VIRGINIA JOURNAL OF LAW & TECHNOLOGY

WINTER 2007 UNIVERSITY OF VIRGINIA VOL. 12, NO. 2

Cable TV Franchises as Barriers to Video Competition

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ABSTRACT

Traditionally, municipal cable TV franchises were advanced as consumer protection to counter "natural monopoly" video providers. Yet historical evidence has demonstrated that franchise regulation – fraught with conflicts and delays, while ultimately proving ineffective in constraining rates – failed to improve consumer welfare. Now, marketplace changes render even this weak traditional case moot. First, local rate controls are, since the 1996 Telecommunications Act, pre-empted by federal law. Second, video rivalry has proven viable, with inter-modal competition from satellite TV and local exchange carriers (LECs) offering "triple play" services. Third, a community's interest in protecting local rights-of-way from excessive or disruptive use, best achieved through generic liability rules, are already in force for LEC video entrants under the terms of their telephone licenses. For these new rivals, which exploit scope efficiencies in entering video markets, cable franchises do not establish parity but duplicate existing regulation. Indeed, cable operators entered voice and data markets via video franchises, avoiding regulatory burdens such as build-out requirements. Eliminating the "double taxation" of overlapping regulatory structures improves economic efficiency by reducing a substantial barrier to competition. Were head-to-head wireline video rivalry – now offered to just under five percent of U.S. households – to extend nationwide, annual benefits to consumers are estimated to approximate $9 billion, with overall economic welfare increasing about $3 billion per year.

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I. INTRODUCTION

> The franchising process eliminates or seriously impedes entry by competitors, imposes substantial costs and delays on franchisees, cable subscribers, and the public, which are not offset by countervailing benefits. The public would be better served by municipal efforts to provide a choice of cable service providers rather than extracting costly concessions from a sole cable franchisee. We therefore recommend that municipalities no longer grant exclusive cable franchises. Instead, municipalities should permit, even encourage, entry by competitive cable service providers.[1]

¶ 1 While local governments safeguard public rights-of-way and police potentially disruptive community activities, cable franchise rules extend far beyond, imposing special taxes, exacting subsidies, and regulating services, technologies and infrastructure. These requirements are expensive and variable, delaying market rivalry while balkanizing markets and undermining scale economies. These inefficiencies are avoidable, given the availability of less obstructive regulatory tools, and expensive, given the opportunity to unleash competition between cable operators and local telephone carriers.

¶ 2 Phone companies have long been seen as the most efficient entrants into local cable markets,[2] and those best suited to overcome strategic reactions launched by incumbents to resist, and deter, competition.[3] This mirrors the economies of scope exploited by cable television operators in offering (fixed line) telephone service. As of mid-2005, approximately forty percent of U.S. households could choose between the phone company and the cable company for telephone service, a proportion of households

[1] Anita Wallgren, *Video Program Distribution and Cable Television: Current Policy Issues and Recommendations,* NAT'L TELECOMM. & INFO. ADMIN. REP. No. 88-233 (June 1988), at 30-31.

[2] *In the Matter of Telephone Company – Cable Television Cross – Ownership Rules, Sections 63.54 – 63.58, Notice of Inquiry*, CC Docket No. 87-266 (Fed. Comm. Commission Rel. Aug. 18, 1987) [hereinafter FCC, *Telco-Cable Cross-Ownership Rules (1987)*], especially ¶ 11.

[3] *See* Thomas W. Hazlett, *Telco Entry Into Video*, in ANNUAL REVIEW OF COMMUNICATIONS 212 (1994-95); Thomas W. Hazlett, *Predation in Local Cable TV Markets*, 40 THE ANTITRUST BULL. 609 (1995) [hereinafter Hazlett (1995)]. *See also*, Patrick Bolton, Joseph F. Brodley, & Michael Riordan, *Predatory Pricing: Strategic Theory and Legal Policy,* 88 GEO. L.J. 2239 (Aug. 2000) [hereinafter Bolton, Brodley & Riordan (2000)] (using observed strategies of incumbent cable operators as a paradigmatic example of anti-competitive conduct).

that is rapidly increasing.[4] Conversely, only about four percent of U.S. homes are offered two choices for cable TV subscription service.[5] Despite the presence of wireless options, most notably those provided by two nationwide satellite TV systems, markets featuring direct wireline competition for video service exhibit prices about fifteen percent below those seen elsewhere.[6]

¶3 In 1987, the Federal Communications Commission (FCC) proposed dropping the rule that blocked local phone carriers from providing video subscription service within their phone service territories, seeing this as an expeditious way to bring competition to emerging cable monopolies. The approach taken, however, was to create a heavily regulated, common carrier model for phone company delivery of television signals – video dialtone (VDT) – which allowed phone carriers to build video delivery capacity, but not to provide the programming services offered to customers.[7] Before being ended in the 1996 Telecommunications Act, only one VDT system, serving a total of 1,250 households in suburban New Jersey,[8] was operational.

¶4 Since 1996, local phone carriers have been allowed to provide cable TV services in their service territories, and some entry has occurred both by incumbents and entrants. The newcomers, generally called Competitive Local Exchange Carriers (CLECs), have built modern networks capable of offering "triple play" services to subscribers – voice, video, and high-speed data (via cable modems). Incumbents (ILECs) have upgraded existing networks to integrate into data (via digital subscriber lines [DSL]), but have only recently begun to make a major push to offer video. This comes as the post-bubble

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[4] LEICHTMAN RESEARCH GROUP, INC., *3Q 2005 Research Notes*, at 5 [hereinafter *Leichtman (3Q 2005)*], http://www.leichtmanresearch.com/research/notes09_2005.pdf. By year-end 2007, it is projected that 93 million U.S. households will be able to subscribe to fixed line voice service from their local cable operator, bypassing the traditional local phone carrier. *In the Matter of Developing a Unified Intercarrier Compensation Regime, Comments of National Cable & Telecommunications Association,* CC Docket No. 01-92 (May 23, 2005), at 2.

[5] *See* fn. 219.

[6] GENERAL ACCOUNTING OFFICE, TELECOMMUNICATIONS: ISSUES RELATED TO COMPETITION AND SUBSCRIBER RATES IN THE CABLE TELEVISION INDUSTRY, GAO-04-8 (Oct. 2003) [hereinafter GAO (2003)], at 60.

[7] Video dialtone providers were allowed to provide a limited amount of programming, so long as the dominant proportion of channel capacity (95%) was reserved for independent distributors on a non-discriminatory basis.

[8] Thomas W. Hazlett, *Economic and Political Consequences of the 1996 Telecommunications Act,* 23 REGULATION 36 (2000), at 42. The 1996 Act essentially replaced the VDT model with an Open Video System (OVS) option for cable market entrants. This common carrier approach allowed the network owner greater opportunities to use its network to deliver retail service, but has attracted only limited use. By the FCC's count, as many as 66,000 subscribers were served via OVS operators in 1998, but the number declined to 60,000 in 2002, the last year the FCC separately reported OVS subscribers. FEDERAL COMMUNICATIONS COMMISSION, IN THE MATTER OF ANNUAL ASSESSMENT OF THE STATUS OF COMPETITION IN THE MARKET FOR THE DELIVERY OF VIDEO PROGRAMMING, NINTH ANNUAL REPORT, MB Docket No. 02-145, at 75 (Rel. Dec. 31, 2002) [hereinafter FCC, NINTH ANNUAL MVPD COMPETITION REPORT]; FEDERAL COMMUNICATIONS COMMISSION, IN THE MATTER OF ANNUAL ASSESSMENT OF THE STATUS OF COMPETITION IN THE MARKET FOR THE DELIVERY OF VIDEO PROGRAMMING, TENTH ANNUAL REPORT, MB Docket No. 03-172, at 115 (Rel. Jan. 28, 2004) [hereinafter FCC, TENTH ANNUAL MVPD COMPETITION REPORT].

financial markets have taken their toll on CLECs, effectively halting network build-outs.[9]

¶5 Ameritech, the Bell Operating Company that served the Midwest region following the 1984 divestiture of AT&T, made the most serious foray into video. Beginning in 1997, the company sought cable franchises in major metropolitan areas, and soon was serving over 300,000 subscribers. The company faced major hurdles in accumulating such franchises, however, and was found to systematically avoid Illinois, a state with a "level playing field" (LPF) law. These statutes subject new competitors to lengthy hearings and mandate that, should a new franchise be issued, it contain provisions "at least as burdensome" as those embedded in the incumbent's cable franchise.[10] Cable operators often file suit to challenge franchises issued in LPF states, and Ameritech found itself in precisely this situation in Illinois.[11] When Ameritech was purchased by SBC in 1999, the company concluded its cable franchise efforts, and sold its video systems.[12]

¶6 Telephone carriers can no longer afford not to be in the video delivery business, however. Cable TV systems have integrated into high-speed data, where cable modem service garners over one-half of the residential broadband market, and provide voice phone service as well. This allows cable operators to offer "triple play" packages, seizing economies of scope, reducing transaction costs via "one stop shopping" and diminished churn. To remain competitive, U.S. phone operators are expanding into video. While the two largest carriers, SBC and Verizon, have (separately) struck deals for joint marketing of satellite TV services, both firms have announced ambitious plans to build high capacity wire networks to deliver multi-channel services to subscribers.[13]

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[9] The largest CLEC offering video service, RCN, filed for bankruptcy protection on May 27, 2004. In 2002, the second largest CLEC, WideOpenWest, suspended previous build-out plans because of financial difficulties. The third largest, Knology, restructured its debt in 2002. *See* Shanon D. Murray, *RCN Eyes Exit by Dec. 31,* DAILY DEAL, Dec. 9, 2004, Section: Bankruptcy; FCC, *NINTH ANNUAL MVPD COMPETITION REPORT*, at 49; Press Release, Knology, Inc., Knology Broadband Proceeds with Reorganization; Operations and Customer Service Will Continue Uninterrupted (Sept. 18, 2002).

[10] 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 (2001) [hereinafter Hazlett & Ford *(2001)*].

[11] *Cable TV Fund 14-A, Ltd. v. City of Naperville*, No. 96 C 5962, 1997 U.S. Dist. LEXIS 7336, (N.D. Ill. May 21, 1997). An incumbent cable operator in Florida once brusquely conceded: "Cable operators invariably resist overbuilds with profuse and expensive litigation." Telesat Cablevision, Inc., *In the Matter of Competition, Rate Reg. and the Commission's Policies Relating to the Provision of Cable Television Service, Comments of Telesat Cablevision, Inc.,* MM Docket No. 89-600, at 15. (Mar. 1, 1990) [hereinafter Telesat, *Comments* (1990)]

[12] FEDERAL COMMUNICATIONS COMMISSION, IN THE MATTER OF ANNUAL ASSESSMENT OF THE STATUS OF COMPETITION IN THE MARKET FOR THE DELIVERY OF VIDEO PROGRAMMING, EIGHTH ANNUAL REPORT, CS Docket No. 01-129, at 7 (Rel. Jan. 14, 2002) [hereinafter *FCC, EIGHTH ANNUAL MVPD COMPETITION REPORT*]; FEDERAL COMMUNICATIONS COMMISSION, IN THE MATTER OF ANNUAL ASSESSMENT OF THE STATUS OF COMPETITION IN THE MARKET FOR THE DELIVERY OF VIDEO PROGRAMMING, SEVENTH ANNUAL REPORT, CS Docket No. 00-132, at 55 (Rel. Jan. 8, 2001); *SBC Considering Sale of Ameritech Cable Systems,* WARREN'S CABLE REG. MONITOR (Mar. 13, 2000).

[13] *SBC CIO Confirms Project Lightspeed Timing, Milestones at Analyst Conference; Successful Technical Field Trial of IP-based Video, High-Speed Internet Access,* BUSINESS WIRE, Nov. 3, 2005, *available at* http://www.tmcnet.com/usubmit/2005/nov/1200957.htm; Craig Kuhl, *Navigating Telco TV;*

¶ 7 Local cable franchises, however, remain a significant barrier to entry. Some 33,000 municipal or county jurisdictions issue franchises,[14] and the permitting process delays competitive entry. Depending on the nature of the administrative process and the terms imposed, franchising may deter entry altogether. Given alternative means of protecting community interests, cable franchises impose substantial social costs without offsetting benefits. With consumer benefits of nationwide cable TV competition estimated to be approximately $9 billion annually,[15] each year of delay is extremely expensive.

¶ 8 Retail price reductions that flow from competitive entry, however, will also harm incumbent cable operators. As much as $6 billion per year in profits could be lost if direct cable competition were to break out nationwide. An open, predictable franchising process that restricted the discretion of local regulators would also cause a reduction in the rent extraction and redistribution opportunities available to local government leaders and interest groups influential at City Hall.

¶ 9 Hence, a heated controversy now rages over the cable franchising process. Proposed national legislation would substantially restrict a local government's ability to regulate competitive cable operators[16] while several state legislatures are considering issuing statewide cable franchises to phone carriers. Such legislation has stalled in the California legislature[17] while being enacted in Texas.[18] Almost immediately, the Texas law was challenged in a lawsuit brought by the Texas Cable Television Association, a case still pending.[19]

A. From Protecting Against Monopoly to Protecting Against Competition

¶ 10 The cable TV franchise was historically justified on natural monopoly grounds – ironically, premised on analogy to the local telephone business. That foundation has vanished due to developments in the video marketplace,[20] as well as in telephony, with

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The Goal Offering Video Might Be the Same, But How the Telcos Are Doing It Can Vary Greatly, CED, Nov. 1, 2005, at 24.

[14] FEDERAL COMMUNICATIONS COMMISSION, IN THE MATTER OF IMPLEMENTATION OF SECTION 3 OF THE CABLE TELEVISION CONSUMER PROTECTION AND COMPETITION ACT OF 1992, STATISTICAL REPORT ON AVERAGE RATES FOR BASIC SERVICE, CABLE PROGRAMMING AND EQUIPMENT: REPORT ON CABLE INDUSTRY PRICES, MM Docket No. 92-266, ¶ 14 (Rel. Jan. 2, 1997) [hereinafter FCC, REPORT ON CABLE INDUSTRY PRICES (1997)].

[15] *See infra* analysis in Section VI.B.

[16] H.R. Staff Discussion Draft of bill sponsored by Congressman Barton (R-Tex.), 109th Cong. (Sept. 15, 2005) (see especially § 301); Broadband Investment and Consumer Choice Act, S. 1504, 109th Cong. (2005) [hereinafter *Ensign Bill*].

[17] *Video Franchise Legislation Moves Forward in Tex.*, COMMUNICATIONS DAILY, July 15, 2005.

[18] *Telecom Law Passed Law Enables Growth, Competition and Innovation,* THE DALLAS MORNING NEWS, Sept. 13, 2005, at 18A [hereinafter *Telecom Law Passed*].

[19] Linda Haugsted, *Texas Challenges New Franchise Law,* MULTICHANNEL NEWS, Sept. 12, 2005, at 1.

[20] The cable television industry argues that competition has come to multichannel video in the form of two national direct broadcast satellite systems, which garner about one in four "cable" subscribers. *See* National Cable & Telecommunications Association, *The Video Market Is Fully Competitive: Almost 27 Million Consumers Now Subscribe to Cable's Competitors*, at 1, (Feb. 2005),

widespread provision of local (fixed line) phone service by cable television operators themselves.[21] Not by mere coincidence is it also the case that public policy has moved a considerable distance, noted in the 1996 Telecommunication Act's announced goal of competitive telecommunications networks sweeping away old market structure assumptions.[22]

¶ 11 The natural monopoly justification was never compelling, as franchise regulation failed to improve consumer welfare.[23] Neither rate controls on video programming nor regulation of other aspects of service proved effective. With rate regulation now defunct, and "natural monopoly" having died a natural death, the arguments offered for municipal cable franchises have melted away. Like a federal agency that outlives the industry it was designed to regulate, however, the cable franchise remains in place across more than 30,000 local jurisdictions.

¶ 12 Once justified as protection against *dominant cable monopolists*, the new rationale for franchising is to protect against *unregulated competitors*. To "level the playing field," franchises target new competitors as the threat to be regulated. Yet, new competition poses no threat to consumers, while delivering the public benefits that franchise monopoly has failed to produce – enhanced services, lower prices, and expanded opportunities for free speech.

¶ 13 In short, the traditionally weak public interest rationale for cable franchising has vanished altogether. Several commentators note the changing circumstances and one states that "[f]ranchise regulations effectively hinder benefits from competition and place burdens on consumers," concluding that "[m]unicipal franchising, therefore, must be eradicated."[24] Yet municipal regulators, faced with an opportunity to exercise political

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http://www.ncta.com/pdf_files/IssueBriefs/2005/competition-in-video-market-1-2005.pdf. Others see competition as driven by both telephone company entrants into video and DBS offerings: "A large factor in the monopoly status of cable television operators is that no viable technology provided true competition to the array of services available through cable during the 1970s and early 1980s. The further development of competing technologies and services over the next two decades, however, created viable alternatives that weakened cable's *de facto* monopoly status. Thus, after the 1996 [Telecommunications] Act permitted telephone companies to enter the video marketplace, telephone companies and the improvements of DBS systems posed a significant threat to the monopoly status of cable television." Jonathan E. Samon, *When "Yes" Means No: The Subjugation of Competition and Consumer Choice by Exclusive Municipal Cable Franchises*, 34 SETON HALL L. REV. 747, 762 (2004).

[21] Leichtman (3Q 2005) at 5. In addition, 98% of U.S. households can subscribe to cable modem service, allowing use of Voice-over-Internet Protocol applications such as supplied by Vonage or Skype. *Id*. at 5.

[22] H.R. CONF. REP. NO. 104-458, at 1 (1996) [hereinafter 1996 Conference Report].

[23] Thomas W. Hazlett, *Private Monopoly and the Public Interest: An Economic Analysis of the Cable Television Franchise*, 134 U. PA. L. REV. 1335 (1986) [hereinafter Hazlett, *Private Monopoly* (1986)].

[24] Kent D. Wakeford, *Municipal Cable Franchising: An Unwarranted Intrusion into Competitive Markets*, 69 S. CAL. L. REV. 233, 285-286 (1995-1996). Similarly, Jonathan Samon writes: "As competition continues to embed itself in the industry, the future for the video marketplace looks bright for customers and providers alike. Officially breaking the monopolistic stranglehold that cable companies enjoy over consumers by eliminating exclusive cable franchises would significantly brighten that picture." Samon, *supra* note 20 at 773. It is important to note that Samon here refers to franchises that are nominally

control over cable franchisees, often attempt to do so. And incumbent cable systems, faced with the opportunity to foreclose rivalry, strongly encourage those efforts.

¶ 14 In fact, cable operators have won awards from their national trade association for successfully lobbying for "level playing field" laws, state statutes explicitly designed to limit competition by raising cable franchise barriers. The paradigmatic example is the 1987 Florida statute, enacted just as Telesat Cablevision, a competitive entrant, was rapidly gaining market share against established cable operators. Before it could gain permission to compete in the state's largest market, however, new barriers were hurriedly erected. As reported by *The Wall Street Journal*:

> In Dade County, Telesat got stopped dead in its tracks by a state law known as the "level playing field" act. In theory, it was designed to ensure that the second cable franchise wouldn't get more favorable treatment than the incumbent. But in the 10 states where such legislation has been enacted, many cable newcomers contend it has enabled incumbents to manipulate the franchising process. Often at the established cable company's urging, local governments hold public hearings and conduct extensive studies on the impact of so-called overbuilders. In the end, communities frequently end up imposing more burdensome financial obligations and construction schedules on second cable systems. Dade County proved no exception.
>
> For instance, a six-month, $100,000 study into the feasibility of competition led to one delay after another in the processing of Telesat's application for a franchise…[as] incumbents prodded the county to ask for more data before taking any action.
>
> Finally, after 2½ years of waiting, Telesat withdrew its application . . . .
>
> Later that year, the Dade County cable administrator who recommended doing a feasibility study was hired by Tele-Communications Inc., owner of Storer Communications Inc., one of the incumbent cable operators . . . .[25]

¶ 15 The strategy worked. Telesat abandoned its effort to compete in Miami's Dade County, and Telesat's owner, Florida Power and Light Group Capital, sold the company to various buyers between 1992 and 1994.[26] Over the past decade, new rivals – now labeled "Broadband Service Providers" by the Federal Communications Commission – have challenged incumbent cable TV operators, but face similar barriers.[27] When

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"non-exclusive" but which are highly monopolistic due to their provisions and the manner in which they are awarded. *Id.* at 761.

[25] Mark Robichaux, *Captive Audience: Cable Firms Say They Welcome Competition But Behave Otherwise --- Some Established Systems Go to Great Lengths to Keep Rivals Out of the Game --- A Nasty Battle in Niceville*, THE WALL STREET JOURNAL, Sept. 24, 1992, at A1 [hereinafter Robichaux (1992)].

[26] Robichaux (1992); T. Christian Miller, *Telesat Tells County It Just Can't,* ST. PETERSBURG TIMES, Aug. 11, 1994, at 1.

[27] Hazlett & Ford (2001); Broadband Service Providers Association, *In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, Comments*

successful, these firms have been found to lower cable rates fifteen percent or more, while improving customer service and system quality.[28] Yet, the introduction of competition, again promising during the tech boom, has slowed since. As of late 2005, only about 4.4 million homes,[29] of 111 million households passed by cable nationwide,[30] have a choice of cable TV operators. The FCC reports: "[Broadband Service Providers (BSPs)] continue to face considerable challenges . . . . As a result, competition to cable from BSPs is limited to very few markets."[31]

B. Entry Barriers Without a Cause

¶ 16 Municipal franchises are significant impediments to cable entry, a policy conclusion rendered by federal agencies including the FCC,[32] the Department of Commerce's National Telecommunications and Information Administration,[33] and the Federal Trade Commission. These conclusions were rendered years ago, however, during which time the argument to eliminate franchise barriers has grown much stronger. Today, the "natural monopoly" justification for franchising has been eliminated by the emergence of competition in telephony, satellite television, and, in some markets, cable television. Moreover, the ostensible rationale for any cable-specific franchise – pro-consumer regulation – has been removed. Rate regulation, a failure when implemented, has been repealed. Protection of public property is not a cable-specific function and can be efficiently achieved without franchises that threaten pro-consumer competition.

¶ 17 Yet, cable TV franchise barriers are a rich source of economic rents; John Lindsay, former mayor of New York, once referred to cable licenses as "urban oil wells beneath our city streets."[34] Controlling the right to drill allows incumbent municipal franchising agents the opportunity to share in the gains from extraction. The logic of the rent-seeking process is straightforward and obtains even when franchises are nominally "non-exclusive." That is because the franchising process imposes barriers that make the incumbent's rights less competitive and hence more valuable.

¶ 18 First, cable franchises – which often stretch over 100 pages in length[35] – take

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of Broadband Service Providers Association, MB Docket No. 05-255, 12-20 (Sept. 19, 2005) [hereinafter BSPA (2005)].

[28] GENERAL ACCOUNTING OFFICE, TELECOMMUNICATIONS: SUBSCRIBER RATES AND COMPETITION IN THE CABLE TELEVISION INDUSTRY, GAO-04-262T at 6-7 (2004).

[29] BSPA (2005) at 7.

[30] NATIONAL CABLE & TELECOMMUNICATIONS ASSOCIATION, INDUSTRY OVERVIEW [hereinafter NCTA, INDUSTRY OVERVIEW], http://www.ncta.com/Docs/PageContent.cfm?pageID=86 (reporting an A.C. Nielsen estimate for January 2006 of 110,800,000).

