN. § 15.2-2108.19 (2006). Indiana has enacted a statewide franchising law similar to Texas'. IND. CODE § 8-1-34 (2005). Other states considering franchise reform legislation include New Jersey, Kansas, Missouri, California, Florida and South Carolina. Jay Sherman, *Indiana Passes Statewide Video Franchise Law*, TVWeek.com (Mar. 14, 2006), *at* http://www.tvweek.com/news.cms?newsId=9546.

161. TEX. UTIL. CODE ANN. § 66.001 (Vernon 2005).

162. § 66.003.

163. *Id*.

164. § 66.003(b).

165. *Id*.

166. § 66.003(c).

167. §§ 66.010, 66.013.

168. § 66.007.

169. This is implied by section 66.003's requirement that an application for a statewide franchise include "a description of the service area footprint to be served within the municipality, if applicable, otherwise the municipality to be served[.]" § 66.003(b)(4).

The Texas law allows municipalities to require new entrants to provide as many PEG channels as the incumbent does under the municipal franchise agreement.[170] It also sets out a procedure for the new entrant to reclaim any channel capacity that is unused by the municipality.[171] Additionally, the new entrant is not required to do anything beyond transmitting the PEG channel signal.[172]

New entrants must pay the municipality in which they operate the maximum allowable franchise fee of five percent of gross revenues.[173] In addition to this fee, they must also match the nonprice concessions and other payments the incumbent is forced to make. However, in lieu of in-kind contributions, the new entrant is only required to make a periodic cash payment based on the number of subscribers it has.[174]

Under the Texas law, incumbent municipal franchisees are not eligible for statewide franchises until their existing municipal franchise expires.[175] Ideally, however, all service providers should be subject to the same kind of franchise regulation.[176] Although probably very disruptive to the status quo, this could be accomplished by allowing all existing franchisees to terminate their agreements and acquire state franchises that included a set franchise fee and a fixed peg channel requirement.[177] This would eliminate the unreasonable nonprice concessions that many incumbent franchisees are now saddled with. Although it falls short of this ideal, the Texas law does much to ensure regulatory parity and envisions a full transition to state franchises once existing franchises expire.

Texas did not have a "level playing field" statute when its new video franchising law was enacted. However, other legislatures seeking to reform franchising should repeal any such law. This would ensure regulatory parity among video providers not by saddling new entrants with costly franchise obligations, but by removing those burdens from

170. § 66.009.

171. § 66.009(d).

172. § 66.009(f).

173. § 66.005.

174. § 66.006.

175. § 66.004(b). An existing municipal franchisee that is not the incumbent and that serves fewer than 40% of the municipalities video customers may terminate their existing franchise agreement and acquire a state franchise. *Id*.

176. The Texas cable industry has challenged the statewide franchising law in federal court. Among other claims, they allege that the law unconstitutionally discriminates between existing cable operators and telcos by perpetuating legacy regulation for incumbent cable operators but creating streamlined regulations for the new telco entrants. *See* Texas Cable & Telecomm. Ass'n v. Perry, No. A-05-CA-721-LY (W.D. Tex. filed Sept. 8, 2005), *available at* http://www.txcable.com/PDF/TCTA_vs_Governor-of-Texas.pdf.

177. An immediate change, however, will likely give rise to other costs. Many municipalities would immediately find themselves in financial situations that they had not anticipated. A politically realistic reform will transition out of municipal franchises more slowly.

incumbent operators.

B. Federal legislation

Finally, the most comprehensive way to address the franchise barrier to entry would be to amend Title VI itself. Congress seems poised to do this. The Senate has held hearings on video franchising and reform bills have been entered in both the Senate and the House.[178]

Congress has it within its power to aggressively remove the barriers to entry posed by local franchising by doing away with the franchise requirement altogether.[179] In its place, Congress could establish an open entry regime that allows providers to offer video service without first seeking the permission of government as long as they abide by rules of general applicability. Easy entry to the video market will foster the dynamic competition that is the goal of Title VI and that will benefit consumers.

The power of localities to manage their public rights-of-way should of course be preserved. As we have seen, however, franchising is not necessary to do this effectively. Without franchising, however, municipalities will be limited to local laws that are competitively neutral. Providers should also be required to reimburse municipalities for costs imposed on the municipality by its use of the public rights-of-way. However, this payment should be just that—reimbursement. It should not be a source of revenue for the locality because raising revenue for localities is not the proper purpose of the Communications Act. Municipalities, however, should always be free—as a local matter—to impose a tax on all video providers, but it should not be disguised as a charge for the public rights-of-way.[180]

To this end, municipalities should only be allowed to collect a *reasonable* fee from video providers to cover its rights-of-way management costs. To prevent abuse, the fee should be capped—perhaps at five percent of gross revenues, just as franchise fees are capped today.[181] However, this should not mean that municipalities

178. *See* Video Choice Act of 2005, H.R. 3146, 109th Cong. (2005); Video Choice Act of 2005, S. 1349, 109th Cong. (2005); Broadband Investment and Consumer Choice Act, S. 1504, 109th Cong. § 13 (2005); Digital Age Communications Act of 2005, S. 2113, 109th Cong. (2005).

179. States and localities should not be allowed to require that video providers acquire a franchise before they may offer video service. For example, *see* Broadband Investment and Consumer Choice Act, S. 1504, 109th Cong. § 13(a)(1) (2005).

180. If the goal of Title VI is to promote competition, then this necessarily means that it also promotes increased use of the rights-of-way. Use of the public rights-of-way is a good thing and should therefore not be discouraged by attaching a revenue-generating tax to it. Instead, a use fee set at cost should be used only to reimburse the municipality and to act as a congestion price to prevent overuse.

