Economic Lessons from the Video Franchising Debate

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Outline

- Economics of video franchising
- Key concepts
- Applying concepts to other issues in communications

How we got here …

- Cable often had monopoly franchises (but not always)
- 1984 Cable Act requires local franchising
- 1984-99: On-again, off-again price regulation
- Local authority can regulate “basic” price if cable lacks effective competition (but 90% of customers buy “expanded basic”)
- Franchising in 1992 Cable Act
  - Monopoly franchises prohibited
  - Local authority may not “unreasonably refuse” to award a competitive franchise

Basic elements of franchising

- Firm gets permission to use rights-of-way and enter market
- Franchise fee (capped at 5%)
- "Nonprice concessions"
- Price regulation of basic service if effective competition is absent

Economic justifications for franchise monopoly

- "Unsustainable" natural monopoly
  - Never proven, frequently refuted
  - Requires effective price regulation
- Specific capital and risk reduction
  - Unclear if possible in theory
  - Never proven
  - Requires effective price regulation
- Management of rights-of-way
  - Requires pricing or rules, not monopoly
  - Irrelevant for entrants already using rights-of-way

Actual effects of franchise monopoly

- Market power raises price, lowers quality
- Nonprice concessions raise costs
  - 16% of capital and 11% of operating costs in 1984 survey
  - PEG fees on bills ≈ 1%
- 5% maximum franchise fee raises price

Wireline competition (FCC data 2002-04)

- "Monthly rate" 12-15% lower with competition
- 6-7% more channels
- Price per channel 19-21% lower

- Digital tier 3-6% lower
- 5-7% more digital channels
- Price per digital channel 6-12% lower

US Govt. Accountability Office analyses

- 2004: cable rates 16 percent lower with direct wireline competition, after controlling for other factors
- Paired case study finds 15-41 percent rate difference
- Consistent with 20 years of government and independent research finding wireline competition lowers cable rates

Wealth transfers from California cable subscribers

Effect	Monthly Price Change	Subscribers	Annual Wealth Transfer
Market Power – Basic, extended, equipment	$7.10	6.8 million	$580 million
+ Nonprice concessions	$0.46	6.8 million	$37.5 million
+ Franchise fees	$2.28	6.8 million	$186 million
TOTAL	**$9.83**	**6.8 million**	**$803 million**

Understanding unseen consumer costs

- Costs alter prices; fewer consumers subscribe
- These consumers lose difference between what the service is worth to them and what they would have paid for it
- Loss is big when demand is sensitive to price
- 1% price increase causes 1.5-3% reduction in video subscribers

Total annual cost to California consumers

Effect	Reduction in # of subscribers	Forgone consumer surplus	Wealth Transfer	Total consumer cost
Market Power – Basic, extended, equipment	2.1 million	$90 million	$580 million	$670 million
+ Nonprice concessions	2.3 million	$102 million	$617 million	$719 million
+ Franchise fees	2.9 million	**$173 million**	**$803 million**	**$976 million**

This excludes:

Market power and franchise fees on digital cable

Value of greater # of channels furnished when there is wireline video competition

Absence of competition costs California municipalities

- Current:
  - 6.8 million CA subs. x $45.52 x 12 x .05 = $186 million
- Competition:
  - 9.7 million CA subs. x $38.42 x 12 x .05 = $224 million
- Local govts. forego $38 million!
- Govt. loses revenue whenever the elasticity of demand for the service > 1.

Economic lessons from video franchising

- Market power creates big consumer costs
- Demand evidence, not just armchair theorizing
- Consumers pay for “in-kind” services
- Accurate prices reflect incremental costs
- Analyze hidden consumer costs
- Fees can reduce govt. revenues if demand is sensitive to price
- Control for other factors affecting the result

Potential market power concerns

- Exclusive right-of-way grants for muni wi-fi

Armchair theorizing

- Video “redlining” by new entrants
  - Never served?
  - Who’s served first?

- Cessation of service by incumbents

Consumers pay for “in-kind” services

- Muni networks
  - Cable
  - Phone
  - Wi-fi

Hidden consumer costs

- Universal service contributions
  - Long-distance $1.16 billion consumer welfare loss
  - Wireless $978 billion consumer welfare loss

Accurate prices reflect incremental costs

- Especially important if service paying the fee has price-sensitive demand!
  - Muni wireless
  - Broadband over powerlines (pole attachment fees)

Fees can reduce revenues

- Wireless taxes & fees
  - Wireless demand elasticity likely exceeds 1
    - CA 13.18%, vs. 8.84% natl. average (2004)
    - CA is 9th highest

Control for other factors

- Performance measures for universal service
- Select a benchmark for affordability
- Calculate # and % of consumers paying less than the benchmark
- Calculate the prices they would pay in the absence of the subsidy
- Calculate # and % of consumers paying less than the benchmark if prices were not subsidized
- Difference is the change in outcome attributable to subsidies

Note: Some subsidies inflate costs

Conclusion

"Everyone is entitled to his own opinion, but not his own facts."

-- Sen. Daniel Patrick Moynihan

"Basically, all our similarities are different."

-- Dale Berra, comparing himself to his father, Yogi