[31] FEDERAL COMMUNICATIONS COMMISSION, IN THE MATTER OF ANNUAL ASSESSMENT OF THE STATUS OF COMPETITION IN THE MARKET FOR THE DELIVERY OF VIDEO PROGRAMMING, ELEVENTH ANNUAL REPORT, MB Docket No. 04-227 (Rel. Feb. 4, 2005), 47-48 [hereinafter FCC, ELEVENTH ANNUAL MVPD COMPETITION REPORT]. (footnotes omitted).

[32] FCC, TENTH ANNUAL MVPD COMPETITION REPORT at 8.

[33] See passage quoted at the beginning of this paper.

[34] Albin Krebs, *Cities Reassured on Cable TV Rights*, N.Y. TIMES, Feb. 6, 1973, at 73 [hereinafter Krebs (1973)],.

[35] Sol Schildhause, *Can Local Franchising of Cable TV Be Trusted?*, 6 COMM. LAW. 1 (1988) [hereinafter Schildhause (1988)].

considerable time to craft, and can long delay entry. Studies, needs assessments, and public hearings, ostensibly undertaken to make an informed franchise decision, extend delays. Second, "level playing fields" often explicitly tilt against entrants. "Level" is commonly defined to mean that a competitive franchise cannot receive more favorable terms to entry; providing less favorable terms is perfectly acceptable. This allows franchising authorities to impose far harsher costs on competitors than shouldered by the original cable franchisee. Third, even where burdens appear to be stated in identical terms, economic costs can be skewed against the entrant. This is because the initial cable franchisee, being first, enjoyed a monopoly, while an entrant expects to achieve market share only about one-half as large and to charge prices that will be substantially lower. This sharp distinction in the market opportunities facing competitive versus monopoly franchisees makes nominally symmetric franchise requirements sharply asymmetric in financial effect.

¶ 19 A widespread provision in existing cable franchises requires the operator to build-out any part of the market where density is thirty homes per mile or more.[36] (Average U.S. cable density is approximately 100 homes per mile.[37]) Assuming standard industry costs for a state of the art system and national averages for penetration (subscribers per home passed) and gross operating profits, a financial analysis shows a monopoly cable franchise can expect to break even at just under thirty homes per plant mile, i.e., below the density of the build-out requirement. But using precisely these numbers to gauge the entry of a competitive firm reveals that break even build-out occurs at about sixty-five homes per mile. With only about half as many anticipated subscribers and prices expected to decline by at least fifteen percent, the entrant is heavily taxed by imposition of a provision that costs the incumbent monopolist nothing, as the territory "required" to be built would be profitable to serve on its own.[38]

¶ 20 Policy positions taken by incumbent cable operators with regard to build-out requirements illustrate the asymmetry. Established system operators aggressively lobby for build-out requirements for potential competitors, making "universal service" and "anti-redlining" provisions standard elements in the franchises available to competitors.[39] Characteristically, the argument is made that the incumbent welcomes competition so long as the new competitor is required to "overbuild"[40] the incumbent everywhere.[41]

¶ 21 This policy position is transparently anti-competitive. As an entrant increases the scope of its overbuilding, the incumbent is doubly harmed – additional subscribers are

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[36] *See, e.g.*, *Cable Television Franchise Agreement By and Between the City of Palo Alto, California on Behalf of the Joint Powers and TCI Cablevision of California, Inc.* (July 24, 2000), § 7.10.2, *available at* http://www.city.palo-alto.ca.us/cable/franchise-agreement.html.

[37] According to the NCTA's 2005 Mid-Year Industry Overview, in 2005, there were more than one million miles of cable plant and approximately 110 million occupied homes passed by cable nationwide. NATIONAL CABLE & TELECOMMUNICATIONS ASSOCIATION, 2005 MID-YEAR INDUSTRY OVERVIEW (2005).

[38] See analysis in Section V.

[39] *Telesat, Comments (1990)*; *Hazlett & Ford (2001)*, *supra* note 10, at 25

[40] "Overbuild" refers to an entrant building new facilities to compete with an established cable operator. The term "overbuilder" has been used pejoratively to infer that two rivals are one too many.

[41] Robichaux (1992), *supra* note 25.

lost, and prices further decline as the competitive territory expands.[42] The cable operator's interest in mandating larger service areas or faster build-out requirements for potential competitors is clear: the rules are anticipated to result in *less* competition. Imposing higher costs on rivals is a standard anti-competitive tactic.[43] Promoting regulation to achieve this outcome is a standard paradigm in economics.[44] By deterring entry, the incumbent endorses build-out requirements for entrants as a profit-maximizing strategy. This very calculation reveals that consumers are far less likely to reap the benefits of competition when such cable franchise measures are adopted.

II. PRO-CONSUMER POLICY REFORM

¶ 22 If the goal of cable TV regulation is to maximize consumer welfare, the cable franchise has outlived whatever usefulness was claimed for the institution. It is therefore unnecessary to establish that franchises have been historically unsuccessful in advancing consumer interests. It is only necessary to establish that cable franchises today form substantial barriers to entry uncompensated by social benefits.

¶ 23 The social costs of anti-competitive policies are exacerbated, relative to previous periods, by delaying the emergence of the cable versus telco rivalry. Given the regulatory options available, there are no benefits associated with cable franchising that offset the losses emanating from reduced competition.

¶ 24 Public interests can be protected with efficient, competitively neutral rules. Legal entry barriers that were once justified as essentially free – on the grounds that natural monopoly pre-determined exclusivity in the supply of services – are now clearly expensive. Competitive entry into video markets has occurred, and substantially more could occur were franchise barriers eliminated.

¶ 25 Beyond the quantifiable consumer welfare damage, franchise impediments stunt the growth of advanced broadband communications networks, limiting economic development and restricting free speech. Franchises govern the scope of competition, thrusting municipal government officials into a joint venture with incumbent cable operators. Instead of cable developing as an independent medium of expression, one particularly well situated to inform citizens about local government policies, operators traded their press credentials for cozy monopolies.

¶ 26 There is no balancing test that need be conducted, as these serious social losses are not compensated by countervailing gains. The cable TV franchise is a fossilized, regulatory dinosaur. Pro-consumer policies would facilitate its march to extinction.

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[42] George S. Ford, Thomas M. Koutsky & Lawrence J. Spiwak, *Phoenix Center Policy Paper Number 22: The Consumer Welfare Cost of Cable "Build-out" Rules,* PHOENIX CENTER POL'Y PAPER SERIES, 6-7 (July 2005, Second Release).

[43] Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price,* 96 YALE L.J. 209 (1986).

[44] George J. Stigler, *The Theory of Economic Regulation,* 2 BELL J. OF ECON. AND MGMT. SCI. 3 (Spring 1971).

¶ 27 The argument can be summarized as follows.

A. Cable Regulation Should Protect the Public

¶ 28 Franchises are traditionally justified as protecting the use of public rights-of-way (ROWs) and limiting disruption caused by the construction of cable TV systems. Yet, these purposes can be achieved without the anti-competitive consequences of franchises. Newspapers, for example, use public streets for daily deliveries, and public sidewalks for vending machine distribution; both uses are regulated with generic laws that limit inconvenience or disruption in the community, no franchise is needed.

¶ 29 Telephone companies offering to provide video services in competition with cable TV systems already have franchises that regulate their use of ROWs; the introduction of new video bits – riding over already regulated infrastructure – does not pose additional risks to local residents. When direct broadcast satellite (DBS) operators compete with cable operators, it would be needlessly anti-competitive for the satellite systems to obtain local franchises, despite the fact that cable operators have attempted to promote such laws on the grounds of fairness.[45] That DBS can offer competition without imposing additional (public) costs is an efficiency that should be welcomed rather than stifled to protect incumbent interests. Likewise, the existing regulatory constraints on telephone networks should not be duplicated by franchises that limit the economies of scope telephone carriers enjoy.

B. Franchises Are Justified Today as Equitable to the Incumbent

¶ 30 The primary justifications offered historically for cable franchises – rate regulation and natural monopoly – have been mooted. Today, the rationale has switched to one of horizontal equity: cable system incumbents had to obtain franchises, and so should their new competitors. This criterion is not only uncompelling on its own – cable systems were often constructed without franchises, while those that did receive franchises often did not comply with stated regulatory requirements – but also is clearly anti-consumer. That is because consumers are best served by encouraging all efficient forms of competition, including that which operates without local franchise regulation.

¶ 31 Because telco-video service can be provided under franchises already in place, cable franchising constitutes double taxation. Raising the cost of entry harms consumers, who thereby see competitive entry deterred. This is enormously expensive to consumers: head-to-head competition, nationwide, would save multi-channel video subscribers about *$9 billion* annually.[46] As a holder of state common carrier licenses, telephone companies must comply with rules governing access to ROWs and activities that may result in disruption to the community. Requiring additional cable permits is to franchise for franchising's sake.

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[45] While cable franchises have not been extended to encompass DBS services, cable operators have argued that regulation is needed to ensure parity in the marketplace.

[46] See Section VI.B.

C. Cable Incumbents and Municipal Regulators Share Franchise Rents

¶ 32 The cable franchise is pursued by both incumbents and regulators to impose entry barriers, awarding supra-competitive profits to the incumbent. These returns – rents, in economic terms – accrue to incumbent operators, but some fraction of them are, in turn, diverted to franchising agents or the political constituencies of their choice. Such payments include campaign contributions, legal payments (including shares of stock in cable firms, a common practice in the late 1970s and early 1980s, when it was dubbed "rent a citizen"), employment of former city council staff members or others close to municipal officials, and illegal bribes. Additionally, certain tax and subsidy obligations are assumed by incumbent cable operators, including the payment of franchise fees, the provision of PEG (public, educational, and government) cable channels, free cable connections for public schools and government agencies, and "universal service" requirements.

¶ 33 The arrangement fits neatly within Richard Posner's model of "taxation by regulation."[47] Regulators tax the community by erecting entry barriers, conferring protection on franchisees. Incumbents, in return, agree to fund various activities via cross subsidies. Such mechanisms are typically inefficient in two respects. First, monopoly restrictions are relatively expensive taxes, distorting markets and imposing dead weight loss in excess of that resulting from broader levies. Secondly, subsidies are undertaken with relatively little transparency, escaping cost-benefit scrutiny. Typically, the value of such programs is low, relative to their expense.

D. Alternative Policies Safeguard Consumer Welfare by Increasing Competition

¶ 34 State or federal licensing of video entrants would pre-empt municipal franchise barriers, serving the interests of consumers. Such an approach has been applied in several instances, including video markets. The Federal Communications Commission has taken steps to eliminate zoning ordinances and other entry barriers for satellite television dishes, which municipalities have sought to regulate.[48] Similarly, courts have struck down certain efforts by local governments to impose franchise restrictions on private developments, where home owners associations or developers have sought to establish their own contracts with video suppliers.[49] Federal preemption of rate regulation was imposed in the 1984 Cable Act and – after re-regulation in the 1992 Cable Act – again imposed in the 1996 Telecommunications Act.[50]

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[47] Richard A. Posner, *Taxation by Regulation*, 2 BELL J. OF ECON. & MGMT. SCI. 22 (1971) [hereinafter Posner (1971)].

[48] Federal Communications Commission, *Information Sheet: Over-the-Air Reception Devices Rule* (July 2005), http://www.fcc.gov/mb/facts/otard.html.

[49] Satellite Television of New York Associates v. Finneran, 579 F. Supp. 1546 (S.D.N.Y. 1984); *TM Cablevision v. Daon*, 6 Media L. Rep (BNA) 2576 (Cal. Super. Ct., San Diego Co. 1981).

[50] Telecommunications Act of 1996, 47 U.S.C. § 609 (1996); Cable Television Consumer Protection and Competition Act of 1992, Pub. L. No. 102-385 (codified as amended in scattered sections of 47 U.S.C.); Cable Communications Policy Act of 1984, Pub. L. No. 98-549, 98 Stat. 2779 (1984).

¶ 35 In phone markets, federal pre-emption of state or local regulatory authority has proven successful in promoting efficiency. In 1993, Congress ended state-level rate regulation of cellular phone charges. With the award of new personal communications services (PCS) licenses in 1995 and 1997, mean prices plummeted from above fifty cents per minute of use in 1993 to just twelve cents in 2002.[51] The episode underscores the ineffectiveness of government regulation relative to direct rivalry in protecting consumers.[52] And in 1996, the Telecommunications Act abolished state monopolies in local telephone service.[53] This provision has allowed, for instance, cable operators to offer telephone service, and has not encumbered the right with build-out regulations.

¶ 36 This approach has succeeded where a different tack in cable failed. In the 1992 Cable Act, municipalities were instructed by Congress to issue competitive franchises and, in particular, to refrain from imposing stringent build-out requirements that would deter entry. Yet, there was no enforcement mechanism to ensure compliance. An actual solution could be supplied via state or federal authorizations that bypass municipal cable franchise roadblocks, either by limiting the scope of franchise regulation or by issuing alternative (state or federal) authorizations. New competitors would still be liable for costs they incur and for non-compliance with general rules of access to public property and local ROWs. But competitive markets would be enabled as franchising barriers were stripped away for telephone companies and all fixed line video competitors.[54]

III. DECONSTRUCTING THE CABLE TELEVISION FRANCHISE

¶ 37 Franchises limit entry, awarding special rights in exchange for obligations levied. This "quid pro quo" arrangement, to be efficient, rests on three propositions. First, an unregulated market must exhibit some form of market failure which government regulation is anticipated to remedy. Usually, the standard sources of market failure are externalities and monopoly. Second, the remedy is expected to improve social welfare, generating benefits in excess of costs. Third, the optimal form of regulation must obtain, meaning that the franchise produces superior net benefits to other sets of rules targeted to remedy the observed market failure.

A. Externalities in the Use of Public Property and ROWs

> The City of Palo Alto is authorized to regulate the use of and grant access to the public rights-of-way. It exercises this authority to ensure that the public rights-of-way are protected in order to maximize their efficient use, minimize disruption, and prevent harm. Generally, cable television and open video system operators place portions of their physical plant in the

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[51] Thomas W. Hazlett, *Is Federal Preemption Efficient in Cellular Phone Regulation?,* 56 FED. COMM. L. J. 155, 165 (Dec. 2003) [hereinafter Hazlett (2003)].

[52] Jerry Hausman, *Mobile Telephone*, in Martin E. Cave, et al., eds., 1 HANDBOOK OF TELECOMM. ECON. (North Holland, 2002).

[53] Telecommunications Act of 1996 § 253.

[54] This is not to say that wireless platforms should face such barriers, but to assume that they will continue to be exempt from local cable TV franchise regulation.

public rights-of-way, and the City in turn regulates their use.[55]

¶ 38 In supplying goods and services, firms incur costs. An input used to produce a particular output is not available to assist production elsewhere.[56] Efficiency obtains via the constraint that the supplier must bid for the valuable resources it denies others. It will thereby employ only those whose value in one use is sufficient to offset the opportunities sacrificed.

¶ 39 Externalities may result when this bidding process is interrupted by ill-defined property rights, leaving certain valuable resources without an owner. The constraint – having to outbid others by paying the full value of a resource's alternative use – is withdrawn. Inputs appear too cheap, resulting in inefficient over-production.[57] The standard example is pollution, a byproduct from (or input to) valuable production that creates losses not taken into account by the producer. A rational feedback loop is lost, and resources are not expected to satisfy the highest valued demands of consumers. Social welfare is squandered.

¶ 40 Cable television systems potentially impose two types of external costs: the "consumption" of capacity in public ROWs and community disturbances attendant to system construction and maintenance.

1. Allocating Public ROW Slots

¶ 41 Video distribution networks attach copper twisted pairs, coaxial or fiber optic cables (the principal "plant" of a video distribution grid) on utility poles used for aerial wiring, as well as placing them in underground conduits. These pathways typically utilize easements held by a utility company or governmental unit, and cross private and public property throughout a given community. The purpose of such easements is to facilitate the provision of valuable services which might be thwarted by the transaction costs of arranging individual transit agreements with property owners. In particular, some owners might "hold out" to extract rents. The aggregate cost of such payments may render network investment unprofitable.[58]

¶ 42 A standard solution has been to declare easements available for use by qualified parties. Access is then regulated such that the cost to property owners remains slight. Users of ROWs, which include power, water, sewer, and telephone companies, developers, and governments, are liable for damages inflicted. Typically, insurance and/or bonding requirements limit the likelihood of external costs.

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[55] City of Palo Alto, *City Manager Report CMR 237:00* (May 8, 2000), *available at* http://www.city.palo-alto.ca.us/cmrs/237-00.html.

[56] In the case of a pure public good, the proposition remains correct at the production stage, when costs are incurred.

[57] A symmetric externality occurs when rights are poorly defined with respect to outputs, reducing compensation of suppliers. This results in under-production of valuable outputs.

[58] This has been called "the tragedy of the anticommons." *See* Michael Heller, *The Tragedy of the Anticommons: Property in the Transition from Marx to Markets*, 111 HARV. L. REV. 621 (1998) [hereinafter Heller (1998)]; Lee Anne Fennell, *Common Interest Tragedies*, 98 NW. U. L. REV. 907 (2004); Thomas W. Hazlett, *Spectrum Tragedies*, 22 YALE J. ON REG. 242 (2005).

¶ 43 The cable franchise has regulated access to public easements on two premises. The first is that available slots are scarce, and that a new operator's cables may not fit on existing poles or within underground conduits. The argument has been extended to a claim that the government should protect this limited capacity by authorizing only preferred operators or technologies.

¶ 44 This approach limits entry, which is counter to the purpose of public ROWs. The proper regulatory instrument is price, ensuring that entrants pay the opportunity cost of the resources consumed.[59] This rule may be instituted without controlling entry via cable franchises. Imposing liability on operators for damage they inflict and for additional investments required to maintain ROWs forces incumbents and entrants to internalize the costs they impose.

¶ 45 Note that a monopoly cable franchise will not solve the public disruption externality, because monopolists will not have incentives to economize on the disruption "input" in the absence of liability rules that make them compensate such costs. It is true that monopoly franchises limit entry and so limit the amount of infrastructure investment, but this is a notoriously expensive and inefficient mechanism for limiting disruption. General rules of liability accomplish that desirable limitation.

¶ 46 The price of access to ROWs is not efficiently set so as to maximize fees. In fact, the standard governmental interest alleged – "[f]ranchise fees are the rent cable operators pay for the use of public rights-of-way"[60] – is highly misleading. Rather than operate as a private landlord extracting profits from an owned investment, the public interest in regulating ROWs mimics competitive results, imposing *access prices equal to marginal cost*. At prices greater than this, entry is inefficiently restricted. This taxes consumers via monopoly pricing, a highly distortionary outcome.

¶ 47 Investments undertaken by private owners put assets in place that reap future payments, anticipated to be in excess of operating costs. These are deemed rents.[61] Private owners attempt to maximize rents; it is the motive for investing. Public ROWs, however, are not constructed via risky capital invested by private owners, but are created by police powers of the government. It is counter-productive to maximize rent payments; it puts a dollar into one pocket (the municipality's) and takes many more out of others (belonging to the municipality's current and future cable subscribers). There are more efficient ways to raise revenues than by taxing competitive entrants. The government, charged with acting as an agent of local residents, misappropriates public property when it views ROWs as did the late New York City Mayor John Lindsay, who stated that localities "have the right to develop public income from that asset to be used for the

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[59] Importantly, this implies that a *competitive price* is charged for ROW access, not a monopoly price – which would create non-market failure by over-pricing (and under-utilizing) ROWs.

[60] National Association of Counties, *The American County Platform & Resolutions 03-04*, TELECOMM. & TECHNOLOGY 3-4 (July 20, 2004), *available at* http://www.naco.org/ContentManagement/ContentDisplay.cfm?ContentID=14334.

[61] Sometimes such payments are identified as "quasi rents," as re-investment (including investments going for maintenance) will only be made if sunk costs are (looking forward) recoverable.

public good."[62] If ROWs are treated as independent profit centers, this severely handicaps competitive entry, reducing the social benefits ROWs were designed to produce.

¶ 48 As a practical matter, incremental cables can always be accommodated; the relevant question is the cost. When entry occurs via telephone company wires carrying voice, data, and video traffic, essentially no incremental space is consumed. When a separate video line is used, it must be placed some distance (assumed to be twelve inches[63]) from other communications cables (due to radio interference), and this does "consume" incremental capacity.

¶ 49 The operator should be liable for the cost of this consumption, which is straightforwardly achieved. Not only are entrants charged fees for occupying ROWs (utility pole attachments are regulated by federal statute[64]), but also they can (and should) shoulder costs of increasing capacity where it is necessary to do so. Where poles are crowded, "L brackets" are commonly used to create new space. In some instances, poles are replaced by larger ones. So long as liability falls on the entrant, efficient solutions are obtained. By denying the entrant the opportunity to pay marginal costs, efficiency is undermined, as competitive entry is unduly restricted. General rules governing ROW use can be (and sometimes are) imposed by local, state, and federal governments. Cable franchises are not necessary for this purpose.

2. Public Disruption

¶ 50 Public disruption, the second potential source of externality, is again solved via general constraints and liabilities. Rules governing either are already imposed by local governments; developers, for instance, cannot engage in noisy operations at certain times of day, are limited in digging through roadways, and must post bonds to ensure compliance.

¶ 51 Municipalities have argued that cable TV franchises are necessary to protect residents from a variety of disruptive activities, including:

- An increase in traffic from cable TV operator service vehicles;[65]
- Ecologically damaging tree trimming as aerial cables are hung;[66]
- Aesthetic degradation from an additional coaxial cable attached to poles;[67] and
- Additional pets being released when cable technicians leave backyard gates ajar.[68]

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[62] Krebs (1973), *supra* note 34, at 73.

[63] Federal Communications Commission, *In the Matter of Implementation of Section 703(e) of the Telecommunications Act of 1996, Amendment of the Commission's Rules and Policies Governing Pole Attachments, Report and Order,* CS Docket No. 97-151 ¶ 22 (Rel. Feb. 6, 1998).

[64] 47 U.S.C. § 224 (2006).

[65] Pac. W. Cable Co. v. City of Sacramento, 672 F. Supp. 1322 (E.D. Cal. 1987).

[66] Nor-West Cable Communications Partnership v. City of St. Paul, No. 3-93 Civ. 1228 (D. Minn., Sept. 1, 1988).

[67] Preferred Communications, Inc., v. City of Los Angeles, No. CV 83-5846 (CBM), 1989 U.S. Dist. LEXIS 18379 (C.D. Cal. Jun. 5, 1989).

[68] Century Federal, Inc. v. City of Palo Alto, 648 F. Supp. 1465, 1478 (N.D. Cal. 1986).

¶ 52 While there are unlimited external costs or public purposes that may be alleged, none justify cable franchising. The external costs are not specific to the activities of cable operators, and are best controlled via rules that apply without discrimination. Moreover, imposing cable franchises for franchising's sake disrupts the opportunity for telephone companies to provide integrated voice-data-video networks – networks which economize on public impacts by combining service transmissions. In other words, cable franchises themselves impose negative externalities by reducing economical use of existing regulatory structures (and networks) to efficiently serve the public.