181. 47 U.S.C. § 542(b) (2000).

should be allowed to automatically require the maximum fee. The reasonable charge should be assessed periodically and a mechanism for appeal should be created. Additionally, if a new entrant is already a user of the rights-of-way and is already making payments for access, these should be taken into consideration when determining a reasonable fee.

Given the spread of the Internet, the need for PEG channels has been greatly undermined. Using the worldwide web, individuals now have the ability to cheaply and effectively reach a potential audience of millions. The web is especially suited to local and niche information because it can be found and accessed by just the small number of persons that are interested. Local governments can narrowcast their meetings cheaply and effectively online without taking up valuable channel space on video systems.[182] Communication online is also two-way, allowing interested citizens to participate and not merely listen in.

Nevertheless, the political reality is that Congress will likely find it difficult to do away with the PEG channel requirement. It should nonetheless set some limits on what municipalities can require from video providers. The Texas statewide franchising law suggests a good rule of thumb: video providers could be required to carry no more than a fixed number of PEG channels. If an incumbent does not provide PEG channels, the Texas statute has set the maximum number PEG channels that a new entrant can be required to provide at three channels for a municipality with a population of at least 50,000, and two channels for a municipality with a population of less than 50,000.[183] Such a simple formula ensures certainty and regulatory parity.

If franchises are eliminated, so are franchise fees and nonprice concessions. PEG channels have relied on these fees and in-kind payments for their funding. If the municipal governments are to fund these channels, they should do so explicitly through taxation, not by indirectly raising consumers' cable rates. By having to rely on a local tax on video services, municipalities will be forced to purchase only the amount PEG service the locality's constituency will bear, not some inflated quantity attained through higher consumer rates. It is quite possible that the number of PEG channels today is excessive from a consumer point of view. As Posner has explained,

> A troubling characteristic of the internal subsidy is its low visibility, which impedes responsible review. The amounts and recipients of

182. Cities like Des Moines, Iowa, and Boston, Massachusetts, already webcast their city council meetings on the Internet. City of Des Moines, Live and Archived Streaming Video, http://www.infoweb.state.ia.us/dsm/ (last visited Feb. 21, 2006); City of Boston, Boston City Council Television, http://www.cityofboston.gov/citycouncil/live.asp (last visited Feb. 21, 2006).

183. TEX. UTIL. CODE ANN. § 66.009(c) (Vernon 2005).

> direct subsidies are ordinarily specifically stated, but this is not the case with internal subsidies. Since information is not a free good, a subsidy program whose magnitude requires computation is less apt to be challenged than one whose magnitude is patent.[184]

By making a tax used to fund PEG channels explicit, local authorities and proposed programs will be more accountable to constituents. If viewers truly value the programs on public access, or municipal information on government access channels, they should be happy to pay a tax to support that programming.[185]

The elimination of franchises will also eliminate buildout requirements and "level playing field laws."[186] Entry into the video market—even if partial—should be encouraged, as it will benefit consumers with increased choices and lower rates. Without buildout requirements, competitors will be able to get a foothold in a community before expanding their service.

Lastly, any franchising reform by Congress should be made applicable not just to new entrants, but to incumbents as well. Competition can be promoted by removing regulatory burdens that now keep entrants away. However, new entrants should not be granted a competitive advantage, and those same regulatory burdens should be removed from incumbent cable operators.

CONCLUSION

The potential consumer benefits of robust video competition are huge. Widespread video competition could create $6.3 billion in consumer benefits annually. The benefits take two forms. On average, current cable subscribers in markets without wireline video competition would see their rates fall by about $86 annually, for a total of $5.5 billion.[187] Consumers who do not currently subscribe would find it worthwhile to do so at the lower, competitive price. These new subscribers would be better off by an average of about $43 annually, the difference between what they would pay for cable service and what the service is worth to them. The total value of this benefit to these

184. Posner, *supra* note 141, at 43.

185. The same logic applies to institutional networks and other in-kind concessions that LFAs extract from franchisees today. Many of these perquisites go unused and are therefore wasteful. *See supra* note 37 and accompanying text. By requiring localities should to pay for the services they use, waste will be reduced and accountability increased.

186. States and localities should not be allowed to require that video build out their systems in any particular way. For example, *see* Broadband Investment and Consumer Choice Act, S. 1504, 109th Cong. § 13(a)(2) (2005).

187. Our estimate in Table 4 shows that wireline cable competition would reduce cable rates by about $5.5 billion in markets that currently lack such competition. Dividing that figure by the 64 million subscribers in these markets yields $86.

consumers is approximately $850 million annually.[188]

The total cost to consumers of franchise regulation is even larger than these figures imply, for two reasons. First, wireline video competition also improves quality by increasing the number of channels –a benefit we estimate is worth about $375 million annually to consumers. Second, franchising allows local government to impose costly nonprice concessions and collect franchise fees. Taking all of these factors into account, cable franchising costs consumers a total of $10.4 billion annually in higher prices and the value of forgone services.

The policy of the United States has long been one of competition in communications markets. Franchise regulation may not be the only barrier to entry that new video competitors face, but most evidence suggests that it is a significant one. The FCC, states, and Congress have it within their power to address this problem to varying degrees and to bring competition to bear on video services. Consumers have much to gain—in lower rates and more options—by such action.

188. Our estimate in Table 4 shows that consumers who do not currently have cable service are better off by approximately $850 million when competition lowers the price and more consumers choose to subscribe. The calculations that generated this figure imply that cable subscribership would increase by about 19.5 million. Dividing $850 million by 19.5 million yields $43.