¶ 53 Cable franchise regulation has always had to offer a distinction in the cable operator's use of ROWs against that of other businesses, particularly local newspapers where "franchises" would clearly violate the First Amendment's free speech and free press clauses.[69] One commentator attacks the issue thusly:

> Cable franchising is not analogous to newspaper licensing. Newspaper vendors and trucks make use of city streets, but the use is transitory. Their use does not prevent any other use of the streets. Where newspapers seek nontransitory uses, such as in newsracks, more regulation is permissible, and their exclusion altogether may be permitted.[70]

¶ 54 The logic is unpersuasive. First, the distinction between "transitory" and "nontransitory" is not drawn. Second, the "transitory" assertion is dubious. Newspapers make repeated use of streets and rights-of-way. Indeed, sidewalk use of vending machines is not transitory but permanent or semi-permanent. Third, and far more fundamentally, the quantitative comparison is entirely ad hoc. Cable TV plant is buried in underground conduits or attached overhead on utility poles, whereupon it delivers video bits to customers unobtrusively. Newspaper print edition distribution, on the contrary, involves substantial, ongoing use of streets, posing the burdens associated with increased vehicle traffic. As another commenter notes:

> In most cities, newspapers cause litter that must daily be removed from city streets, sidewalks, and the like; second, old newspapers must be collected and recycled or disposed of at landfills; and third, newspaper delivery vehicles create wear and tear on city streets and contribute to traffic congestion. . . .
>
> Further, cable's disruption of rights-of-way takes place only for limited periods of time in limited areas of the community.
>
> Once the cable is installed, rights-of-way are not disrupted and the public is not inconvenienced. If the need for some form of cable regulation stems from disruption of rights-of-way, then logically government oversight

[69] *Miami Herald Publishing Co. v. Tornillo,* 418 U.S. 241 (1974). *See also*, William E. Lee, *Cable Franchising and the First Amendment*, 36 VAND. L. REV. 867 (1983) [hereinafter Lee (1983)].

[70] Daniel Brenner, *Cable Television and the Freedom of Expression*, 1988 DUKE L.J. 329, 346 (1988) (footnote omitted).

> should cease when construction ceases. The necessity of public safety regulations does not mandate the regulation of any other aspect of the communications activity, whether the activity is a parade, street assembly, distribution of a newspaper, or distribution of information via cable television.[71]

¶ 55 The external costs generated by local newspapers are likely far higher than cable TV operations. A study of Berkeley, California found that newspaper spillovers cost residents over $1 million annually, while the cable television system's externalities cost just $30,000.[72] Newspapers use public streets to deliver daily or weekly papers, operate vending machines that take up space on city sidewalks, and generate a sizeable fraction of local trash tonnage. This turns out to be far more burdensome, in terms of external costs, than cable systems that dig up streets or attach lines to poles (about seventy percent of a standard cable TV system is aerial, thirty percent underground) but are thereafter relatively unobtrusive.

¶ 56 The real comparison is not one of distinction, but one of similarity. Newspapers are subject to general rules that limit inconvenience to the citizens of a community, including constraints on the size and location of sidewalk newspaper racks. External costs are constrained without franchises. Such a regime is readily transferable to video services.

¶ 57 In fact, it has been used. Prior to the 1984 Cable Act, which imposed a cable franchise requirement,[73] many jurisdictions allowed cable television to be provided by a firm possessing only a business license. Many unincorporated county areas followed this policy, including those in San Diego, California, Pima (Tucson), Arizona and Prince William, Virginia where a business license was the only permit required.[74]

¶ 58 The federal pre-emption of non-franchising policies deserves explanation. For years after the passage of the 1984 Cable Act, the president of the National Cable Television Association featured the newspaper headline announcing the law mounted on his wall.[75] The trophy was more than boastful salesmanship. Cable TV incumbents scored a public policy trifecta in the Act.

¶ 59 First, operators won the requirement of a cable franchise.[76] Competitors would have to surmount regulatory hurdles, protecting incumbents. Where the pre-emption was

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[71] William E. Lee, *The First Amendment Versus Municipal Regulation of Cable Television,* CATO INST. POL'Y ANALYSIS NO. 40 (Aug. 7, 1984).

[72] Brobeck Corporation, *Public Sector Costs for Newspaper and Cable TV in the City of Berkeley*, Study prepared for Farrow, Schildhause, Wilson & Rains, 1 (1983).

[73] Cable Communications Policy Act of 1984 § 621.

[74] Thomas W. Hazlett, *Competition vs. Franchise Monopoly in Cable Television,* 4 CONTEMP. POL'Y ISSUES 80, 83 (1986) [hereinafter Hazlett, Competition vs. Franchise Monopoly (1986)].

[75] "Hanging in [National Cable Television Association president James] Mooney's office is a copy of the Cable Communications Policy Act of 1984, which deregulated cable, enriched cable operators and contributed to the cable programming boon of the 1980s. It is a tribute to Mooney's legislative prowess." Harry A. Jessell, *Mooney: Rereg No Sure Thing*, 122 BROADCASTING 4 (May 4, 1992).

[76] Cable Communications Policy Act of 1984 § 621(b)(1).

binding – i.e., in areas where no franchise had been required – the policy switch did not improve performance of firms or serve to remedy externalities.

¶ 60 Second, telephone companies were ruled ineligible for cable franchises in their local service areas. This statute reinforced a 1970 FCC cable-telco cross-ownership ban.[77] Given that the FCC was soon to suggest an end to the ban,[78] this was a strategic victory. In the 1996 Telecommunications Act, this prohibition was repealed.

¶ 61 Finally by December 29, 1986, cable operators won a phase-out of local rate regulation.[79] The effects of this deregulatory initiative were largely positive for consumers, as discussed below. The specific point here is that substantial regulatory pre-emption has occurred, producing significant benefits for incumbent operators.

B. Franchise Regulation

¶ 62 As a practical matter, "cities exercise the franchising power to extract services such as access channels from cable companies in exchange for permission to use public rights-of-way."[80] The process has tended to promote de facto exclusive licensing;[81] when (implicit or explicit) exclusivity is offered, firms are willing to pay more for the franchise.[82] But the extraction is relatively expensive for society, because it imposes monopolistic output restrictions, limiting innovation and gains from competitive enterprise.

¶ 63 Cable television franchises can easily run to 100 pages,[83] and regulate

- *Use of streets, rights-of-way*;
- *Requirements to serve*, fixing when service is offered, or ceases;
- *Service areas*, mandating system build-out, typically with exemptions for areas with fewer than 20-30 homes passed per mile (customers in lower density areas paying extra fees to cover line extension);
- *Franchise build-out schedule,* anti-redlining rules;
- *Institutional networks,* connecting government (or other) users;
- *Franchise authority reimbursement*, paying administrative costs of regulation;

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[77] Federal Communications Commission, *In the Matter of Telephone Company-Cable Television; Cross-Ownership Rules*, *Further Notice of Inquiry and Notice of Proposed Rulemaking*, CC Docket No. 87-266 (Rel. Sept. 22, 1988) ¶¶ 2-3.

[78] FCC, *Telco-Cable Cross-Ownership Rules (1987)*, *supra* note 2.

[79] Rate controls were ended in any community where "effective competition" existed. The FCC was instructed to define this term; the existence of just three over-the-air broadcast television stations was defined as "effectively competitive." This removed systems serving about 99% of cable TV subscribers from rate regulation. Hazlett & Spitzer (1997), *supra*, at 55-56.

[80] Lee (1983), *supra* note 69, at 868 (footnote omitted).

[81] *See* Hazlett, *Private Monopoly* (1986), *supra* note 23; Thomas W. Hazlett, *Duopolistic Competition in Cable Television: Implications for Public Policy*, 7 YALE J. ON REG. 65 (1990).

[82] Victor Goldberg uses this as a possible justification for cable TV franchises, broadcast TV licenses and other monopolistic institutions. *See* Victor P. Goldberg, *Regulations and Administered Contracts,* 7 BELL J. OF ECON. 426 (1976).

[83] Schildhause (1988), *supra* note 35.

- *PEG channels*, setting aside public, educational, and government channels;
- *Public access/local origination,* subsidies for programming;
- *System design and capacity,* technology mandates;
- *Rates*, controlling retail charges when not pre-empted by federal law;
- *Customer service,* rules for responding to complaints, outages, etc.; and,
- *Liability*, protecting a community from damage via insurance or bonding.[84]

¶ 64 These regulations can be categorized as *access rules* (imposing liability and limiting disruption); *taxes* (including franchise fees paid in cash and in-kind contributions of network capacity or production facilities such as studios); *service regulation* (including rate controls and customer service rules); and *system regulation* (technology and build-out requirements). This heterogeneous mix of regulatory instruments can best be analyzed by deconstructing its constituent parts.

1. Access Rules

> Although some commentators characterize this form of franchising as a legitimate exercise of government power, Harold Farrow, counsel for the petitioner in Community Communications stated that the cities' franchising practices are more appropriately "spelled e--x--t--o--r--t--i--o--n."[85]

¶ 65 The right to lay video cables using publicly regulated easements is authorized by the standard cable TV franchise. Rules governing use of public ROWs cover "time and place" regulations, which limit disruptive practices (such as drilling underground conduits in a residential neighborhood at 3 AM, or blocking traffic with construction projects that drag on for weeks or months). Such regulations are imposed on a variety of firms constructing facilities, as well as on service providers using easements for distributional economies, and typically include proof of liability (such as insurance or bonding requirements). There is no factor here that distinguishes cable operators from these other firms. Compliance to similar rules should be enforced to encourage rational use of economic resources across different services.

¶ 66 Cable operators' access to ROWs, however, is leveraged to extract special taxes and to impose particular regulations on a negotiated basis. It is consequently correct to note that franchising entails legitimate governmental interests *and* that it extends beyond such interests to raw horse trading over payments for monopolistic protections. Rules to ensure that externalities are efficiently incorporated into the decisions of cable TV competitors can be unbundled from the traditional franchise, delivering the social benefits of competition while maintaining – in fact, improving – protection of legitimate community interests.

¶ 67 The optimal policy approach, discussed in more detail below, opens entry into

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[84] *See id.*

[85] Lee (1983), *supra* note 69, at 868-69. The late Harold Farrow was a prominent cable TV attorney, obtaining a landmark U.S. Supreme Court verdict in *City of Los Angeles v. Preferred Communications, Inc.*, 476 U.S. 488 (1986).

cable TV markets while maintaining rules that impose liability on operators for the costs they may impose. Without barriers to entry, there is no artificial scarcity and the franchise "auction"[86] is eliminated, as general rules are enforced for use of public ROWs and the number of competitors is determined by the marketplace. Thus ends the rent seeking competition for special privilege.

¶ 68 This competition for franchises dissipates social value.[87] Moreover, it yields strong incentives for local officials to create and maintain monopolies, as rent seekers aim to procure their favor.[88] This results in opportunities for influence in arranging various cross-subsidies, campaign contributions, lucrative private employment for staff members, family members, or themselves, illegal bribes, and legal bribes to friends or associates. These legal bribes were routinized in the cable franchising "gold rush" (from the late 1970s to the early 1980s). As described in Section IV, cable operators bidding for franchises would create local subsidiaries and distribute a substantial minority equity interest to influential community members. These stock holders would then lobby municipal officials, receiving windfalls in the value of their shares should their company receive a de facto exclusive cable franchise.

¶ 69 The transfer of value from cable operators to local influence peddlers does not, by itself, raise efficiency concerns. What does create a loss of social value, however, is the incentive to create monopoly conditions facilitating such transfers. It is a clear temptation for local officials to promote a system favorable to their supporters and political allies, precisely why such individuals are singled out for windfalls by cable operators seeking franchises. The policies that logically result from such a rent-seeking competition favor a market structure most profitable to the firm selected by the municipal franchising authority, depriving society of the benefits of competitive enterprise.[89]

¶ 70 Associated costs are very high. Mark Zupan's study estimated that about twenty-six percent of capital costs and eleven percent of operating expenses were attributed to "bells and whistles" mandated by local governments but delivering little or no value to subscribers.[90] The most significant costs are the losses associated with pre-empting head-to-head rivalry which could produce gains for consumers of up to $9 billion annually. (See Section V.)

¶ 71 These losses could be avoided with alternative regulatory mechanisms, one of which is already in place. Prior to 1970, when the FCC banned phone company provision of video services in all but the smallest rural markets, phone carriers were often

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[86] Preferred Communications, Inc. v. City of Los Angeles, 754 F.2d 1396 (9th Cir. 1985).

[87] *See generally* Richard A. Posner, *The Social Costs of Monopoly and Regulation,* 83 J. OF POL. ECON. 807 (1975); Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft,* 5 W. ECON. J. 224 (1967).

[88] The problems that ensue when policy makers seize upon opportunities to extract rents are formally analyzed in FRED S. MCCHESNEY, MONEY FOR NOTHING: POLITICIANS, RENT EXTRACTION AND POLITICAL EXTORTION (Harvard University Press 1997).

[89] *See* Phillip A. Beutel, *City Objectives in Monopoly Franchising: The Case of Cable Television*, 22 APPLIED ECON. 1237 (1990); Hazlett, *Competition vs. Franchise Monopoly*, *supra* note 74.

[90] 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).

permitted to offer cable TV services without additional licenses. Even when opposed by municipal regulators, courts typically found that no cable franchises were needed:

> Courts considering the issue [of video franchises for telephone carriers providing cable TV services] 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.[91]

¶ 72 A broader open entry approach incorporating this policy solution is outlined below.

2. Taxes

¶ 73 Taxes are imposed via franchise fees, customarily set at five percent of video revenues, the maximum allowed under the limits set first by the FCC and then codified in the 1984 Cable Act.[92] But, just as a national limit pre-empts local franchisor discretion, a national (or state) policy could set the actual tax level, eliminating franchise fees altogether. Taxes would be paid without negotiated agreements but according to the general policy implemented. The same is possible with in-kind taxation. Franchise PEG requirements are loosely governed by rules incorporated into the 1984 Cable Act.[93] This has been the approach with respect to DBS, where four to seven percent of channel capacity is (by federal law) set aside for public access programming.[94]

3. Service Regulation

¶ 74 Cable TV franchises also regulate various aspects of cable TV system offerings, including rates and services. As is shown below in Figure 1, cable TV rates were not effectively constrained when local governments had wide scope to regulate them; nominal rate controls were dependably offset with quality adjustments – changes in channel packages or programming, marketing efforts, and infrastructure investments – that rendered "controlled" rates relatively undesirable to consumers. Such evidence was in large measure responsible for the deregulation of cable rates in the 1996 Telecommunications Act, effective March 31, 1999.[95]

¶ 75 In the absence of rate controls, regulation of cable operators' services is doomed to be ineffective in protecting consumers. Even where rules succeed in improving services, the increased value will be priced at monopoly levels. The converse is also true: regulation of rates cannot be effective without quality regulation. That is because, for a given price ceiling imposed by law, quality reductions can obviate any consumer gains.

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[91] Robert F. Copple, *Cable Television and the Allocation of Regulatory Power: A Study of Governmental Demarcation and Roles*, 44 FED. COMM. L.J. 1, 21 (1991).

[92] 1984 Cable Act, § 622(b), 47 U.S.C. § 542(b) (2006).

[93] 1984 Cable Act, § 611, 47 U.S.C. § 531 (2006).

[94] 47 U.S.C. §335(b)(1).

[95] Telecommunications Act of 1996, § 301(a)(4), 47 U.S.C. § 543(c)(4); 1996 Conference Report, § 301(b), H. R. CONF. REP. 104-458, at 62 (1996).

The binding constraint in this circular loop is that there is little chance of ever implementing effective service regulation in U.S. cable TV markets. Local governments are constitutionally prohibited from exercising effective control over cable programming services, as operators enjoy First Amendment rights to select video channels and to determine what programs these networks will provide.[96]

¶ 76 The marketplace demonstrates the impotency of municipal franchise regulation, as competitive systems regularly feature superior engineering, and have been designed to offer better, more advanced services. Overbuilders enter markets with modern infrastructure that offers more capacity than in existing monopoly franchises. This is particularly seen with respect to cable modem service, where competitive systems have offered much higher speeds by building much smaller nodes.[97] Video program line-ups have also been far more extensive with the new entrants; satellite TV systems, for instance, forced cable systems to spend over $80 billion, 1999-2004, to upgrade networks so as to compete via digital cable packages.

¶ 77 The reality is that the service regulations imposed by cable franchises are little more than rhetorical devices or make-work projects. Falling into the latter category is the following survey instrument mandated by the City of Seattle as part of the franchise issued to an overbuilder, Western Integrated Networks (WIN), in 2001. Competitive entry is itself far more effective than franchise regulation in improving customer service, and reliably lowers retail rates fifteen to twenty percent. But the franchise imposes the following burden on WIN:

> The City, not more frequently than twice during the term of this Franchise, shall arrange and pay for a systematic ascertainment of the community's views regarding the nature and adequacy of Grantee's performance of this Franchise, and of the needs and interests of the community and preferences of subscribers regarding this Franchise. A written summary of the findings made by such an ascertainment, which shall be conducted by an independent entity using generally accepted market research techniques, shall be provided to Grantee. Such summary shall include a description of the methodology used.
>
> Within 30 days of the delivery of such summary, Grantee shall pay to the City, in addition to all other fees and charges due under this Franchise, the costs incurred by City in performing such ascertainment and procuring

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[96] *See Preferred Commc'ns, Inc., v. City of Los Angeles* 754 F.2d 1396, 1403 (9th Cir, 1985), *aff'd*, 476 U.S. 488 (1986). Some "content neutral" regulation has been permitted. In *Turner Broadcasting Sys., Inc. v. FCC*, 520 U.S. 180 (1997), the Court ruled that "must carry" regulations, forcing cable systems to carry (without payment) the signals of all local TV stations, were permissible. The 5-4 decision was met with a stinging and articulate dissent by Justice Sandra Day O'Connor. *See also* Thomas W. Hazlett, *Digitizing "Must-Carry" Under Turner Broadcasting v. FCC (1997)*, 8 SUP. CT. ECON. REV. 141 (2000).

[97] Monopoly cable systems have traditionally offered cable modem service in architectures where about 500 homes share a local area network. Overbuilders have constructed nodes of just 75-150 homes. Thomas W. Hazlett & George Bittlingmayer, *The Political Economy of Cable "Open Access"* 4 STAN. TECH. L. REV. 4, 21 (2003) [hereinafter Hazlett & Bittlingmayer (2003)].

> summary or $1.00 per subscriber whichever is less. In the event such ascertainment process and summary is conducted jointly in connection with similar ascertainments of other Cable Service franchisees, then Grantee's obligation shall be its prorated share of the costs or $1.00 per subscriber, whichever is less.[98]

¶ 78 Such requirements are perverse; they tax competitive entrants to fund bureaucratic franchise administration, when such institutions have been repeatedly demonstrated to produce inferior choices for consumers relative to competition among video providers. Such regulatory requirements increase barriers to entry, thereby *lessening* the likelihood that consumers will see the increases in service quality or the discounts in cable pricing widely observed in competitive cable markets. Hence, these regulatory terms are counter-productive; eliminating them would improve consumer welfare.

4. System Regulation

¶ 79 Technology has been upgraded over time within the cable TV sector. "State of the art" systems in the 1960s featured twelve channels of capacity. In the 1970s, scientific advances lowered the cost of bandwidth, leading standard new systems to provide thirty-five channels of capacity. By the 1980s, this increased to sixty-four channels. In the 1990s, standard systems were built (or rebuilt) with 125 analog channel capacity, and providing additional opportunities – given two-way digital technology – for using some of the 125 channels, each with 6 MHz of bandwidth, for digital programming. Video compression techniques allow between four and ten digitized program feeds to be squeezed through one channel. Hence, in addition to voice and data services, modern cable systems now have the capacity to deliver hundreds of simultaneous programs to subscribers.[99]

¶ 80 These advances, similar to those occurring elsewhere in information networks, were derived from the profit incentives of technology suppliers, on the one side, and cable TV operators, on the other. The incentives of operators were also impacted by the expansion of programming; cable networks, which began to form in the 1970s, numbered over 300 in 2004,[100] an expansion that both drove, and was driven by, system channel capacity increases, including those provided by satellite TV.

¶ 81 Local regulators have had little role in this process, and what little impact they have asserted has been to impose inefficiencies. The inefficiencies come from two effects. The first is that, in creating barriers to entry, franchises delay competition, which leads to the second, that entry tends to increase technological upgrades. This latter effect is clearly seen when an overbuilder enters a local cable TV market, provoking a system upgrade by the incumbent – a common observation dating back at least two decades.[101]

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[98] Western Integrated Networks of Washington Operating, LLC, *Seattle Franchise Agreement* 10 (Jan. 23, 2001), *available at* http://www.pan.ci.seattle.wa.us/cable/WIN/franchise_agreement.pdf.

[99] For an analysis of spectrum allocation within cable TV systems, see Hazlett, *Cable Television* (2005), *supra* note †.

[100] FCC, *Eleventh Annual MVPD Competition Report*, *supra* note 31 at 9.

[101] *Id.* at 4; Hazlett, *Competition vs. Franchise Monopoly* (1986), *supra* note 74 at 92.

It has also been witnessed in the cable industry's response to nationwide video entry by two direct broadcast satellite operators.[102]

¶ 82 Franchise authority technology mandates are a crude form of industrial policy. They do not yield efficiencies; technological innovation, provided via "creative destruction" in the marketplace, is distorted by such mandates.[103] Innovation is facilitated by deregulatory measures that eliminate disincentives for capital investment. Decontrolling prices in the Cable Act of 1984 led to a large expansion in cable system capacity, for example,[104] a process repeated with the entry of satellite TV systems.

¶ 83 The most contentious franchise requirements for competitive entrants deal with build-out schedules. These seemingly "symmetric" requirements have intensely asymmetric economic impact. While such rules are only loosely enforced on franchisees not facing direct rivals, incumbents reliably lobby and litigate to ensure that cable franchise authorities enforce such rules for entrants. The limiting case illustrates the essential asymmetry: an existing cable franchise that has already built out its system incurs no costs when a new franchise (or franchise extension) requires that the system immediately offer service across the entire franchise area, whereas the same requirement would be prohibitively costly for an entrant. The disparate impact of construction schedule regulations on competitors in different stages of entry, and facing distinct market conditions, extends generally, as shown in detail in Section V.

¶ 84 The financial investment undertaken by cable systems embeds a projection of future returns that is fundamentally altered when the pattern of network construction is controlled by external political agents. These agents not only lack any allegiance to the entrant, they may be actively hostile to the interests of competitors that undermine the economic position of an erstwhile monopoly franchisee with extensive political and financial ties to incumbent officials.

¶ 85 The essential architecture of a cable TV video system entails a distribution grid linking households to a central receiving point. The latter is called a "head end," and it collects a variety of video programs via satellite earth stations, over-the-air reception facilities, fiber-optic cables, and other links. It then processes these signals, repackages them, and distributes them to subscribers via high-capacity wires. This wireline grid is called the "cable plant," and it constitutes the dominant capital expense of the system. That expense is recouped in subscriber fees from programming services and in selling local advertising. Historically, about forty percent of the revenues constitute gross profit,[105] meaning that operating costs (including fees paid to program networks) are

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[102] Thomas W. Hazlett, Coleman Bazelon, John Rutledge, & Deborah Allen Hewitt, *Sending the Right Signals: Promoting Competition through Telecommunications Reform*, A Report to the U.S. Chamber of Commerce 50-51 (Sept. 22, 2004), http://www.uschamber.com/portal/teleconsensus/041006telecommstudy.htm.

[103] William J. Baumol, THE FREE MARKET INNOVATION MACHINE: ANALYZING THE GROWTH MIRACLE OF CAPITALISM 136-38 (Princeton University Press 2002).

[104] *See* Hazlett & Spitzer (1997), 69-101.

[105] Kagan Research, Broadband Cable Financial Databook 2005, at 38 (listing average "cash flow margin" for major U.S. cable operators at 37.8 percent).

usually about sixty percent of sales. This cash flow (forty percent of revenues) is then available to compensate for the initial outlays made to construct the distribution grid, an investment which is made upfront and is irreversible; if the business model proves non-remunerative, investments sunk cannot be recouped by redeploying the assets in a different market.

¶ 86 Entrants facing an established cable operator are particularly vulnerable to build-out mandates. That is because a head-to-head competitive market predictably yields lower market shares (below 100%) and lowers retail prices; these expectations can lead to deterrence of competitors when such entrants face strict construction schedules. Suppose, for instance, that an entrant expects that its system will yield a profit equal (in present value) to Y when serving the most profitable seventy percent of the franchise area, to yield a profit equal to zero in the next most profitable twenty percent, and to yield a loss equal to Z in the least profitable ten percent. Such profit differences are dictated largely by density – homes passed per mile – with the most sparsely populated areas being the least profitable to serve.

¶ 87 Regulations requiring an entrant build-out the least profitable market area, or build it out first, [106] deter entry. First, some competitive systems will simply not be built at all. This will be the case when $Z > Y$, meaning that the build-out requirement makes the expected net present value of the investment in competitive facilities negative. Second, firms will tend to avoid markets where franchise requirements are costly, entering other markets first. This was seen in the Philadelphia efforts by overbuilder RCN. From 1998 until 2001, RCN sought a cable franchise from the City of Philadelphia. Negotiations centered on franchise obligations, including build-out requirements. RCN, which obtained less regulatory franchises in the Philadelphia suburbs, which it now serves, withdrew its Philadelphia franchise application in 2001, stating:

> In Philadelphia, we experienced significant delays in securing authorization from the city to provide cable or OVS service on commercially reasonable terms. As a result, RCN has withdrawn from such negotiations with the city and has no present plans to build out its system in Philadelphia.[107]

Third, build-out requirements are subject to negotiation. This bargaining process can stretch out years, delaying the benefits of competition.

¶ 88 These costs are not offset by benefits. Competitive entry does not create any harm, even if it is confined to a distinct submarket of the franchise area. Prices will be

[106] Telesat Cablevision, the aggressive overbuilder in the 1980s Florida market that invested over $100 million constructing competitive cable systems before giving up its quest, reported that some municipal franchises contained "rural first" provisions requiring it to commence operations by constructing plant in the most sparsely populated franchise areas, areas which incumbent operators had avoided for decades. Telesat Cablevision, Inc., *In the Matter of Competition, Rate Regulation and the Commission's Policies Relating to the Provision of Cable Television Service, Reply Comments of Telesat Cablevision, Inc.,* MM Docket No. 89-600, 3-4 (Apr. 2, 1990) [hereinafter Telesat, *Reply Comments* (1990)].

[107] RCN Corp., Annual Report (Form 10-K), at 20 (Mar. 29, 2002).

reduced (at least) in the area of competitive overlap, while prices elsewhere will be no higher.[108] Indeed, the threat of potential entry will have a moderating effect. If local governments wish to extend the benefits of cable competition, the effective policy instrument is a uniform pricing rule. This would constrain the incumbent cable operator to reduce prices system-wide when responding to the competitive foray of a new rival.

¶ 89 Build-out requirements are often seen to be anti-competitive. Congress, in the Cable Consumer Protection and Competition Act of 1992, explicitly advised local governments to waive strict build-out requirements that discouraged competitive entry.[109] Unfortunately, there was no enforcement mechanism included, meaning that local governments could continue to impose "unreasonable" build-out requirements without sanction. Existing cable franchisees have long been excused from serving the most sparsely populated areas of their franchise territories, precisely because it would be uneconomic to construct systems there. (See discussion in Section V.)

¶ 90 Cable operators have also been permitted to offer voice telephony and broadband access (via cable modems) without facing universal service requirements for either. This allows new competitors to develop toeholds in new markets, expanding as financial conditions permit. This policy was generically adopted for competitive local exchange carriers (CLECs) following the 1996 Telecommunications Act. CLECs were not obligated to serve specified geographic markets, and largely specialized in providing voice service to business, not residential, customers.[110] Many focused on niche markets. As a rule, no CLEC attempted to duplicate the existing service territory of an existing ILEC – exactly the rule that some now advocate for new entrants into video.

¶ 91 This competitive dynamic is widely observed in other markets. Perhaps the best known example involves the rivalry in passenger air travel emanating from "low cost regional airlines." If entrants such as Southwest or JetBlue were mandated to provide service across the entire United States from their initiation, entry would be deterred and air fares much higher. Competition is facilitated precisely because the entrant is not subjected to uneconomic constraints. This remains true despite the fact that the benefits of competitive pricing may be available in some markets before they are available in others.

IV. TRADITIONAL JUSTIFICATIONS FOR FRANCHISE REGULATION

¶ 92 Regulation of ROW access is at best an incomplete rationale for cable franchising, as public easements have often been used without such franchises. Licenses specific to local video distribution require additional justification, and this has traditionally been supplied by the assertion of market failure. Free entry, it is argued, would not lead to a favorable outcome for local consumers due to natural monopoly cost

[108] It is sometimes asserted that incumbents will raise prices in monopolistic areas in order to finance price reductions in newly competitive areas. This is incorrect, because it assumes that cable operators were not already charging profit-maximizing prices in the monopoly areas.

[109] Cable Television Consumer Protection and Competition Act of 1992, § 7, 106 Stat. 1483 (1992).

[110] *Local Competition,* FEDERAL COMMUNICATIONS COMMISSION, COMMON CARRIER BUREAU 5 (Dec. 1998).

conditions.

A. Natural Monopoly

¶ 93 The natural monopoly rationale for franchise regulation implied that consumers lost little or nothing when the government selected the "best" cable operator.[111] The reasoning was porous,[112] but the historical record establishes that this was the standard defense of franchising.

¶ 94 For instance, when the City of Los Angeles was challenged for issuing a sole cable TV franchise[113] in a First Amendment suit that went all the way to the U.S. Supreme Court[114], its defense was that there existed both "physical scarcity" – limited slots for cables on telephone poles – and a "natural monopoly."[115] With regard to pole capacity, the City conceded that there was sufficient space for the applicant to use, but that the capacity could become constrained if more operators used up additional spaces in the future. With regard to market structure, the City argued that denying an entrant the right to compete was not a violation of their constitutional rights because no additional cable firms, other than the first franchised, could prove financially viable.

¶ 95 Natural monopoly was also stressed by academic analysts. UCLA Law Professor Charles Firestone wrote in 1986 that "cable has some characteristics analogous to telephone carriers . . . . Cable's delivery of information over a wire-based technology using public streets and rights[-]of[-]way involves high capital costs of entry and increasing economies of scale."[116] Firestone defended cable TV franchises, "the cornerstone of which is a city's ability to restrict entry by non-franchisees."[117]

¶ 96 A string of victories in federal courts scored by First Amendment advocates in 1985 and 1986 pressured this view.[118] The case for franchising was then stated with

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[111] "Essentially, the Cities argue that if there is a reasonable probability that their service area will economically support only one CTV [cable TV] operator, then they should be able to choose, at the outset, that operator who will provide the highest quality service and use the offer of an exclusive franchise as a plum to bargain for certain concessions, e.g., access channels, that they might not be able to acquire if an operator knew that it would have to compete with other cable providers." Century Fed., Inc. v. City of Palo Alto, 648 F. Supp. 1465, 1476 (N.D. Cal. 1986).

[112] The existence of a natural monopoly did not itself recommend local franchise regulation. A further showing was required to establish that regulation actually worked to help advance consumer interests. This showing was difficult to make, given the empirical evidence available concerning what local regulation actually achieved. Hazlett, *Private Monopoly* (1986), *supra* note 23, 1406-1409.

[113] Los Angeles issued several cable franchises, but only one per geographic market.

[114] *Preferred Commc'ns, Inc.*, *supra* note 96.

[115] *Id.* at 1401-1402, 1404.

[116] Charles Firestone, *Cable Television and the First Amendment*, Position Paper, The Center for the Study of Democratic Institutions, Roundtable on Cable Television, 12 (Nov. 19, 1986) [hereinafter Firestone (1986)].

[117] Firestone (1986), *supra* note 115, at 13.

[118] First Amendment victories included Preferred Communications, Inc. v. City of Los Angeles, 13 F.3d 1327 (9th Cir. 1994); Group W Cable, Inc. v. City of Santa Cruz, 679 F. Supp. 977 (N.D. Cal. 1988); Pac. W. Cable Co. v. City of Sacramento, 672 F. Supp. 1322 (E.D. Cal. 1987); Century Fed., 648 F. Supp. 1465. First Amendment franchising claims which were lost included Telesat Cablevision, Inc. v. City of

greater force, tightening its link to monopoly market structure. Attorneys who represented cities justified the existing regulatory regime by belittling the concept of cable competition:

> The prophets of complete deregulation conjure up an image of an environment in which consumers will have a choice among cable companies, with the discipline of the market protecting the public interest, obviating the need for regulation. This image is an illusion. Cable is still the same uncompetitive business it was when municipal franchising was developed, and when Congress confirmed local franchising authority in 1984.[119]

¶ 97 The rationale is now defunct, the marketplace having evolved to embrace multiple service providers, including rival video and local telephone carriers. Moreover, with head-to-head rivalry observed between rival voice networks, satellite TV operators, mobile phone systems, and residential broadband networks (cable modems versus DSL), franchise cable monopolies today constitute an anomalous market structure. Franchising, now justified as a way to protect incumbents from "unfair competition," was originally premised on just the reverse idea – that incumbents exercised overwhelming advantages. The factual foundation of the cable franchising argument has crumbled, leaving cable franchises as unambiguous restraints of trade, entry barriers without a cause.

B. Rate Regulation

¶ 98 The natural monopoly argument for franchising needed an additional component: rate regulation. It makes little sense to control entry if rates are left unregulated; even if other dimensions of service and quality are being prescribed in the franchise agreement, consumers would be left at the mercy of government-protected monopoly suppliers who will predictably extract profit-maximizing prices.[120] In this regard, the D.C. Circuit Court of Appeals has noted that free market pricing with monopoly franchises is about the worst consumers can do.[121]

¶ 99 Actually, it *is* possible for consumers to do worse – as proven with cable rate regulation.[122] With each transition from regulation to deregulation, or vice versa, it has

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Riviera Beach*,* 773 F. Supp. 383 (S.D. Fla. 1991) and Nor-West Cable Communications P'ship v. City of St. Paul, No. 3-93 Civ. 1228 (D. Minn. 1988).

[119] Nicholas P. Miller, Alan Ciamporcero, & Larrine S. Holbrooke, *The State of Municipal Cable Television Regulation*, 6 COMM. LAW. 1, 26 (1988).

[120] *See* Time Warner Entm't Co. v. Fed. Communications Comm'n*,* 56 F.3d 151 (D.C. Cir. 1995).

[121] *Id.* at 178-179.

[122] This empirical conclusion surprised even economists – including this one. I had written that unregulated franchise monopoly was the worst consumers could do, an argument relevant to the cable franchising debate in the post 1984 world where cable rate controls had been pre-empted by federal law. But evidence later proved this not to be true. Curiously, the D.C. Circuit opinion noting that unregulated monopoly was the worst position for consumers cited my previous research; by the time of their opinion I had changed my opinion. *See* Thomas W. Hazlett, *Prices and Outputs Under Cable TV Reregulation,* 12 J. REG. ECON. 173 (1997) [hereinafter Hazlett (1997)]; Hazlett & Spitzer (1997); Thomas W. Hazlett, *Cable Television Rate Deregulation,* 3 INT'L. J. ECON. OF BUS. 145 (1996).

been shown that the distortions and inefficiencies caused by cable rate regulation actually leave consumers worse off than unregulated monopoly pricing. In short, rate regulation is not a viable form of consumer protection.

¶ 100 The history of cable rate regulation can be summarized as follows:

- Up to Dec. 29, 1986 – local rate regulation by local franchise authorities;
- Dec. 29, 1986-Oct. 5, 1992 – federal pre-emption of rate regulation;
- Oct. 5, 1992-Nov. 10, 1994 – Cable Act of 1992 mandates price regulation, rate roll-backs enforced by franchising authorities under FCC guidelines;
- Nov. 10, 1994-March 31, 1999 – Relaxation of price controls under FCC guidelines (informal deregulation); and
- March 31, 1999-present – federal pre-emption of local rate regulation as per 1996 Telecommunications Act (statutory deregulation).

¶ 101 This cyclical pattern of regulate/deregulate yields data on the effects of price controls which firmly establish that rate controls are ineffective in protecting consumers. The key is that price regulation restrains nominal charges, yet nominal prices mean nothing by themselves – it is what a given dollar price will buy that matters. That depends on the quality of the services rendered, but quality is much more difficult – and in some important dimensions illegal – for governments to regulate. The resulting dynamic has incumbent cable operators responding to rate controls with evasive actions, much as rent controls lead apartment owners to reduce maintenance and divert housing investments to other markets. Suppressing nominal rates prompts cable operators to re-tier, 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. It is very difficult for municipal franchising authorities to monitor quality of service, and they are barred from effectively regulating program quality. That is because the cable operator enjoys a First Amendment right to select content, governments are (and presumably should be) constrained in their efforts to encourage higher quality shows, given the arbitrary assessment of "quality."[123]

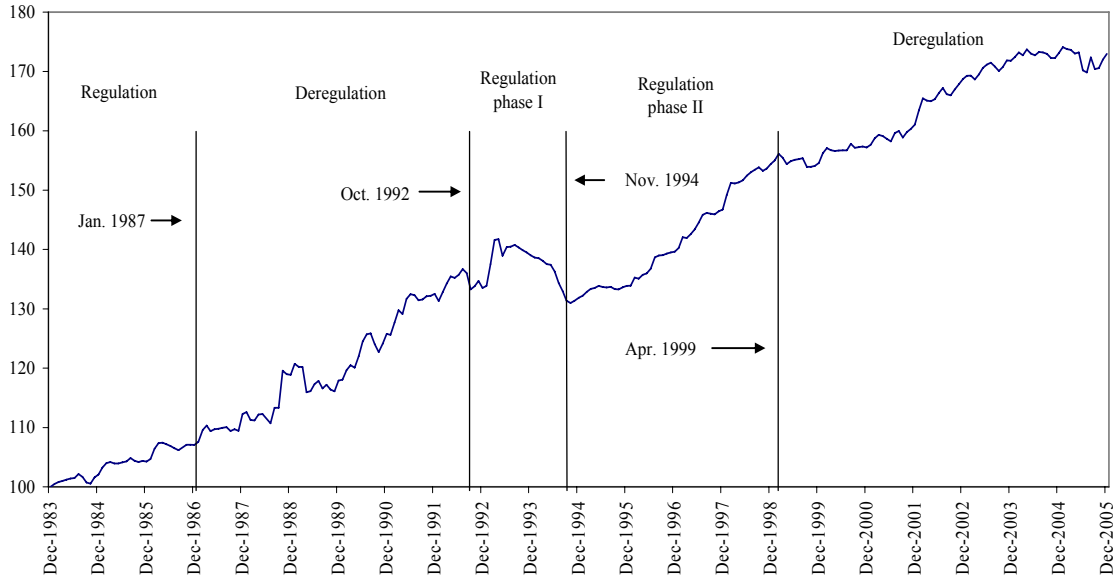
¶ 102 The failures of rate regulation were so apparent to federal regulators that an implicit deregulation was undertaken by the FCC starting in late 1994, undoing the rate controls initiated in the 1992 Cable Act. This regime switch was vigorously supported by cable programmers, who convinced the Commission that rate roll-backs had induced cable operators to curtail investments in channel capacity or new program networks. Nominal rate reductions in 1993-94 resulted in slowing subscriber growth, indicating that customers did not prefer the lower-priced, lower-quality offerings under rate regulation. When the Commission relaxed controls, allowing price increases in 1995, cable growth quickly resumed.

¶ 103 While the effectiveness of cable rate regulation cannot be fully explained without reference to subscribership and other output metrics, it is nonetheless instructive to observe simply the pattern in nominal prices, as charted since December 1983 by the

[123] *See* Hazlett (1997), *supra* note 121, at 149. *See generally* Hazlett & Spitzer (1997).

Bureau of Labor Statistics (BLS). See Figure 1. These prices have been normalized, such that the index begins at a value equal to 100, and have deflated, meaning that the price trend shown is for real (inflation-adjusted) cable rates. These rates, as constructed by the BLS, take into account a typical "bundle" of video services ordered in various markets around the country.

FIGURE 1. DECONSTRUCTING CABLE RATE REGULATION



Data from the U.S. Department of Labor, Bureau of Labor Statistics. The Cable and satellite television and radio service CPI for U.S. cities is deflated by All-Items CPI, available at http://data.bls.gov/PDQ/outside.jsp?survey=cu. Data are not seasonally adjusted. For historical information see page 29.

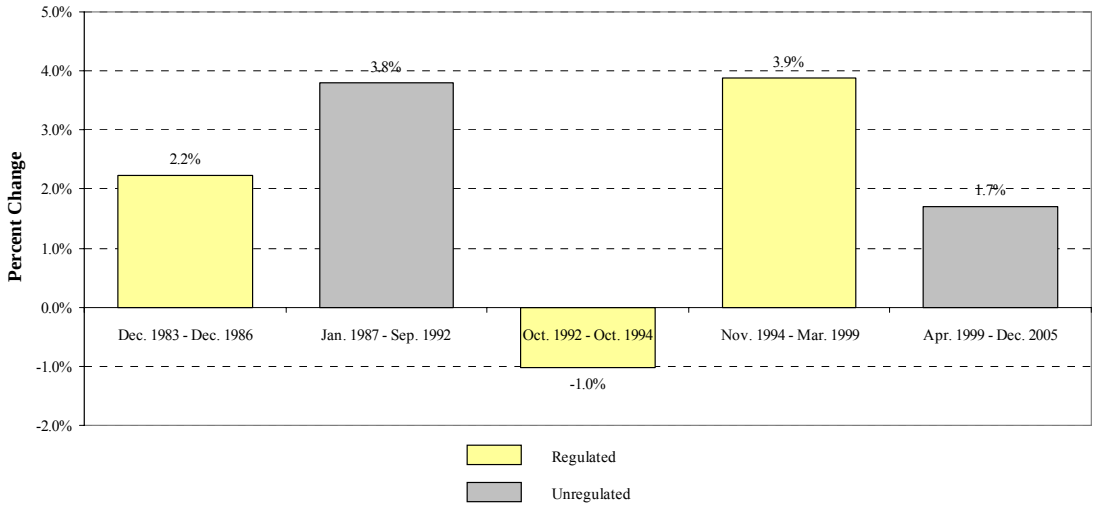
¶ 104 The long upward trend conveys that real rates have tended to increase over time. While often characterized as a byproduct of monopoly, the monopoly problem is one of *high* prices rather than *rising* prices. The fact that prices tend to be lower in one year than they are the next is not explained by market structure, which changes little, but by the expanding package of video services delivered. This dynamically evolving product mix is itself a key reason why cable TV service is difficult to effectively price regulate.

¶ 105 The one significant break in the upward trend occurred during the re-regulation of 1992-94, when prices slightly declined over a two-year period. The reduction from trend in the average cable bill was about nine percent.[124] The decrease could have produced additional cable subscription growth, an outcome associated with successful implementation of rate regulation. As noted, however, growth did not increase, but declined from trend. The implication is that something other than price changed; in fact, quality was reduced. This market response more than offset the pro-consumer payoff of nominal rate reductions, and indirectly led regulators to abandon rate roll-backs.

[124] Hazlett (1997), *supra* note 121, at 180.

¶ 106 As price controls were relaxed by the FCC, the rate of price increase resumed at approximately the growth rate of formal deregulation (1987-92). See Figure 2. Prices did not fly-up with deregulation in April 1999. Rate regulation, deemed a failure by regulators themselves,[125] was reduced to a non-binding constraint.[126]

FIGURE 2. ANNUALIZED REAL CABLE RATE INCREASES



See Figure 1. Growth rates calculated as the straight line change between the CPI of the beginning of the period and the CPI of the end of the period. For historical information see page 29.

C. Rent Seeking and Corruption

¶ 107 Traditionally, the cable franchising process has been formally triggered when a municipal government enacted a cable television ordinance and outlined a series of steps it will take. This often precipitated a "needs assessment" study provided by an outside consultant. In larger cities, a blue-ribbon advisory council was also customary.

¶ 108 Once the municipality ascertained that cable TV service was needed by the community, a request for proposals (RFP) was issued. The RFP attracted competing proposals that were evaluated and ranked by the consultant, the government staff, and the legislative committee. Public hearings were then held. A campaign ensued, with rival bidders vying for the votes of council members. Publicly, firms offered excellent service, modern technology, and subsidies for politically popular but non-remunerative services such as local origination/public access programming (for example, studio facilities). The winning bidder of the 1983 Sacramento County franchise pledged to fund projects

[125] "What indeed was the point of the regulation, if the beneficiaries were neither thankful nor economically better off?" Reed E. Hundt, YOU SAY YOU WANT A REVOLUTION? 56 (Yale University Press, 2000).

[126] While price controls appear ineffective in suppressing prices charged customers, they may well increase riskiness for specific assets, reducing sector investment.

estimating (by the County's consultant) to cost $2.67 per subscriber per month.[127] A bidder in a previous competition (which resulted in no franchise being selected) had promised to plant 20,000 trees.[128] On average, one study found such commitments accounting for about eleven percent of operating costs and twenty-six percent of capital costs for franchised systems.[129]

¶ 109 In addition, prominent local citizens were collected and paid, given stock at steep discounts not offered the public generally, and these 'owners' were incorporated into proposals by firms bidding for the franchise. The following letter sets forth the basic terms, which in this instance were extended to the influential investor, Warren Buffett:

> Specifically [our cable company] is prepared to support up to 20 percent local investment carried interest basis; that is, these investors are required only to subscribe for their stock at a nominal par value, with the parent company advancing all necessary funds for the construction and operation of the franchise . . . .
>
> Aside from financing, however, we view the local investors as full partners, particularly with regard to developing the strategy to obtain the favorable vote of the city for award of the franchise . . . .
>
> Finally the winning of a cable franchise is essentially a political campaign…. The ability of local investors to take the political temperature, make introductions and appointments on a timely basis, and to lend their personal credibility to our formal business proposal is vitally important to the success of our proposal.[130]

¶ 110 Buffett declined this invitation. But the stock distribution scheme, which was widely used during the franchising "gold rush" of the late 1970s and early 1980s, quantifies the degree of political cronyism in the franchising process. Standard cable subsidiaries created to submit bids to RFPs were often allocating twenty percent of equity shares (as in the Buffett offer) to citizens who in truth were not rented, but purchased outright.[131]

¶ 111 A *Washington Post* article described the practice, as employed by Storer Cable, in Fairfax, Virginia:

> Storer's Fairfax subsidiary, Trans County Cable, sought out [former

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[127] Touche Ross, SACRAMENTO METROPOLITAN CABLE COMMISSION -- FINANCIAL ANALYSIS OF POTENTIAL ADDITIONAL CABLE TELEVISION FRANCHISE AWARDS (Touche Ross International, 1986).

[128] Peter Kerr, *Cable Notes: Cities Are Waking Up to What Were Empty Promises*, N.Y. TIMES, Dec. 11, 1983, § 2, at 238.

[129] Zupan*, supra* note 90, at 405.

[130] *Quoted in* Thomas W. Hazlett, *The Rent-a-Citizen Shopping Channel on Cable*, May 18, 1989.

[131] Peter W. Bernstein, *Television's Expanding World,* FORTUNE (July 2, 1979), p. 64.

> Fairfax supervisor Alan] Magazine, 10 other prominent local citizens, and two organizations, and gave them 20 percent of the company's equity and 50 percent of its local management control. All the Fairfax "investors" share one trait with Magazine: they got their stock without paying any cash. They say they are making an 'in-kind' contribution of time and effort toward preparing the Fairfax proposal instead of helping to underwrite the estimated $30 million to $60 million in capital expenditures necessary to build a working cable system in the county.[132]

¶ 112 The politicization of franchise awards was documented in a study of the Minneapolis franchise bidding.[133] The situation there was noteworthy in that it was done in a relatively corruption-free environment and undertaken with noble goals and aspirations and with abundant input and expertise from citizen advisory groups, outside consultants, and a state cable television commission. The result is reported this way:

> The actual relevance of the franchise proposals in Minneapolis was limited. The proposals were the basic prerequisite for entry into the process and generally evidenced the legitimacy of each competitor. More important, each proposal provided political allies with a public rationale for what was essentially political behavior. Favorable features of any preferred bid could be offered as seemingly rational and beneficent reasons for a Council member's vote.
>
> Indeed, the crucial factor in the Minneapolis cable franchise decision was politics. The cable companies followed the pattern which has become commonplace in cable franchise contests. Each company went to considerable effort to align themselves favorably within the local political dynamic. Lawyers, lobbyists, local investors, public relations firms and community groups were all involved . . . .
>
> Local officials were only concerned marginally with rational assessment of design configurations, service offerings and the enhancement of community life through the introduction of an advanced telecommunications technology. Once judged as adequate, proposals were viewed as equal, and politics became a key element in the decision-making process.[134]

¶ 113 With politics dominating the franchising process, it is perhaps predictable that corruption became endemic. Left without objective criteria for franchise awards, and committed to policies that bestowed monopoly privileges, rent seeking logically advanced the self interest of franchising agents and franchise bidders. Hence, cable

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[132] Pat Bauer, *Free Shares of Cable TV Cost Its Users*, WASH. POST, Sept. 14, 1980, at A1.

[133] Peter D. Edwards, *Cable Television Franchising: A Case Study of Minneapolis, Minnesota*, NEW YORK LAW SCHOOL, COMMUNICATIONS MEDIA CENTER 29 (1985).

[134] *Id.* at 90, 94.

television franchising became widely known for corrupt practices.

¶ 114 A series of bribery convictions in connection with franchises awarded in New Jersey became a statewide scandal in the 1970s.[135] Irving Kahn, CEO of the largest cable operator at that time, TelePrompTer, went to federal prison for an illegal payment made to secure the franchise in Johnstown, Pennsylvania.[136] When Queens Borough President Donald Manes committed suicide in the midst of a corruption investigation of New York City officials in the early 1980s, a key aspect of the investigation centered on extortion of cable franchise bidders.[137] In Sacramento, California, a county supervisor and a well-connected political operative (who organized a group of seventy-three local citizens to receive heavily discounted stock in the winning cable franchisee) served time in federal prison for payments they received from a cable system construction contractor instrumental in lobbying for the successful franchise bidder.[138] When sentencing a Washington, D.C. lawyer in 1985, federal district court Judge Susan Getzendanner said: "I think it was a bribe, and apparently [that is] what goes on in the cable industry all the time."[139]

¶ 115 The public policy relevance is two fold. First, abundant opportunities for such illegal behavior occur because the choices made by cable franchising agents are arbitrary, on the one side, and difficult for citizens to monitor, on the other. These opportunities should be reduced when efficient alternatives exist because mechanisms which lead to less illegal activity are, all else equal, superior. Cable franchising, an "attractive nuisance," promotes more corruption relative to general rules governing public disruption and access to public rights-of-way.

¶ 116 Second, widespread illegal activity reveals an extreme agency problem. The public interest tests put forward to justify procedures and goals in selecting parties for franchise awards mask a political process that is essentially standardless. Franchise needs assessments, studies, hearings, and announced policies are put forward by administrators, consultants, commissions and specialists who "strive to lay a scientific

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[135] Kent Lassman, *Franchising in the Local Communications Market: A Primer and Discussion of Three Questions,* PROGRESS ON POINT: PERIODIC COMMENTARIES ON THE POLICY DEBATE Release 12.9, June 2005, at 6, n.22, http://www.pff.org/issues-pubs/pops/pop12.9franchise.pdf.

[136] ". . . Irving Kahn was convicted of having bribed council members in Johnstown, Pennsylvania in order to obtain a renewal of the franchise on the TelePrompTer system there. Irving Kahn's defense was that he was extorted by the council members that unless he paid them cash they would give the franchise to someone else . . ." Interview by Max D. Paglin with Jay Ricks, Partner, Hogan & Hartson, in Wash. D.C. (Aug. 1987), http://www.cablecenter.org/education/library/oralhistorydetails.cfm?id=251.

[137] "Allegations of cable corruption were part of the problem for Donald Manes, the Queens borough president who killed himself while under investigation. A recent Wall Street Journal editorial, quoting court papers, drew this portrait of a 1982 meeting between Manes and a cable executive: 'Fearing the room was bugged, Manes tried unsuccessfully to communicate through hand gestures and lip movements his desire for a bribe.'" John A. Barnes, *Why Cable Costs Too Much*, WASH. MONTHLY, June, 1989, at 2, *available at* http://cfc.convio.net/documents/WashMonthly%5B1%5D.pdf. John Zaccaro, husband of former New York Congresswoman Geraldine Ferraro, informed a prospective cable franchisee it would cost them $1 million to secure a franchise. He was acquitted, however, of illegal conduct. *See* Joseph P. Fried, *Zaccaro Is Charged on 3 Counts; Pleads Not Guilty At Arraignment,* N.Y. TIMES, Oct. 10, 1986, at A1.

[138] Barnes, *supra* note 136.

[139] *Id*.

disguise on the local selection process," writes First Amendment lawyer and cable industry expert Sol Schildhause.[140] Some courts have pierced this "disguise" and rejected the justification for local franchising altogether. A federal jury in 1987 heard evidence about the franchising process conducted by the County and City of Sacramento, California, and answered as follows:

> - Was "natural monopoly" a sham used by defendants [City and County of Sacramento] to obtain increased campaign contributions for local elected officials?
>   - [JURY:] Yes.
>
> . . .
>
> - [W]ere defendants motivated to provide such benefits [public access channels and other community grants] by either a desire to obtain increased political influence for elected or appointed local officials, or a desire to favor local officials' political supporters?
>   - [JURY:] Yes.[141]

¶ 117 Or, as *Channels of Communication* wrote in March 1986 of Milwaukee's franchising decision, "[t]he dream had been to pick a cable operator on the merits. The reality was that, without any illegality, politics carried the day."[142] A process that defends political horse trading under the auspices of consumer protection is not only vulnerable to corrupt practices, but is also unlikely, even under the best of circumstances, to protect consumers.

D. Free Speech

¶ 118 The fact that cable franchising has proved "intensely political" and has accommodated "improper influence, bribery, and conspiracy" led naturally to the conclusion that the process itself constituted a constitutional violation of the right to free speech and a free press.[143] This conclusion has been reached in a number of federal court decisions.[144] One of the strongest statements was issued by the Ninth Circuit Court of Appeals, in an opinion concerning the Los Angeles cable franchise:

> "[A]llowing only the single company selected through the franchise auction process to erect and operate a cable system in each region" exacts too heavy a toll on the First Amendment interests at stake here. Competition in the marketplace of ideas—as in every other market—leads

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[140] Schildhause, *supra* note 35, at 1.

[141] Pac. W. Cable Co. v. City of Sacramento, 672 F. Supp. 1322, 1350, 1352 (E.D. Cal. 1987).

[142] *Cited in* Thomas W. Hazlett, *Wiring the Constitution for Cable*, 12 REGULATION 1 (1988).

[143] Lee (1983) at 870-71.

[144] *See, e.g.,* Central Telecommunications, Inc. v. TCI Cablevision, Inc., 800 F.2d 711 (8th Cir. 1986); Century Fed., Inc. v. City of Palo Alto, 648 F. Supp. 1465 (N.D. Cal. 1986); Group W Cable, Inc. v. City of Santa Cruz, 679 F. Supp. 977 (N.D. Cal. 1988).

> to a far greater diversity of viewpoints (and better service) than if a single vendor is granted a crown monopoly. The risk that a single operator will be captured by city hall (or in turn will capture regulators) is far greater than where two or more operators face off against each other and must contend with the harsh realities of competition.[145]

¶ 119 The U.S. Supreme Court upheld the Ninth Circuit's decision, ruling that cable franchising implicated the First Amendment rights of excluded competitors in the cable market.[146] Yet no remedies were provided: the case, on remand, ended without the City being enjoined to issue a franchise, and no fees or damages were levied against the City for violating the constitutional rights of the denied applicants.[147] Potential entrants are often deterred by pro-monopoly franchising policies, with city governments protected due to Congress' decision to bar monetary damages against municipalities for engaging in anti-competitive cable franchising practices.[148] In this scheme, local government officials assist cable franchisees in blocking competitive entry, and incumbent systems are logically willing to trade some level of editorial control to affect this bargain. Tempering the coverage of local political affairs by cable-supported news channels, or resisting the temptation to fund such programming at all, is a small price to pay for exclusive rights.

¶ 120 The once-promising cable TV format for local news coverage has resulted in sparse political reporting on the local government level. Whether this is because of the uneconomic nature of such news – perhaps cable subscribers are uninterested, given the cost of funding such programs – or because cable franchisees do not desire to upset their franchise patrons is difficult to discern. What appears to be the case is that, despite the popularity of some local cable news channels,[149] scant "watchdog" reporting takes place on cable news channels relative to that appearing in local newspapers. It is even clearer, of course, that licensing of the press constitutes a "chilling effect," the rationale on which such a practice is prohibited by the First Amendment.[150]

V. ASYMMETRIC IMPACTS OF NOMINALLY SYMMETRIC BUILD-OUT REQUIREMENTS

¶ 121 The most persuasive argument used to defend franchise regulation is the "level playing field" idea. Given that incumbent cable TV operators are franchised and must comply with regulatory constraints imposed therein, it is fitting, proper, and fair to

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[145] Preferred Communications, Inc., 13 F.3d at 1330-1331 (*quoting* Preferred Communications, Inc., 754 F.2d at 1406).

[146] 476 U.S. 488.

[147] In fact, the applicants, who had attempted to procure a cable franchise starting in 1979, failed to be awarded court costs or attorneys' fees when the litigation – which they technically won – concluded in 1994.

[148] 1992 Cable Act, § 24(a).

[149] *See* News 12, NY1, New England Cable News, CLTV, RNN, & Newschannel 8, *Non-Stop News: A Look at 24-Hour Local Cable News Channels*, *available at* http://www.rtnda.org/resources/nonstopnews/text/text_executive.html.

[150] Lee, *supra* note 70, at 913 n.200.

impose identical requirements on new entrants that wish to compete head-to-head. Indeed, were entrants permitted to compete without shouldering such obligations, the playing field would tilt, favoring new arrivals and distorting market outcomes. Aimed at Bell telephone video entrants, the argument is stated thusly:

> Cable TV providers have opposed efforts to exempt the Bells from local franchises, saying the telecom providers should have to jump through the same hoops as they had to. The 1996 Telecommunications Act already allowed the Bells to enter the video market, but they've taken years to do so, said Steve Berry, senior vice president for government relations at the National Cable Television Association, a trade group.
>
> The Bells, among the largest companies in the world, don't need special breaks, Berry added. A steamlined [sic] franchising law would give the Bells a "unique competitive advantage to the largest telecommunications providers in the world," he said.
>
> "You need to treat like services alike," Berry added. "There's no reason to give the telecommunications companies . . . a break at this stage of the game."[151]

¶ 122 This argument is made by both cable system incumbents and municipal franchising authorities.[152] It justifies enactment of state "level playing field" (LPF) statutes,[153] it forms the core of local cable ordinances adopting their own LPF rules, and it drives the success of "most favored nations" clauses in municipal cable franchises, provisions protecting incumbents from competition with an operator having "less burdensome" franchise obligations.[154]

¶ 123 It is crucial to note, at the outset, that the "symmetry" argument now serves to justify franchise obligations for entrants even as the original rationales – natural monopoly and rate regulation – have disappeared. The premise of regulation has flipped from *consumer* protection to *incumbent* protection. Incumbents would be harmed financially under rules resulting in greater competitive system build-out; that they ardently support such obligations for entrants is compelling evidence that the mandates are expected to reduce the scope of head-to-head competition altogether.

¶ 124 Cable operators and industry consultants commonly reveal the fundamental asymmetry in mandating "level" franchise burdens. On attempts to gain passage of LPF

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[151] Grant Gross, *Congress Braces for TV Over IP Fight: Telecommunications Companies, Cable TV Providers Argue Over Regulation,* PC WORLD, July 20, 2005, *available at* http://www.pcworld.com/news/article/0,aid,121884,00.asp.

[152] "'It doesn't bother us if the Bells want to enter our market,' says Kerry Knott, Comcast's vice president of federal government affairs who was a chief of staff to then-House Majority Leader Dick Armey, R-Texas. 'Where it does bother us is if they get to play in our market with a different set of rules.'" Bara Vaida, Special Report, *Clashing High-Tech Titans*, 37 NAT'L J, 39, Sept. 24, 2005.

[153] Hazlett & Ford (2001), *supra* note 11.

[154] NAT'L ASS'N OF TELECOMMUNICATIONS OFFICERS AND ADVISORS, FTTH SUBCOMMITTEE, TELEPHONE COMPANY CABLE FRANCHISES-AN ANALYSIS 2, 5 (2005), *available at* http://www.natoa.org/public/articles/Phone_Company_Cable_Franchise_Analysis_-_Final.pdf.

legislation, the cable trade press has reported: *California Anti-Competition Bill Pending*.[155] Successful LPF enactments are heralded as: *Florida Operators Gain Weapon in Fight Against Overbuilders: New Law Sets Franchise Hurdles.*[156] When victories are achieved, operators are often blunt in their celebratory comments. "Another competitive threat was muted this session," boasted the Virginia Cable TV operators trade group, "when the legislature included cable-backed 'level playing field' language into a bill. . . ."[157] Two industry legal experts have commented that "[c]able companies and their national and state trade associations have been at the forefront of efforts to persuade state legislatures to ban or significantly impair the ability of public entities to provide or facilitate the provision of competitive services in their communities."[158]

¶ 125 Moreover, the factual assertions underlying the standard fairness claims are dubious.

- *First, franchise rules are not symmetric for entrants and incumbents*. LPF statutes and ordinances are explicitly crafted to impose obligations on entrants that are *at least as burdensome* as those falling on incumbents, meaning that the "symmetric" protection is applied *asymmetrically*. It is perfectly legal, under "level playing field" rules, for entrants to shoulder larger obligations than incumbents.
- *Second, existing cable franchises often took decades to construct.* Indeed, many current cable systems were built where no cable franchises were required, and no build-out provisions obtained, a situation that was not uncommon prior to the 1984 Cable Act (mandating local franchises).
- *Third, nominally identical franchise obligations are typically far more economically burdensome for competitive entrants*. A mandate to wire areas with as few as 30 homes per mile of cable plant is likely to be profitable for a monopoly firm. But a second entrant facing the same constraint finds it a substantial tax as break-even density may not occur until sixty or seventy homes per mile, assuming a fifty percent market share and retail prices reduced twenty percent by head-to-head rivalry.
- *Fourth, duplicative franchise barriers do not create competitive neutrality.* The claim that "you need to treat like services alike" is – as construed – incorrect. It is efficient to allow entry with a minimum of regulatory barriers, and particularly inter-modal entry, where existing regulatory structures permit

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[155] Paul Kagan Associates, Inc., *California Anti-Competition Bill Pending*, CABLE TV FRANCHISING, Aug. 31, 1988.

[156] John Wolfe, *Florida Operators Gain Weapon in Fight Against Overbuilders,* CABLEVISION, June 15, 1987, at 50. The article began: "The Florida state legislature, under intense pressure from the state's franchised cable operators, has passed a law aimed at reducing the instances of second companies overbuilding all or part of existing cable systems. The measure, dubbed the 'Level Playing Field Act' by Florida operators, is the first of its kind and could become a model for operators seeking government protection from selective overbuilding in other states, according to industry officials."

[157] VIRGINIA CABLE TELECOMMUNICATIONS ASS'N, REGULATORY UPDATE (Mar. 2002), *available at* http://www.vcta.com/industry/reg_reports/march2002.doc.

[158] Jim Baller & Casey Lide, *Curbing Anticompetitive Practices by Cable Incumbents: If Not Now, When?*, 11 NATOA J. MUNICIPAL TELECOMMUNICATIONS POL'Y 24, 27 (2003).

additional competitive enterprise. This is the rationale for not franchising wireless video rivals, and is the argument used successfully by cable incumbents to escape franchise requirements in providing voice and data. Phone companies offer plain old telephone service (POTS) and DSL under regulatory rules – including build-out and non-discrimination requirements – from which incumbent cable operators offering POTS[159] and cable modem service are exempted.

- *Fifth, there is no consumer harm in competitive entry.* Limited "overbuilds" reduce prices for consumers in competitive submarkets, and do not cause price increases elsewhere. If local franchising authorities seek to extend the benefits of competition, uniform pricing rules are the appropriate tool. These extend discounts by incumbents responding to competition franchise-wide.

¶ 126 These factual issues are discussed here in more detail.

A. Franchise Rules Not Symmetric for Entrants and Incumbents

¶ 127 "Level playing field" statutes[160] mandate that local governments may not issue franchises that are less burdensome, leaving open the option to issue franchises *more* burdensome.[161] Municipalities often adopt "most favored nation" (MFN) protections for incumbent franchisees, either in local ordinances or as provisions inserted into the franchises.[162] These regulations at least avoid the Orwellian lexicon where all cable franchise burdens will be equal, but more equal for some than others. The MFNs explicitly state that incumbents will be the "most favored." Take the 1987 Florida state statute, used as a model around the nation:[163]

> No municipality or county shall grant any overlapping franchises for cable service within its jurisdiction on terms or conditions more favorable or less burdensome than those in any existing franchise within such municipality or county.[164]

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[159] Some of the POTS offered by cable operators are supplied via Voice over Internet Protocol, or VoIP. The principle is nicely extended by the example. The regulatory obligations of incumbent provided POTS, including universal service or other build-out requirements, have not been imposed on the emerging inter-modal substitute, VoIP, because such rules would impede competition. This renders distinct rules on "like services," and constitutes the efficient regulatory response.

[160] States with level playing field statutes: Alabama, California, Connecticut, Florida, Illinois, Kentucky, Minnesota, New Hampshire, Oklahoma, Tennessee and Virginia. *See* Hazlett & Ford (2001), *supra* note 11, at 27.

[161] *Id.* at 29.

[162] *See*, *e.g.*, FRANCHISE AGREEMENT BETWEEN THE CITY OF MONTEREY, CALIFORNIA AND TCI CABLEVISION OF CALIFORNIA, INC. § 4.2 (1998), *available at* http://www.monterey.org/cable/final.pdf.

[163] The Florida Cable Television Association, a trade association of incumbent cable operators, was awarded a prize by the National Cable Television Association (NCTA) for successfully lobbying for the statute. Then NCTA Chair James Mooney said: "I am filled with admiration for what the Florida association has been able to do." Jeanine Aversa, *Florida Law Sets Rules for Overbuilds*, MULTICHANNEL NEWS, June 8, 1987, *cited in* Hazlett, *supra* note 11, at 28 n.39.

[164] Fla. Stat. Ann. § 166.096 (1988).

¶ 128 This approach is relied upon in current cable franchise activity. In considering an application from the large, local telephone carrier Verizon to offer video subscription service in its county, the franchising authority for Fairfax, Virginia issued the following analysis:

> While the state "level playing field" requirement prohibits the Board from granting a competitive franchise that is "more favorable or less burdensome" than an incumbent cable operator's franchise, the law does not prohibit the Board from granting a competitive franchise on terms that are more onerous. In fact some of the terms and conditions of Verizon's Proposed Franchise Agreement are more onerous than those in the franchise agreements the Board awarded to either or both of the incumbent cable operators. Most significantly, the Verizon Proposed Franchise Agreement commits Verizon to a system design that is substantially more burdensome than the design requirements to which the incumbent cable operators are subject.[165]

¶ 129 Hence, franchising agents may impose nominally asymmetric burdens, levying heightened mandates on the competitive entrant. In the case of Verizon's Fairfax franchise, the entrant is required to offer cable TV service, within seven years, throughout the franchise area to any neighborhood with a density of thirty homes-per-mile or greater. This is a more stringent requirement than that imposed on either of the incumbent Fairfax systems during their build-out phase. One, Cox, has a thirty-four homes-per-mile minimum, a requirement dating to its predecessors' initial 1982 franchise; the other, Comcast, acquired a system that was constructed prior to having a franchise.[166] Telesat Cablevision, when attempting to compete in Florida in the late 1980s, was confronted with some franchises that imposed "rural first" build-out requirements and other burdens not levied on incumbents. As explained in the company's 1990 FCC filing:

> In Hillsborough County, for example, Telesat is required not only to build out the entire county, but to build out first the most sparsely populated, highest-cost-per-subscriber portions of the franchise area. This requirement was imposed at the behest of Paragon Cable….
>
> During the initial 15 or so years Paragon and its predecessors held the franchise in Hillsborough County, they had refused to wire these same areas. When Paragon's franchise was renewed in 1986, no requirement to build out the unwired areas was imposed. Two years later, newcomer Telesat was required to do so….

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[165] FAIRFAX COUNTY DEPARTMENT OF CABLE COMMUNICATIONS AND CONSUMER PROTECTION, ANALYSIS OF VERIZON VIRGINIA INC.'S APPLICATION FOR A CABLE TELEVISION FRANCHISE 9 (July 21, 2005), *available at* http://www.fairfaxcounty.gov/cable/regulation/verizon/staff_report.pdf.

[166] *Id.* at 8. The incumbents serve different areas, and do not compete directly. This prompts an additional asymmetry in franchise terms, of course. Any build-out requirement imposed on the entrant forced the firm to serve competitive areas it might, for business reasons, choose not to serve. The incumbents have not been mandated to serve any competitive areas.

> In other instances, Telesat simply has been unable to overcome the influence of incumbents upon the local franchise authorities.… In Collier County, Palmer Cablevision successfully lobbied the county to require Telesat to post a $7 million construction-guarantee bond, or 110% of the initial **projected** cost of construction **and** a cash deposit of $1 million. A normal construction bond for this size system, required of the incumbent, would have been $50,000 - $100,000. The terms of the proposed agreement were simply too onerous for Telesat to accept and it was ultimately forced to withdraw.[167]

B. Existing Cable Systems Often Took Decades to Construct

¶ 130 While build-out requirements in cable TV franchises are sometimes referenced as "universal service" obligations, franchises held by incumbents have not generally provided timely service or even availability to all households within the franchise area. Systems operate for years, or decades, before passing 100% of franchise area households. Many systems have yet to achieve this level of coverage, despite having been initially franchised in the 1960s or 1970s. Moreover, "service" is never *universal*. Rather, connections exist in only about sixty percent of homes passed (and less of all homes in the franchise areas). Unlike wireline telephone service, which is ubiquitously offered and actually (until wireless substitution recently began to reduce penetration rates) used in about ninety-five percent of homes,[168] cable services are not considered necessities and regulators have not instituted policies to bring the service to all residential customers.

¶ 131 Empirically, the evidence suggests that incumbents' "universal service" obligations have largely been window dressing. Construction regularly appears to proceed not according to franchise "requirements" but according to profit criteria of incumbents. Given the large number of U.S. cable franchises, and difficulty in obtaining historical data, a complete picture of the build-out pattern across the industry has not been undertaken. Yet key information is revealed in two different approaches taken here.

¶ 132 In the first, I obtained the most current data for California cable TV systems from the *Television & Cable Factbook*.[169] This source lists, for a given cable system, the year service was first offered or the year a franchise was initially awarded. From this information I calculate a beginning date (*BD*) as the date the service was first offered if available and as the date the franchise was awarded if the beginning service date is not available. Information is also given on the current status of service, including how many homes are passed by cable plant (*HP*) and how many homes are within the franchise area (*HFA*). Dividing the former by the latter produces the relevant statistic, which is called "saturation" (*S*). The calculations of interest, then, concern S (= HP/HFA) and T_{05}

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[167] Telesat, *Comments* (1990), 18-19 (emphasis in original).

[168] ALEXANDER BELINFANTE, FEDERAL COMMUNICATIONS COMMISSION, WIRELINE COMPETITION BUREAU, TELEPHONE SUBSCRIBERSHIP IN THE UNITED STATES (DATA THROUGH JULY 2005) 3 (2005).

[169] Warren Communications News, TELEVISION & CABLE FACTBOOK (2005) [hereinafter Warren Communications News (2005)].

(=2005-*BD*).

TABLE 1. CALIFORNIA CABLE SYSTEM BUILD-OUT (2005)

Saturation[1] *(S)*	*Number of Systems*	*% of Total*	*Total HFA*	*% of Total CA Homes in Sample*	*Average Years* $(T_{05})^{2,3}$
0-9.99%	-	-	-	-	-
10-19.99%	1	0.77%	5,800	0.08%	19
20-29.99%	-	-	-	-	-
30-39.99%	2	1.54%	50,000	0.69%	16.5
40-49.99%	3	2.31%	16,833	0.23%	20
50-59.99%	1	0.77%	40,000	0.55%	53
60-69.99%	4	3.08%	138,367	1.90%	21
70-79.99%	6	4.62%	421,638	5.78%	37
80-89.99%	10	7.69%	126,394	1.73%	29
90-94.99%	14	10.77%	1,077,344	14.78%	35.1
95-99.99%	34	26.15%	2,145,878	29.44%	32.2
100%	55	42.31%	3,267,422	44.82%	n.a.
Total	**130**	**100.00%**	**7,289,676**	**100.00%**	

[1] Percentage Saturation is defined as Homes Passed divided by Homes in the Franchise Area times 100.
[2] System Years is defined as 2005 minus the System Start year, if the System Start year is missing, I use the Franchise Granted year. The Television and Cable Factbook corresponding variables are Began for System Start Year and Award Date for Franchise Granted Year.
[3] Observations with non available data in System Years were excluded to calculate the average System Years.
Data from Warren Communications News (2005) and Analysis Group Calculations. Of a reported 274 operating cable systems in California, 130 reported sufficient data to be included in this table.

¶ 133 Of the 130 California cable systems described in the data source, fifty-five systems have achieved *S*=100%. See Table 1. Note that these data are self-reported by cable TV system operators, and may be interpreted as favorable to build-out. Systems desire higher reported build-out levels not only for franchise compliance, but for market valuation reasons. Most systems, however, do not report full build-out, despite having – on average – multiple decades to do so. In aggregate, cable operators report passing about ninety-five percent of California households, as seen in the Summary Statistics displayed in Table 2. This suggests that, even after a considerable period of time, and given monopoly market structure, cable franchise authorities have largely failed to impose universal build-out.

TABLE 2. SUMMARY STATISTICS FOR CALIFORNIA CABLE SYSTEM BUILD-OUT (2005)	
Total Homes Passed	6,935,335
Total Homes in Franchise Area	7,289,676
Total Franchises	130
Total Franchises with *S*=100%	55
% California Franchises with *S*=100%	42.31%
Total California Build-Out (*S*)	95.14%

See Table 1.

¶ 134 To investigate the amount of time cable franchisees took to build-out their franchise areas, I examined data on California cable systems from International Thomson Communications Inc.'s CableFile/86.[170] With the data self-reported by cable operators from 1986, I am able to replace HFA with Potential Homes Passed (PHP)—the number of homes a cable system expects to pass.[171] The new saturation measure, S′=HP/PHP, includes housing units the cable system is not required to pass via franchise terms. With one year's sample, data are extracted for systems where $S'<100\%$. These data imply annual build-out rates over the period in which the system has been franchised, T_{86} (=1986-*BD*). For systems with $S'=100\%$, the number of years from *BD* to the completion date is used, when given. Further investigation of build-out periods is required for the remaining systems that report full franchise area coverage. For the unrealistic observations where $T_{86} = 0$, I set $T_{86} = 1$.[172] This assumes that build-out took place very rapidly where evidence to the contrary is unavailable.

¶ 135 Figure 3 displays these data graphically. Added to the graph is a line representing a linear build-out schedule lasting five years, a common franchise build-out term. Only sixty-eight of 191 systems that reported data achieve this outcome – 123 systems, or about two-thirds, do not. Of these systems, complete build-out usually takes at least ten years. The implication is that full build-out of cable TV systems has not been achieved according to build-out schedules, with service offered throughout the areas specified for service in franchise agreements only after much longer periods.

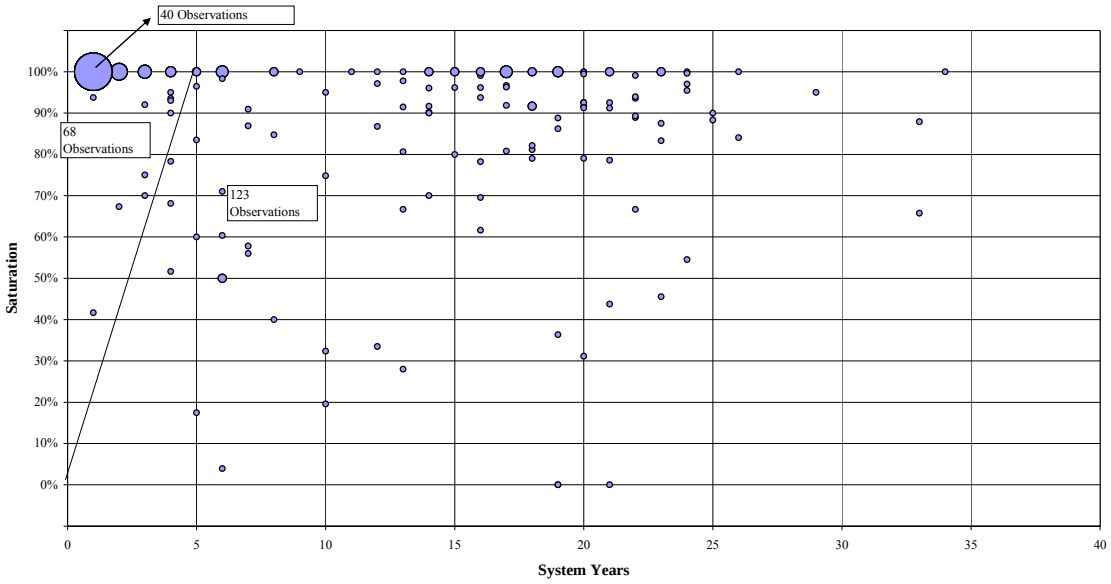
[170] International Thompson Communications, Inc., NORTH AMERICAN CABLEFILE/86 (1986) [hereinafter CABLEFILE/86]. Ideally, I would like to have a dataset with the number of years it took each cable system to reach a given level of build out. These data are not available. Moreover, additional years of data are difficult to obtain. Yet, the picture provided by a 1986 "snapshot" of build-out progress helps calibrate the historical build-out pattern of U.S. cable TV systems. The year, 1986, falls at the end of the cable "gold rush" in which most U.S. households obtained access to cable TV service. From 1976, when 23.1 million homes were passed by cable plant, to 1988, when 77.2 millions were passed, saturation increased from 31% to 85%. During this period, subscribership (as a percent of total U.S. households) rose from 16% to 50%. Hazlett & Spitzer (1997), *supra* note †, at 115. As these data are derived from an earlier period in the development of the cable TV industry, they capture build-out patterns of relevance to newly competitive systems emerging (or being contemplated) today.

[171] CABLEFILE/86 reports "Pot. Homes Passed," which I interpret to mean the total number of homes in the franchise area that is required to be served under the franchise terms.

[172] This highly conservative assumption biases the analysis in favor of shorter build-out times.

¶ 136 This casts the equity argument in a new light. While incumbents offer the "equal burdens" rationale for strict regulation of new franchisees, the argument is not accompanied by empirical consideration of precisely what burdens new franchisees were subjected to when building out their systems. Given available evidence, this omission is material.

FIGURE 3. CALIFORNIA SATURATION AND SYSTEM YEARS (1986)



Data from CABLEFILE/86 and Analysis Group Calculations. Saturation is defined as Homes Passed divided by Potential Homes Passed. System Years denote the age of the system when achieving complete build-out or, if the system has not achieved complete build-out, denote the age of the system in 1986. If System Years' calculation equals "zero", I change the value to equal "one". To account for the year the system started operations, I use the variable System Turn On Yr. Prin. Fran. When this variable is not available, I use Franchise Granted Year. The Diagonal line represents a 20% build-out rate per year. Observations to the Northwest of the line represent franchises that have built or are building at a rate equal or greater than 20% per year. Observations to the Southeast of the line represent franchises that have built or are building at a rate lower than 20% per year.

C. Nominally Identical Obligations Are More Burdensome for Entrants

¶ 137 Anti-competitive barriers increase markedly when the financial impacts of franchise obligations are considered. Nominally identical obligations disparately impact operators because the relative burden is much higher under more competitive market conditions. The second wireline entrant into a local video market anticipates market share about one-half as large, and quality-prices about twenty percent below, the levels enjoyed by a first entrant. As the size of the economic opportunity changes, so too does the sum a rational investor would "bid" to enter the market.

¶ 138 The economics are illustrated by an example gleaned from a neighboring market. In Turkey, the government chose to issue two mobile phone licenses in sequence. The first was to be auctioned, and a price established; this price would be paid by the first entrant and then become the minimum acceptable bid for the second license. The result was that a high price was obtained for the first license, and no bids were received for the

second. Rivals competing for the first license knew that a high price would be compensated in the future by above-competitive profits, and would bid accordingly. This monopoly "fiasco"[173] restricted output, raising retail rates to customers, and was later reversed by policy makers.[174] This is a market test of the "level playing field" regulatory approach, and the lesson is transferable: allowing the terms set for a first entrant to determine terms for the next destroys competition altogether.

¶ 139 Differences created by market structure are similarly observed in cable TV markets. When a franchise is awarded to a firm facing no direct rival, obligations may be met at low cost relative to a firm franchised to operate in a market where an incumbent is already established. A primary regulatory barrier is erected with respect to build-out requirements. When second cable entrants are obligated to match the construction schedule in the first cable licensee's contract (whether or not the original cable franchisee actually met that schedule), entry is often deterred.

¶ 140 Why is entry deterred for the entrant when it did not deter the incumbent? First, as noted in the discussion above, many incumbents did not comply with any build-out requirements, even those specified in franchise agreements. The entrant has no such luxury, as it expects that the incumbent will vigorously lobby and litigate to enforce build-out requirements on the entrant as a way to raise its rival's costs. Second, even when nominal requirements are perfectly symmetric, build-out obligations are financially more onerous the more competitive the market.

¶ 141 The distinction can be formally evaluated. The standard cable TV franchise imposes build-out requirements on operators, such that they are obligated to extend their cable plant to all neighborhoods where density equals at least thirty homes per mile. The cost of meeting this obligation varies dramatically when market structure changes due to the entry of a new operator. This is shown in the following analysis, which develops a simple cash flow model to demonstrate the operating profits captured per mile of cable plant.

¶ 142 Here I assume that a mile of coaxial cable, installed, costs an operator $30,000. I further assume that, for monopoly cable operators, the average cable subscriber bill equals fifty dollars per month; subscriber penetration is seventy percent (seven in ten homes passed subscribe to cable); operating expenses are fifty-five percent of revenues, implying operating profits are forty-five percent of revenue; cable connections require $200 in sunk investment in customer premises equipment, or CPE (which includes the set-top converter box); cable plant has a useful life of twelve years; cable connections (and set-top boxes) have a useful life of six years. Straight-line depreciation is used to annualize capital expenses. For the potential competitor, the assumptions remain the same, except that average revenue per subscriber is anticipated to be forty-five dollars per month (a ten percent reduction from the incumbent's level); penetration is expected to equal forty percent (with aggregate cable penetration rising, due to competition, to eighty

[173] Paul Klemperer, *What Really Matters in Auction Design*, 16 J. OF ECON. PERSP, 169, 176, 178 (2002).

[174] Thomas W. Hazlett & Robert E. Muñoz, *What Really Matters in Spectrum Allocation Design* 1, 11-12 (AEI-BROOKINGS JOINT CENTER FOR REGULATORY STUDIES, Working Paper 04-16, 2004).

percent and the entrant serving one-half); and the ratio of operating profits to revenue falls from forty-five to forty percent (based on the lower prices anticipated by the entrant[175]). For a summary, see Table 3.

¶ 143 These assumptions, which approximate industry conditions, allow one to examine how the build-out requirements differentially impact monopolists and competitors in local cable TV markets. A monopolist finds that, at thirty homes for one mile of plant, it serves twenty-one households and generates operating profits of $5,670 per year. Operating expenses are already accounted for in this calculation (in subtracting fifty-five percent of revenues), but capital expenses are incurred prior to profits being realized. These total $5,367, meaning that the plant-mile built to pass thirty homes generates additional profits. Since we have not accounted for all the costs of the cable system – such as the fixed costs incurred to capitalize the corporation and to construct the head-end – the incremental mileage built at this density contributes to those costs and to shareholder profits.

¶ 144 The picture is sharply different with respect to the entrant. This firm expects to attract just twelve subscribers over the incremental mile, and these subscribers generate a lower level of operating profit. In total, the mile returns annual operating profits of $2,592. While the potential competitor has lower capital expense than a monopoly incumbent, owing to the smaller number of customer connections it will make, the $4,954 amortization cost exceeds operating profits. Even ignoring the fixed costs associated with the cable system, the incremental build-out is unprofitable.

[175] This implicitly assumes that competition brings some cost savings to operators – otherwise, the operating profit ratio would decline even more.

TABLE 3. VALUES ASSUMED IN CABLE BUILD-OUT SIMULATION MODEL

Variable	*Firm*	*Assumed Value*	*Source/Rationale*
Monthly Revenue per Subscriber	Monopoly	$50.00	Assumed by author.
"	Competitor	$45.00	GAO (2003), p. 60 finds competitive cable prices ~ 15% below sole operator market rates.
Subscribers per Homes Passed	Monopoly	0.70	Assumed by author.
"	Competitor	0.40	This assumes about 50% cable share for a market that, in aggregate, expands somewhat due to competitive entry.
Operating expenses	Monopoly	0.55	Bolton, Brodley & Riordan (2000), p. 2298.
"	Competitor	0.60	Lower prices yield higher operating expense ratio.
Plant cost per mile	Monopoly, Competitor	$30,000	Based on a standard mix of aerial and underground wiring costs.
CPE per subscriber	Monopoly, Competitor	$200	Including set-top boxes and customer connections (truck rolls).
Plant life	Monopoly, Competitor	12 years	Assumed by author.
CPE life	Monopoly, Competitor	6 years	Assumed by author.
Discount Rate	Monopoly, Competitor	10%	Assumed by author.

¶ 145 Per-mile profits associated with the distinct types of firms can be estimated across a range of densities, revealing the general pattern. With monopoly market structure, a franchisee expects that incremental build-out is profitable at just over twenty homes per mile. This implies that rules obligating cable operators to offer service to all customers in areas with at least thirty homes per mile is anticipated to be a non-binding constraint. Conversely, a competitive entrant expects that break-even may not occur until greater density is achieved, somewhere over sixty homes per mile. See Figures 4 and 5, which are calculated using the assumptions in Table 3.

¶ 146 The average U.S. cable TV market density equals approximately 100 homes per mile.[176] Most areas are likely to be served by franchisees, whether monopolists or

[176] *See* analysis in Section V..

competitors. The simulation conducted here is not designed to predict exactly where the profitability cut-off is achieved, which changes with the assumptions made. Allowing for growth in households, revenues, or services would have the effect of pushing the break-even densities lower. But these changes would have similar effects on the two market scenarios, and leave the basic schism caused by market structure unaltered. The profitability differential across monopoly and competitive opportunities remains skewed. The density required to pay back sunk investments is much lower in a cable TV market that one firm occupies alone, compared with a market in which the operator must compete head-to-head for subscribers. This graphically demonstrates the asymmetric economic impact of nominally symmetric franchise requirements.

FIGURE 4. MONOPOLY AND DUOPOLY FRANCHISES
CASH FLOW AND AMORTIZATION (PER MILE)

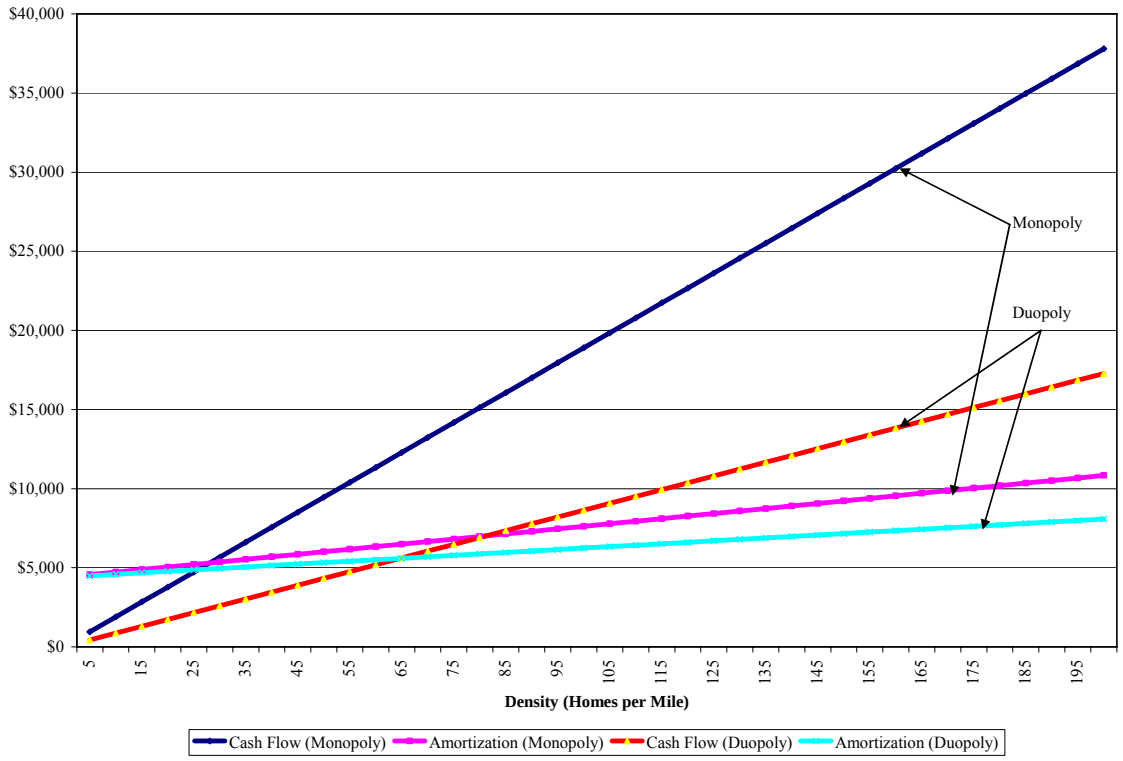
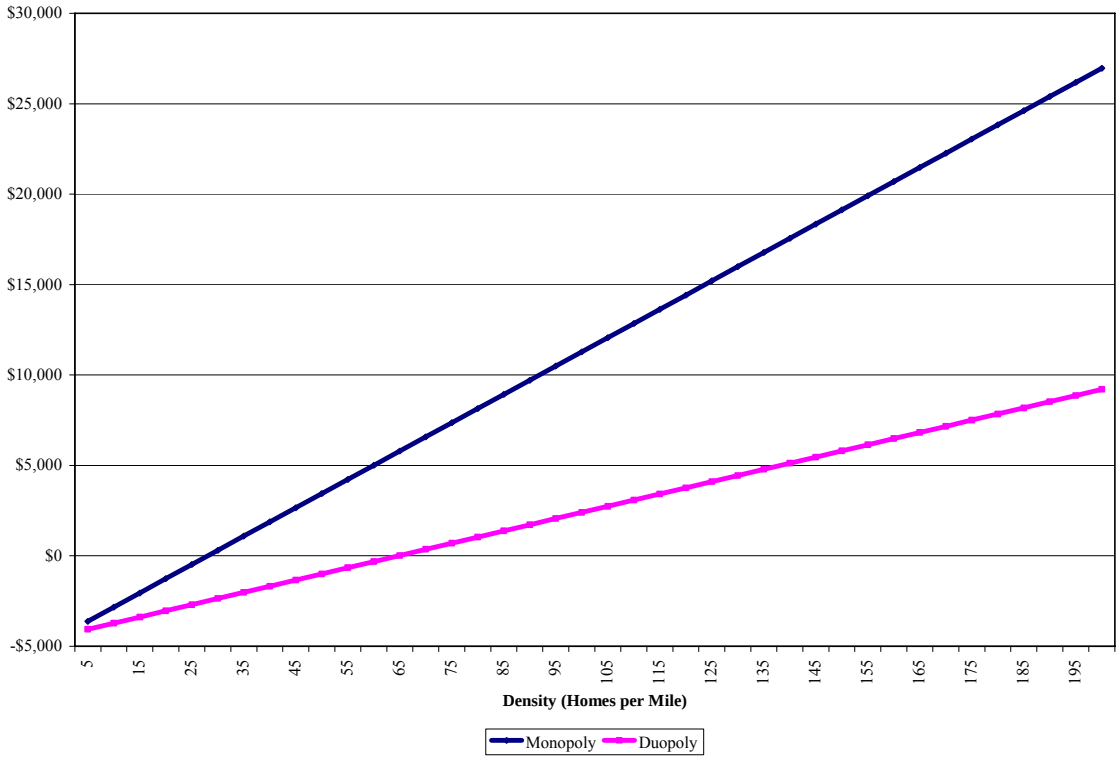


FIGURE 5. MONOPOLY AND DUOPOLY FRANCHISES NET PROFITS (PER MILE)



D. Duplicative Franchise Barriers Do Not Create Competitive Neutrality

¶ 147 The imposition of cable franchises on new video entrants in order to maintain parity with cable TV franchisees conflicts with both pro-consumer public policy and the actual regulatory policy applied to cable TV franchisees themselves. The pro-consumer approach serves to impose only those regulatory burdens that deliver benefits in excess of their costs; franchises for franchising's sake is simply pro-incumbent protectionism. This is seen in the entry of cable TV systems in both voice and broadband services. In neither instance have cable operators been generally required to obtain additional franchises, nor have they anywhere been subject to onerous regulatory requirements, including "universal service" obligations.

¶ 148 The efficiency argument establishes that franchise rules are associated with social gains to the extent that they limit market failures, specifically those associated with external costs. This is not achieved via franchise barriers that are imposed because previous franchise barriers have been imposed, but with rules that allow competitive, low-cost use of public ROWs. This is seen, for example, with entry into video markets by a DBS operator. Having been licensed by the FCC to use radio spectrum and orbital slots for satellite transmissions, the DBS system offers community households cable TV programs in competition with the franchised cable TV operator. The entrant does not require a franchise, despite the fact that the "playing field" may not be "level." The

regulatory regime is not a handicapping agency. To the extent that the entrant can deliver video programming to customers using less costly technologies or forms of organization, it is in the consumers' interests that it be permitted to do so.[177] It might also be noted that regulation of DBS providers can be instituted without cable franchises, as in the obligations imposed by FCC licenses for PEG channel provision.[178]

¶ 149 This same principle is even more vividly illustrated with respect to cable TV operator entry into voice and data service. Video franchises allowing cable systems to construct network infrastructure permitted franchisees to integrate into additional markets without additional franchises, despite the fact that their direct competitors in either market – local exchange carriers – had obtained licenses that imposed relatively heavy regulatory burdens. In the case of voice service, incumbent carriers (ILECs) faced universal service requirements, retail rate regulation, and extensive network sharing obligations (wholesale rate regulation), among other constraints. ILECs were also obligated to allow competitors to use their facilities to provide DSL service, broadband data connections that competed with ILEC DSL offerings while using ILEC local loops. In neither market have cable operators been subject to similar regulatory burdens, an "asymmetric" policy consistent with consumer welfare maximization. Each market is discussed here, as well as Voice-over-Internet Protocol (VoIP), which allows cable systems to deliver voice via broadband.

¶ 150 *Voice Telephony*. Cable operators have offered voice service without obtaining franchises equivalent to – or "more burdensome" than – those regulating incumbents. Cable telephone service providers distinctly face no universal service obligations, no retail or wholesale price controls, and no network sharing mandates allowing rivals to resell services. This regime was facilitated by the 1996 Telecommunications Act that federally pre-empted state laws erecting barriers to entry in local exchange carrier markets. The key provision abolished state monopoly telecommunications franchises.[179] The policy permitted CLECs to offer voice telephony in any sub-market they selected.[180] One result was that CLECs overwhelmingly chose to enter business markets whose prices had been artificially inflated due to regulations that sought to increase prices where demand was relatively inelastic in order to cross-subsidize high-cost service in rural

[177] It is not surprising, however, that cable TV operators have argued that DBS systems be subjected to additional regulation in order to protect incumbents from unfair competition. *See L.A. Customer Service Law for Video Distribution May Not Be Enforceable,* SATELLITE WEEK (Dec. 5, 1994). In California, for example, wireless cable TV systems were included in "level playing field" legislation, meaning that such operators ("MMDS" in FCC proceedings) would be subject to local franchise requirements despite using airwaves regulated by the federal government, rather than public ROWs regulated by municipalities, to distribute programming. The 1988 measure passed the legislature, but was vetoed by then-Governor George Deukmejian. The following year a similar LPF statute was signed into law, but the MMDS franchising provision had been eliminated. H.R. 543, 1989 Leg., Reg. Sess. (Ca. 1989).

[178] Public, educational, and government channels are often given as a justification for local cable franchising. But DBS operators, which do not have local cable franchises, are mandated to provide such via their FCC licenses. David Parkhurst, *NLC Policy Unit Savors ISTEA Passage,* 21 NATION'S CITIES WEEKLY 12 (June 22, 1998).

[179] 1996 Telecommunications Act, 47 U.S.C. § 253(a) (1996).

[180] This practice is sometimes referred to as "cherry-picking."

areas.[181]

¶ 151 Cable systems, operating as CLECs, generally departed from this pattern owing to the fact that they had constructed their plant in residential neighborhoods. Yet, cable telephone service was offered only in selected markets, as operators strove to produce optimal financial results. Hence, network offerings were not "universal," failed to create ubiquitous competition to ILEC voice service, and largely avoided both business customers and sparsely populated rural areas due to economic considerations. This profit-seeking behavior is what incumbent cable operators and many local franchise authorities call "red-lining" with respect to telephone company entry into video.[182]

¶ 152 Cable TV operators face some regulation under state-issued telephone licenses. While CLEC rates are unregulated, suppliers must publicly file tariffs, offer emergency 911 functionality, and pay telecommunications taxes (such as contributions to the Universal Service Fund).[183] This departs from the regulatory requirements imposed on other providers of VoIP service, even when the providers use precisely the same physical network. This is discussed below.

¶ 153 *Cable Modem Service*. The broadband race has produced distinct regulatory rules for competitive services. Cable TV systems have offered high-speed data services without network sharing rules.[184] Telephone companies, in contrast, have had to permit rivals to use their facilities (including local loops and central offices) to provide competing service.[185]

¶ 154 The debate over "open access" rules for cable systems underscores both the importance of regulatory mandates for economic decision-making and the distinction between rules applied to competing services. Proponents of regulation argue that the

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[181] Robert W. Crandall & Thomas W. Hazlett, *Telecommunications Policy Reform in the United States and Canada*, *in* TELECOMMUNICATIONS LIBERALIZATION ON TWO SIDES OF THE ATLANTIC 8 (Martin E. Cave & Robert W. Crandall eds.,, 2001).

[182] "'SBC and Verizon want to come into communities and cherry-pick wealthy neighborhoods at the expense of poorer areas. State-sanctioned redlining of poor people is contrary to everything we stand for as Texans,' [Tom Kinney, chairman of the Texas Cable & Telecommunications Association and president of Time Warner Cable-Austin] said. 'We hope the legislature holds firm against the big phone companies' lobbying efforts to implement legislation that is bad for Texas consumers.'" Press Release, Texas Cable TV Association, Texas Cable Industry Announces Position on HB 3179 (Apr. 12, 2005), *available at* http://www.txcable.com/News/PressReleases/PressRelease20050412.asp.

[183] *FCC Preempts State Utility Regulation of VoIP Services,* CABLE DATACOM NEWS, Dec. 4, 2004, http://www.best-voip-provider.com/december_2004_fcc_preempts_state_utility_regulation_of_voip_di.jspx.

[184] Cable "operators . . . currently are not (as a class) required to make access to that transmission service available to unaffiliated providers of broadband services." National Research Council, BROADBAND: BRINGING HOME THE BITS 302 (National Academy Press 2002).

[185] "When incumbent telecommunications providers offer DSL, this service comes under the purview of the historical legacy of telecommunications regulation. When an incumbent telecommunications provider sells an enhanced service (which is not regulated) over a 'basic' service, the incumbent provider must provide the basic service to others. DSL is seen as a basic service. Thus, at the present time, the ILECs must unbundle their data services at two levels. They unbundle their physical loops so competitive DSL providers can implement DSL, and they unbundle their DSL service so competitive ISPs can sell Internet access over the incumbent's DSL service." *Id*. at 304-305.

cable industry has prospered under video franchises, and should rightfully be subject to further franchise obligations as they provide additional services, particularly since the telephone carriers they compete with in providing cable modem service are more heavily regulated.[186] But incumbent systems make the argument that there is no public policy reason to impose new obligations with the provision of additional service. "Industry commenters assert that franchise fees are inappropriate because their systems do not impose any additional burden on the public rights-of-way.[187] Industry commenters also say that additional franchises are not needed, because a cable franchise provides all the protection a local government requires."[188]

¶ 155 This policy position has carried the day.[189] Indeed, when local governments have attempted to include cable modem sales receipts in the "cable services" revenues on which operators pay franchise fees (generally five percent of gross sales), the FCC and the courts have rebuffed them. One recent case, involving the City of Chicago, prompted this response from a federal court:

> [T]he cable system is already in the right of way pursuant to an existing franchise agreement, which requires defendants to pay 5 percent of its gross revenues derived from cable services for that system's use of the rights-of-way . . . .
>
> The City's argument that it is entitled to more money simply because the defendants [cable operators] provide a new kind of service over existing lines is neither logical nor fair.[190]

¶ 156 Cable modem service's immunity from regulation and taxation was largely determined by federal policy. When the FCC issued its declaratory ruling in March 2002, it determined that broadband connections offered by cable TV operators are not "cable

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[186] "A large and influential industry that has achieved enormous success under a regulatory regime that expressly relies on the exercise of local authority now claims that maintaining that regime with respect to cable modem service would be unreasonable and unlawful. At the same time, the industry rejects any suggestion that it should be regulated in the same fashion as its competitors. There is no basis in fact or law for the rejection of local franchising authority over cable modem services, and the Commission is bound by the Constitution and the Communications Act to uphold that authority." Reply Comments of the Alliance of Local Organizations Against Preemption, *In the Matter of Inquiry Concerning High-Speed Access to the Internet Over Cable and Other Facilities*, GN Docket No. 00-185 i (Federal Communications Commission Aug. 6, 2002).

[187] *Id.* at iii.

[188] *Id*. at iv.

[189] "The FCC . . . has concluded that cable modem service is generally not subject to many of the regulations issued by Local Franchise Authorities. This dispute is currently before the courts. . . ." Kevin J. Martin, Commissioner, Federal Communications Commission, Cable Television in the United States: Trends and Challenges, Remarks at the 5th Sino-International Cable TV Executive Management Conference in Beijing, China (Aug. 26, 2004), http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-251635A1.doc.

[190] City of Chicago v. AT&T Broadband, Inc., 2003 U.S. Dist. LEXIS 15453 1, 13-14 (N.D. Ill. Sep. 4, 2003). A similar result was reached in *Parish of Jefferson v. Cox Communications Louisiana, LLC,* 2003 U.S. Dist. LEXIS 10782 (E.D. La. Jun. 20, 2003). *See also* Memorandum circulated at Cole, Raywid & Braverman L.L.P., "CRB Update: Federal Court Dismisses City of Chicago Claim for Franchise Fees on Cable Modem Revenues as 'Neither Logical Nor Fair,'" (Sept. 9, 2003).

services" (which are presumably subject to franchise regulation at the local level) and not "telecommunications services" (which are presumably subject to common carrier rules), but "information services" (which are presumably unregulated).[191] Further litigation ensued, resulting in the *Brand X* opinion of the U.S. Supreme Court in June 2005.[192] There the Court upheld the FCC's regulatory delineation.

¶ 157 The upshot is that cable modem service is unregulated and untaxed. Despite using public ROWs, cable TV franchises satisfy the operator's obligations such that additional services are free to piggyback on the same network. The asymmetry with the substitute product, DSL, was then remedied by regulators. Following the *Brand X* decision, the FCC moved quickly to extend the deregulatory framework to DSL.[193]

¶ 158 Broadband regulation has now arrived at a reasonable policy. Evidence from market deployments strongly suggests that stronger incentives for networks promote investment and pro-consumer competition.[194] This is seen, for instance, in the initial dominance of cable modem service over DSL; through 2002, cable operators maintained virtually a two-to-one lead in broadband subscribers over their telephone company rivals. The "closed, proprietary" platform evidently outperformed the "open, regulated" platform. In early 2003, however, telcos received a favorable ruling from the FCC that significantly reduced their network sharing obligations, abolishing "line sharing." This effectively raised the price at which rivals could use their facilities, sharply reducing opportunities for independent DSL providers to profitably lease telephone network facilities. But such measures enhanced telephone carrier incentives to improve their networks and to more aggressively market broadband services. The net result is that DSL subscriber additions by 2005 reached parity with cable modem subscriber increases.[195]

¶ 159 Charting the logical flow of this policy is instructive. An existing communications supplier integrated from video service into broadband. Franchise authorities attempted to

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[191] Declaratory Ruling and Notice of Proposed Rulemaking, *In the Matter of Inquiry Concerning High-Speed Access to the Internet Over Cable and Other Facilities*, 17 F.C.C.R 4798, 4802 (2002).

[192] Nat'l Cable & Telecomm. Assoc. v. Brand X Internet Services, 545 U.S. 967 (2005).

[193] "The Federal Communications Commission ruled Friday [Aug. 5] that Internet DSL providers like SBC will no longer be required to lease high-speed lines to independent rivals. . . . The FCC ruling follows a Supreme Court decision in June that said cable companies do not have to open up their networks to Internet service providers. . . . Phone companies like SBC have been required to lease wholesale access to their high-speed lines to competing Internet providers, which number about 4,000 nationwide. On Friday, the FCC ruled that DSL providers were in the business of information services and not bound by the higher regulatory requirements placed on telecommunications companies." Ryan Kim, *FCC Frees DSL Providers from Regulations, Firms No Longer Have to Lease Lines to Their Competitors*, SAN FRANCISCO CHRONICLE, Aug. 6, 2005, at C1.

[194] Thomas W. Hazlett & Coleman Bazelon, *Regulated Unbundling of Telecommunications Networks: A Stepping Stone to Facilities-Based Competition?*, *presented at* the Telecommunications Policy Research Conference (Sep. 20, 2005), *available at* http://web.si.umich.edu/tprc/papers/2005/503/Stepping%20Stone%20TPRC.10.04.05%20.pdf.

[195] "'[DSL vs. cable is] a horserace now, but cable has a 10-length lead,' said Bruce Leichtman, the market research firm's president and principal analyst, in an interview. 'DSL is now running at par with cable. And, in the future, I [expect] the 50-50 split to continue.'" Leichtman Reasearch Group, Inc., *1Q 2005 Research Notes on Broadband, Media & Entertainment Industries*, *available at* http://www.leichtmanresearch.com/research/notes03_2005.pdf.

impose telecommunications regulation on the new service offerings, and some courts were sympathetic to this effort. Of the Ninth Circuit Court of Appeals decision that was later overturned by the Supreme Court in *Brand X*, one commentator notes that "the panel believes cable operators providing cable modem service should be subject to the same common carriage rules as apply to telephone companies providing Internet services."[196] But there are two ways to get to parity, and the regulatory road less traveled – deregulation – was the path ultimately chosen.

¶ 160 *VoIP*. The rules governing Voice-over-Internet Protocol show clearly why treating "like services alike" is a recipe for regulatory conflict and, in many cases, disaster. . VoIP can and does substitute for POTS; this is the great competitive promise argument made by the development of advanced networks. But the emerging services, as well as the network platforms that deliver them, can be delayed or deterred by the imposition of traditional telecommunications regulation. Hence, cable operators argue that VoIP services should not be heavily regulated, as with ILEC-supplied POTS. Rather, VoIP should be deregulated altogether. When the FCC issued a December 2004 ruling that largely embraced this view, cable operators responded positively:

> What this [November 2004 FCC ruling] means is that cable operators seeking to offer VoIP will no longer need to gain each state's approval to enter the telephony market. . . .
>
> Not surprisingly, cable officials, who had fretted that a narrow preemption ruling might hurt the industry by giving Vonage and similar third-party providers a regulatory edge over cable, hailed the FCC's move. They predicted that the order, by removing possible state barriers to market entry, would lead to a faster rollout of IP telephony by MSOs [cable multiple system operators].[197]

¶ 161 *Summary*. Local franchises are not an end in themselves. They are justified in terms of the remedies they provide in the case of market failure. Were certain community assets unpriced or unregulated, it is possible that firms providing video services would "over-consume" such inputs, inefficiently imposing costs on community residents. Rules that attend to these specific problems can be, and are, applied by government agencies in many contexts. Abandoning that focus in favor of "regulatory symmetry," however, leads to perverse results, including rules that result in "faux symmetry" lacking historical substance, or rules that impose discriminatory burdens on entrants while nominally achieving parity.[198] This outcome occurs, in large measure, because making "symmetry" the objective obscures the pursuit of efficiency, igniting a process-intensive, rent-seeking competition in which incumbents have asymmetric

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[196] Joseph Van Eaton, Municipal Franchises: Opportunities, Pitfalls and Alternatives 1, 9, presented at the IMLA 2003 Annual Meeting, Minneapolis, Minnesota (Oct. 2003), http://www.millervaneaton.com/word_docs/MuniFranchises.DOC.

[197] *FCC Preempts State Utility Regulation of VoIP Services*.

[198] *See* previous analysis of cable system build-out and the economic impact of nominally symmetric build-out requirements. *See also* Hazlett & Ford (2001) at 30, 43.

advantages.[199]

¶ 162 The position of cable TV operators is highly instructive. Having received video franchises from local government, they have successfully entered both voice and broadband markets without being subject to costly franchising hurdles or burdensome regulation. Rules have consistently been lighter for cable operators than for the telephone carriers they compete directly with in either voice or data. This has proven successful; rules in broadband are now being adjusted for DSL providers that reduce regulatory obligations to mirror the cable modem regime.

¶ 163 Yet the interests of a community in protecting public ROWs are not adversely affected. As cable operators note, with respect to cable modem service, "their systems do not impose any additional burden on the public rights-of-way . . . a cable franchise provides all the protection a local government requires."[200] This position creates an asymmetry in the sense of permitting competition among firms with distinct regulatory obligations. Entrants into voice and broadband face reduced regulatory burdens. Legitimate public disruption issues are, however, addressed through existing licenses, and the additional competition increases consumer welfare.

E. Partial Market Entry Cannot Harm Consumers

¶ 164 Entry into a local video market is often subjected to franchise obligations, including build-out requirements, on the grounds that partial entry will produce deleterious effects. Most particularly, it will create an inequity between the benefits produced in some neighborhoods and the benefits seen elsewhere. The president of the national cable TV trade association stated that "[c]able operators must be vigilant about plans by phone companies to circumvent the local franchising process to gain unfair competitive advantage by red-lining or any other means. Serving only high and middle income neighborhoods in a community is both discriminatory and anti-competitive."[201]

¶ 165 Incumbents advocate build-out requirements precisely because such rules tend to limit, rather than expand, competition. But the argument that competition, if it occurs in some areas and not in all other areas will be "discriminatory and anti-competitive," bears analysis.

¶ 166 First, it should be noted that defining the areas over which entrants are required to provide service is itself a costly obligation. The entrant, as shown above, expects lower profits from its investments, relative to the incumbent, and so nominally symmetric construction requirements tend to discriminate sharply against the new rival.

¶ 167 Second, in drawing service territories politically, entrants may be extremely disadvantaged by not being able to develop their own business plans. This occurs when a

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[199] Hazlett, *Duopolistic Competition* (1990), *supra* note 82.

[200] ALOAP, *supra* note 185, at iii-iv.

[201] Robert Sachs, President & CEO, National Cable & Telecommunications Association, The Excitement Continues, Remarks to Washington Metropolitan Cable Club (Dec. 14, 2004), www.ncta.com/DocumentBinary.aspx?id=298.

telephone company seeks to enter a particular market with its existing network, which offers economies of scope. Rules mandating video entry take place across a cable TV franchise area, which may intersect the service territory of the telco but is not coterminous with it.[202] (As a general rule, the boundaries of the reach of each telephone company Central Office are not coincident with cable franchise areas.) Rules that force cable operators to provide telephone or cable modem service statewide, or across a large area defined by the incumbent LEC's local service territory, would have similarly anti-competitive effects.

¶ 168 Third, the primary margins determining (unregulated) video build-out patterns are (a) density and (b) construction costs. Service providers make the generic calculation described in Section V(c), where revenues per mile of plant are evaluated. Urban areas and populous suburban neighborhoods often feature more than 200 HP/mile, while other suburbs, exurbs, or rural areas have densities of less than 20 HP/mile. The former are generally much more profitable to serve, despite the fact that the latter often feature higher – or substantially higher – per capita incomes. The cost factor primarily concerns two issues. First, aerial cables – more typically found outside of dense urban areas – are generally much less expensive to place than underground cables. Second, the general rule is violated in the case of "greenfield" housing developments where trenches are opened by builders and cable operators are invited to insert conduits without incurring all the costs of underground placement. These cost factors are not under the control of the cable entrant, but determined by pre-existing infrastructure and housing market activity.

¶ 169 As a rule, the most desirable sub-markets for cable service are densely-built, middle-class neighborhoods populated by families with children. Rules that force construction schedules, while justified as preventing racial or income discrimination, likely do little in this direction, while lowering the probability of entry. This lowers the likelihood that any sub-market will receive the benefits of competition, thereby harming consumers across socio-economic categories. Moreover, rules that mandate money-losing build-out rules are inefficient, because video service in the costly, low-density sub-markets is more economically provided by satellite TV. At most, a "universal service" or "build-out" requirement in a cable franchise should obligate an entrant to offer *video service* across a specified area without imposing a technological constraint on how that is achieved. This would remove the tax on competitive entry by allowing cable systems to contract with DBS operators to serve households that are not efficiently served by cable plant.[203]

¶ 170 Fourth, competition in one part of the market does not raise prices anywhere else. Prices are set by cable operators (or other service providers) to maximize profits. That occurs when marginal revenues (receipts gained from an additional sale) just equal marginal costs (the added expense of that additional sale). Because entry into a sub-

[202] Verizon Communications, *In the Matter of Implementation of Section 621(a) of the Cable Communications Policy Act of 1983 as Amended by the Cable Television Consumer Protection and Competition Act of 1992, Comments of Verizon on Video Franchising,* MB Docket No. 05-311, v (Feb. 13, 2006).

[203] FCC, *Eleventh Annual MVPD Competition Report*, *supra* note 32, at ¶ 67 (discussing co-marketing agreements between phone carriers and DBS operators).

market does not change either marginal revenues or marginal costs associated with serving other sub-markets, prices do not rise elsewhere.

¶ 171 The conclusion is, then, that competitive entry cannot harm consumers, even though it might well help some customers more than others. Policies that prescribe entrant build-out patterns reduce the likelihood of any entry, creating "equity" by eliminating gains for any class of consumers. The pro-consumer policy response is not to erect barriers to entry, then, but to reduce such impediments, increasing the probability that entry will occur, lowering expected prices. Moreover, if policies are desired to extend competitive gains, they should take the form of (a) technology-neutral build-out requirements (allowing video providers to use satellite services to deliver programming to sparsely populated areas), and (b) uniform pricing rules.

¶ 172 It should be noted that federal policy makers have embraced both of these options; in either case, however, enforcement has been ineffective. In the 1992 Cable Act, Congress sought to outlaw anti-competitive build-out requirements: "In awarding a franchise, the franchising authority shall allow the applicant's cable system a reasonable period of time to become capable of providing cable service to all households in the franchise area."[204] Similarly, the Act sought to prevent discriminatory pricing that extinguished competition.[205] Yet, by granting municipal franchising agents immunity from damage awards, there is no effective remedy should regulators impose unreasonable build-out requirements or fail to enforce uniform pricing rules. Antitrust litigation has largely been ineffective as well. Even when cases are won, remedies are weak.[206] Additional policy reforms are needed to reduce barriers to entry in either regard.

VI. QUANTIFYING THE BENEFITS OF VIDEO COMPETITION

¶ 173 Additional entry in the Multichannel Video Programming Distribution (MVPD) marketplace benefits consumers in two ways. First, a new entrant increases the programming options available to consumers both by presenting additional choices and by triggering better programming from existing MVPD suppliers. Second, service prices decline with additional competition. Because competitors are forced to respond, this benefits all MVPD consumers, not just those subscribing to the entrant.

A. Quality Improvements

¶ 174 Video competition leads to a larger, more diverse package of programming services. Not all of the new, expanded choices will represent "higher quality" programs than were offered prior to entry. But subscribers do not view all programs, only those

[204] 47 U.S.C. § 541(a)(4)(A) (2006).

[205] 47 U.S.C. § 543(a)(2) (2006).

[206] An example is the case of *Leza Coleman et al. v. Sacramento Cable Television*, No. 524077 (California Superior Court, County of Sacramento, June 1994). After prevailing on liability by proving that the defendant cable operator violated a California statute limiting price discrimination to subvert competition, the class – cable customers in the 400,000 home Sacramento market – won a judgment of merely $1 million. Pam Slater, *Cable Firm Told to Pay $1 Million*, SACRAMENTO BEE, June 8, 1994, at D6. The author testified as an expert witness for the plaintiffs in this case.

which they are particularly interested in. With a greater range of choices offered, then, quality increases to individual customers, even if customers were to rate average program quality to be declining.

¶ 175 Over time, cable programming services have grown in number and in the range of formats, leading to superior choices.[207] Program networks have been observed to grow (in number) markedly faster when rate regulation has been eliminated,[208] and in response to the nationwide entry of DBS operators. Satellite operators launched video services in 1994 (DirecTV) and 1996 (EchoStar), making a concerted effort to compete on the quality dimension. Either system offered higher picture quality via digital video signals (at the time cable offered only analog), a greatly increased number of channels, and near video-on-demand offerings. The cable industry's response to the so-called "Deathstar" was to upgrade cable infrastructure, investing over $65 billion, during 1999-2003, to allow systems to deliver digital channels, video-on-demand, two-way high-speed internet access, and other features.[209] The statutory elimination of cable rate regulation as of March 31, 1999[210] also played a key role in inducing cable system upgrades.

¶ 176 The increased quality can be measured. One useful, if imperfect, metric is the quantity of channels available to subscribers. Average cable system capacity increased from fifty-nine channels in June 1997 to 223 channels in January 2004.[211] The FCC has noted that, "[c]able operators indicate that they need to provide additional and advanced services to compete with DBS."[212]

¶ 177 Another quality measure is the number of cable programming networks. As indicated in Figure 6 and Table 4, some of the fastest growth in cable networks occurred in the years just after DBS entry.

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[207] DAVID WATERMAN & ANDREW A. WEISS, VERTICAL INTEGRATION IN CABLE TELEVISION 38 (MIT Press and AEI Press 1997).

[208] Hazlett & Spitzer (1997), *supra* note †, at 95-98.

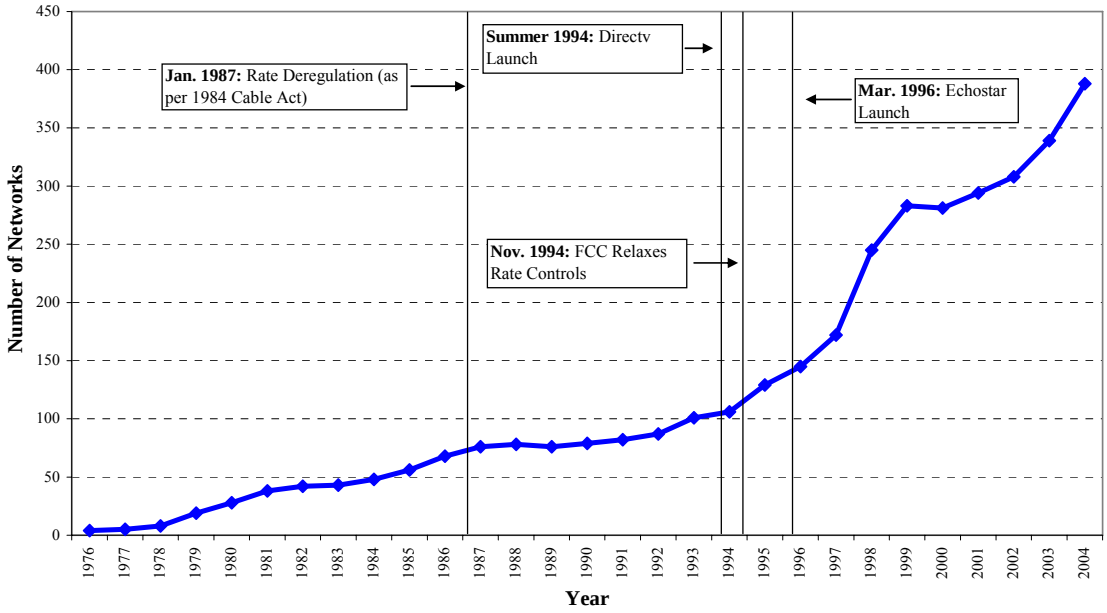
[209] Hazlett et al. (2004), *supra* note 103, at 50-53.

[210] 1996 Telecom Act, 110 Stat 56 § 301(b) (1996).

[211] Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming, Fourth Annual Report,* CS Docket No. 97-141, 7 (Rel. Jan. 13, 1998); FCC, *Eleventh Annual MVPD Competition Report*, *supra* note 32, at 18 (Table 3).

[212] Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming, Sixth Annual Report,* CS Docket No. 99-230, 12 (Rel. Jan. 14, 2000) (citing Comcast Reply Comments).

FIGURE 6. CABLE NETWORK DATA (1976 - 2004)



Data for the years 1976 to 1993 from National Cable Television Association, Cable Television Developments (Spring 1995), p. 7, as found in Hazlett & Spitzer (1997), p. 96. Data for the years 1994 to 2004 from FCC, Eleventh Annual MVPD Competition Report, p. 10. Data reported for the years 1994 to 2004 are as of June of each year. For historical information, see p. 30; Directv, Introduction to Directv, available at http://satellitetv.digitalinsurrection.com/directv/directv.php; and Dish Network, Introduction to Dish Network, available at http://satellitetv.digitalinsurrection.com/dishnetwork/dishnetwork.php.

TABLE 4. CABLE NETWORK GROWTH (1976 - 2004)

Year	*Number of Cable Networks*	*Net Increase from Previous Year*	*Annual Increase*		*Year*	*Number of Cable Networks*	*Net Increase from Previous Year*	*Annual Increase*
1976	4	-	-					
1977	5	1	25.00%		1991	82	3	3.80%
1978	8	3	60.00%		1992	87	5	6.10%
1979	19	11	137.50%		1993	101	14	16.09%
1980	28	9	47.37%		1994	106	5	4.95%
1981	38	10	35.71%		1995	129	23	21.70%
1982	42	4	10.53%		1996	145	16	12.40%
1983	43	1	2.38%		1997	172	27	18.62%
1984	48	5	11.63%		1998	245	73	42.44%
1985	56	8	16.67%		1999	283	38	15.51%
1986	68	12	21.43%		2000	281	-2	-0.71%
1987	76	8	11.76%		2001	294	13	4.63%
1988	78	2	2.63%		2002	308	14	4.76%
1989	76	-2	-2.56%		2003	339	31	10.06%
1990	79	3	3.95%		2004	388	49	14.45%

Data for the years 1976 to 1993 from National Cable Television Association, *Cable Television Development,* (Spring 1995), p. 7, as found in Hazlett & Spitzer (1997), p. 96. Data for the years 1994 to 2004 from FCC, *Eleventh Annual MVPD Competition Report*, p. 10. Data reported for the years 1994 to 2004 are as of June of each year.

B. Price Effects

1. Modeling Entry

¶ 178 How competitive entry will affect prices, quality, and subscriber levels cannot be known with precision. Yet historical evidence exists, dredged from our experience with markets where industry structure has changed. Here, it is highly convenient to focus on price effects. Numerous studies and surveys report price reductions of ten percent to over thirty percent when a monopoly cable system faces competitive wireline entry. One recent assessment is found in a 2003 GAO report, where "overbuild" competition is found to reduce prices by fifteen percent.[213] This subsection describes an economic model used to estimate welfare effects from additional entry, and is calibrated to replicate

[213] GAO (2003), *supra* note 7, at 60.

the GAO price reduction results. For illustrative purposes, the analysis herein examines entry as if the entire U.S. was one market.[214]

¶ 179 *Market Power.* The market for MVPD is modeled under the Cournot assumption on conjectural variations, a standard paradigm for evaluating market structure.[215] Under this framework, each profit-maximizing firm is assumed to adjust the quantity of output they supply, given that all of the other market participants behave similarly. The framework assumes that, with a limited number of firms, each firm recognizes that it possesses some degree of pricing power. This is reflected in the price-cost margin, where costs are marginal costs. The model anticipates that additional entry will reduce this margin.

¶ 180 The Cournot model used here incorporates a measure of market concentration, the Herfindahl-Hirschman Index (HHI), in its calculation of the price-cost margin.[216] The pricing equation is:

Equation 1: $$\frac{(p-c)}{p} = \frac{HHI}{-10,000 * \eta}.$$

p = the market price for MVPD services.
p is initially set equal to $47.01— the average monthly cable bill in 2004.[217]

c = marginal cost.
c is derived from Equation 1 for each pair of HHI and η examined, given the initial price. It is then held constant to permit calculation of the post-entry margin.

HHI = the Herfindahl-Hirschman Index, $HHI = \sum_{i=1}^{n} share_i^2$.
The current market shares are listed below in Table 5. They imply a pre-entry HHI of 5,453.[218]

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[214] The results would hold precisely in any submarket where the distribution of video providers is proportional to the national numbers reported in Table 5.

[215] As such, it is often used by regulatory agencies to analyze how prices will be impacted by competitive entry. *See*, *e.g.*, Evan R. Kwerel & John R. Williams, *Changing Channels: Voluntary Reallocation of UHF Television Spectrum*, Federal Communications Commission, OPP Working Paper No. 27, 81-82 (Nov. 1992).

[216] *See*, *e.g.*, Federal Communications Commission, *In the Matter of Application of EchoStar Communications Corporation, (a Nevada Corporation), General Motors Corporation, and Hughes Electronics Corporation (Delaware Corporations) (Transferors) and EchoStar Communications Corporation (a Delaware Corporation) (Transferee)*, *Hearing Designation Order,* CS Docket No. 01-348, 118, n.660 (Rel. Oct. 18, 2002) [hereinafter FCC, *EchoStar Merger Order*].

[217] FCC, *Eleventh Annual MVPD Competition Report*, *supra* note 32, at 20. Price = [(Basic Service and CPST Tiers + Premium (Pay) Tiers + VOD–Pay-Per-View) / Basic Subscribers (mil.)]/12.

[218] This calculation uses national market shares. Calculating concentration ratios market by market would, in many contexts, yield more informative and finely calibrated data. But that method would be needlessly complicated in the extant exercise, which aims to approximate competitive gains in the

η = the elasticity of demand for MVPD services.
η is calibrated to be -1.5 (see discussion below).

TABLE 5. U.S. MVPD MARKET

	June 2004[1]		*Post Entry*[2]	
Provider	*Subscribers*	*Market Share*	*Subscribers*	*Market Share*
Incumbent Cable	66,100,000	72%	59,191,935	54%
DIRECTV[3]	13,040,000	14%	11,677,199	11%
EchoStar[4]	10,120,000	11%	9,062,366	8%
MMDS	200,000	0%	179,098	0%
SMATV	1,100,000	1%	985,040	1%
HSD	335,766	0%	300,675	0%
BSP	1,400,000	2%	1,253,687	1%
Entrant	0	0%	27,550,000	25%
Total	**92,295,766**	**100%**	**110,200,000**[5]	**100%**
HHI		**5,453**		**3,692**

[1] Data from the FCC, *Eleventh Annual MVPD Competition Report*, p. 115.
[2] Post entry market shares assume entrant draws subscribers from incumbents in proportion to their current market share.
[3] FCC, *Eleventh Annual MVPD Competition Report*, p. 39.
[4] FCC, *Eleventh Annual MVPD Competition Report*, p. 39.
[5] Total post entry subscribers limited by total U.S. households.

¶ 181 *Effect of Entry.* We do not know precisely how entry will affect market concentration. Evidence on entry by cable overbuilders yields some clues, however. RCN, the largest overbuilder, reports twenty-seven video subscribers for every 100 homes passed, implying a penetration ratio of twenty-seven percent.[219] More broadly, the FCC reports that in 2004 U.S. overbuilders account for about 1.4 million subscribers, with plant passing approximately 4.2 million homes, producing an average penetration ratio of thirty-three percent.[220] When penetration rates are translated into market shares,

nationwide MVPD market. It should be noted that the most important distinction in national market shares versus aggregated local market shares concerns the existence of local markets featuring BSP competition. These markets constitute only about 4% of U.S. households. The other major competitors in MVPD, satellite TV providers, offer service nationwide and are properly evaluated via national market shares.

[219] RCN Corporation, Annual Report (Form 10-K), at 9 (for year ending Dec. 31, 2003), http://investor.rcn.com/downloads/2003_10-K.pdf.

[220] FCC, *Eleventh Annual MVPD Competition Report*, *supra* note 32, at 115-16; Comments of Broadband Service Providers Association, *In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming,* MB Docket No. 04-227, 6 (July 23, 2004). This implies about 4% of the 106 million occupied homes passed by cable are served by overbuilders. FCC, *Eleventh Annual MVPD Competition Report*, *supra* note 32, at 13.

competitive entrants are garnering about three in ten MVPD subscribers. My analysis displays results of entrant market shares from twenty to forty percent. It is assumed that the entrant's share is taken proportionally from MVPD rivals.

¶ 182 All else equal, price reductions cause subscribership to increase.[221] How much it grows depends on the elasticity of demand.[222] Elasticity estimates for segments of the MVPD marketplace fall in the 1.5 to 3.25 range. For example, the GAO found in a 2002 study that the price elasticity of demand for cable subscribers was 2.12, as opposed to 3.22 in a previous study.[223] A 2003 GAO study estimated the price elasticity of demand for cable subscribers to equal 1.54.[224] Austan Goolsbee and Amil Petrin found the elasticity of demand for expanded basic to be 1.5, for premium cable to be 3.2, and for DBS to be 2.4.[225] The FCC reports Paul MacAvoy's elasticity of demand for DBS estimate of 1.55,[226] and notes that Greg Sidak's analysis of market power assumed a DBS elasticity estimate of 3.0 and cable elasticity of 1.95.[227]

¶ 183 The overall MVPD market elasticity of demand is predictably lower than the elasticities of its component parts.[228] The estimates for the sub-markets, then, imply that market elasticity is probably between 1 and 2; hence, I report results using three elasticities (1, 1.5 and 2.0) in this range.

¶ 184 *The Model Solution.* I solve Equation 1 under a range of assumptions on elasticity (described above) to calculate an implied, constant marginal cost, *c*. The *HHI* is recalculated based on the assumed market share of the entrant.[229] The new *HHI*, the fixed marginal cost, *c*, and the assumed elasticity are then used to calculate the new market price for MVPD services. The percent decrease in price under varying assumptions is reported in Table 6.

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[221] With competitive entry, not all else will be equal. But the changes generally push output in a reinforcing direction, as quality increases and marketing effort intensifies.

[222] Elasticity of demand is defined as the percentage change in quantity demanded for a percentage change in price, all other factors remaining constant. Technically, the measure is negative, as price and quantity demanded move in opposite directions along a fixed demand curve. In the text, I follow the convention of referring to the absolute value of elasticity measures, dropping the negative sign.

[223] General Accounting Office, *Telecommunications: Issues in Providing Cable and Satellite Television Services,* GAO-03-130 (Oct. 2002) 45, n.41.

[224] GAO (2003)*, supra* note 7, at 59.

[225] Austan Goolsbee & Amil Petrin, *The Consumer Gains from Direct Broadcast Satellites and the Competition with Cable TV*, 72 ECONOMETRICA 351, 377 (Mar. 2004).

[226] FCC, *EchoStar Merger Order*, *supra* note 217, at 117.

[227] *Id.* at 118.

[228] This is because the substitutability is predictably greater among industry segments than among industries.

[229] For some combinations of variables total subscribers exceed total U.S. households. In those instances, total subscribers are limited to total U.S. households.

TABLE 6. PRICE CHANGES FROM CABLE ENTRY

Entrant market share	*Elasticity of demand (η) =*		
	1.0	*1.5*	*2.0*
20%	-25.6%	-14.1%	-9.7%
25%	-27.9%	-15.6%	-10.8%
30%	-29.3%	-16.5%	-11.4%
40%	-29.4%	-16.5%	-11.5%

Analysis Group calculations.

¶ 185 Table 6 indicates that the greater the market share of the entrant, the greater the effect of entry on prices (this continues up to the point where the entrant gains the largest market share, which would occur at just over forty percent). It also shows that the lower the absolute value of demand elasticity, the higher the price reduction associated with entry. Taking both sets of assumed values into account, predicted price reductions range from approximately ten to thirty percent.

¶ 186 *Model Calibration.* This model is then calibrated by comparing the above results to an analysis of cable entry performed by the Government Accountability Office (GAO).[230] In an October 2003 study, the GAO reported that prices for cable service in markets with BSP competition were approximately fifteen percent lower than in markets without such wireline competition.[231] The GAO model also reported a partial price elasticity of demand for cable subscribers of about 1.5.[232] Consequently, the results reported in Table 6 replicate the GAO analysis assuming an elasticity of demand of 1.5 and an entrant market share of between twenty and twenty-five percent. In the following benchmark analysis, twenty-five percent market share is used with an elasticity of 1.5. This implies a cable price reduction equal to 15.6%.

2. Quantifying Effects on Consumers

¶ 187 Consumer surplus measures the value a good or service delivers over and above what it costs to purchase. In this analysis, the change in consumer surplus has two components. First, all of the existing subscribers enjoy a price reduction on the services they subscribe to. This is measured as the price savings times the number of subscribers prior to entry. Second, new subscribers enter the market and also enjoy some consumer surplus but less than the full amount of the price decrease enjoyed by the existing subscribers. (This is true because these marginal demanders demonstrated that they were not willing to pay as much as others to purchase the service.) The change in consumer surplus associated with a 15.6% cable price reduction is approximately $741 million per

[230] Previously known as the General Accounting Office.
[231] GAO (2003), *supra* note 7, at 60.
[232] *Id.* at 59.

month, or $8.9 billion per year.[233]

3. Quantifying Effects on Producers

¶ 188 Entry harms incumbent producers both by reducing prices and their market shares. These effects are quantified by calculating the change in producer surplus (profits). Here, the change in aggregate producer surplus equals the revenues gained from new subscribers, minus the incremental costs incurred in providing the additional service, minus the revenues lost on the existing subscriber base (these price discounts show up as a gain to consumers). This change is negative; owing to the greater competitiveness of the market, suppliers as a whole see profits decline by about $501 million per month, or $6.0 billion per year.[234]

4. Net Social Benefits[235]

¶ 189 An estimate of the net benefits to society accruing from competitive, nationwide entry combines the respective estimates of consumer gain and producer loss. Efficiency gains are estimated to be $241 million per month or about $2.9 billion per year. These potential gains reveal the value of the opportunity society loses for each month (or year) of delay in which nationwide cable market entry is deterred. With pre-entry monthly revenues in the model used for this analysis of approximately $4.3 billion ($51.6 billion annually), the efficiency gains are approximately six percent of industry revenues.

5. Interpreting Results

¶ 190 The magnitude of the consumer gains from increased competition in local video markets underscores the potential payoffs of policy reform. Were regulatory delays associated with franchising reduced or eliminated, "overbuild" competition could proceed much more broadly and much more rapidly. It is not possible to estimate, with any precision, how much more rapidly or how much more broadly. What the above analysis shows is that, were policies to succeed in inducing nationwide competition, annual consumer gains of nearly $9 billion would likely result. Thus there is a very large opportunity to improve consumer welfare.

¶ 191 In reality, eliminating municipal franchise barriers would not produce an instant

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[233] $741 million per month consumer surplus = {[| - $7.32 change in monthly price | x (92,295,766 subscribers pre- entry)] + [| -$7.32 change in monthly price | x (17,904,234 subscriber increase post-entry)]/2}. $8.892 billion per year = ($741 million per month) x (12 months).

[234] -$501 million per month producer surplus = [(17,904,234 change in subscriber base resulting from entry) x ($39.69 new monthly price)] – [(17,904,234 change in subscriber base resulting from entry) x ($29.92 implied industry average marginal cost)] – [| -$7.32 change in monthly price | x (92,295,766 subscribers before entry)]. -$6.0 billion per year = (-$501 million per month producer surplus) x (12 months).

[235] An additional effect, not analyzed here, is that franchise fee payments could increase with additional competition. *See* George S. Ford & Thomas M. Koutsky, *Franchise Fee Revenues After Video Competition: The "Competition Dividend" for Local Governments,* PHOENIX CENTER POL'Y BULL. NO. 12 (Nov. 2005).

nationwide build-out by entrants. Nor would a lack of reform necessarily block all competitive entry by wireline video providers. To more precisely quantify the marginal gains from policy reform, one would have to make assumptions about the build-out patterns under both the status quo and a reformed (streamlined) franchise regime. I have recently performed this analysis elsewhere, estimating the present value of franchising policy reforms in the range of $16 billion to $28 billion.[236]

C. BSP Competition

¶ 192 The experience of BSPs illustrates the policy issues surrounding franchising. Currently, there are about 1.4 million video subscribers to firms such as RCN, Knology, and Wide Open West (the three largest BSPs), which collectively pass about 4.2 million homes.[237] This competitive experiment forms the basis for numerous studies by the FCC, GAO, and others, all of which document substantial social benefits in direct cable rivalry. The estimate derived above, showing consumers would find $8.9 billion of value annually from nationwide rivalry, suggests the very large gains available from policies to promote entry.

¶ 193 Currently, BSPs are not expanding. RCN, Knology, and Wide Open West have all been through bankruptcy or "financial restructurings," and have retrenched, curtailing launches of new markets and slowing growth within existing franchises.[238] According to FCC data, BSP subscribership actually declined in 2004, and the Commission noted that, "BSPs continue to face considerable challenges…. As a result, competition to cable from BSPs is limited to very few markets."[239]

¶ 194 The successes and failures of BSP entry reveal important lessons. First, competitive entry is extremely valuable to cable consumers. This has been quantified above. Second, "triple play" offerings of voice, video, and broadband, increase the viability of overbuilds.[240] This form of product integration allows efficiencies to be exploited both in spreading the common costs of advanced networks over greater revenue sources and in marketing multiple services as a sales package – "one stop shopping."

¶ 195 Third, we observe that the task of the second entrant is more difficult than that of the first, particularly as how the first may engage in strategies designed to resist competition. In this skirmish, economies of scope attendant to "triple play" service menus and advanced telecommunications networks take on added significance as competitive tools. When entrants build networks across large markets or regions, they

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[236] Thomas W. Hazlett, *Declaration of Thomas W. Hazlett*, submitted to the Federal Communications Commission by Verizon Communications*, In the Matter of Implementation of Section 621(a) of the Cable Communications Policy Act of 1984 as Amended by the Cable Television Consumer Protection and Competition Act of 1992*, MB Docket No. 05-311 (Feb. 13, 2006).

[237] FCC, *Eleventh Annual MVPD Competition Report*, *supra* note 32, ¶¶ 71-72.

[238] *Id.* at ¶ 73.

[239] *Id.* at ¶ 70 (footnote omitted).

[240] "[W]e ended 2004 with over 398,000 connections and eclipsed the 400,000 connection mark early in the first quarter of 2005. I attribute our success to the focus we have maintained on selling the value of the 'three part bundle.'" Letter from Rodger L. Johnson to Shareholders, Knology Annual Report (2004), p. 1, http://library.corporate-ir.net/library/13/130/130221/items/152752/Knology2004ARl.pdf.

gain advantages in overcoming selective price cutting (undertaken to deter the entrant's build-out, particularly by discouraging capital markets from financing such construction [241]) in matching programming packages offered by incumbents (and programmers extend volume discounts) and in overcoming the hurdles presented by cable TV franchising.

¶ 196 In each of these dimensions, video entry by local telephone operators can exploit advantages that strengthen competitive forays. Of particular interest here are economies offered with respect to franchising. Having obtained regulatory permits to access ROWs and possessing communications infrastructure that may supply additional bits without further encroachment on public resources, the telephone carrier video provider is well situated to provide a robust competitive option. In light of the failure of BSPs to progress past about four percent of the total U.S. market, policies enabling this competitive pathway may be crucial in enabling competition.

¶ 197 As recently as 2001, RCN fought strenuously to obtain a municipal cable franchise in Philadelphia. There it sought to construct advanced telecommunications networks offering consumers "triple play" services, one which would compete directly with Verizon (telephone) and Comcast (cable) networks. The City made demands in its franchising process that RCN found onerous, leading RCN to withdraw its application.[242] According to a local newspaper account:

> Philadelphia has taken a brazen step in snubbing a high-tech company that could have potentially brought in $250 million in investment and hundreds of jobs – and a bit of competition for the city's major cable provider.
>
> RCN Corp., the Princeton-based cable upstart, had hoped to install cable lines in the Northeast and Northwest sections of the city. The firm offered hope that residents could have two choices for cable service and might actually be able to save money on monthly bills. The firm also planned to offer Internet and phone service.
>
> Alas, RCN's grueling battle to get regulatory and City Council approval – all two-and-a-half years of it – was mired in the kind of political wrangling for which the city has long been known. [243]

¶ 198 Policy reforms that allow firms to efficiently utilize state or national licenses, or to offer additional services with franchises already held – as in the case of a utility or telephone company – permit entrants to become "unmired." It is not surprising, if a bit ironic, that the corporate victim of such barriers, RCN, now opposes streamlining the cable franchise process:

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[241] *See* Bolton, Brodley & Riordan (2000), *supra* note 3.

[242] Interestingly, RCN succeeded in securing 15 franchises in suburban Philadelphia, and serves many homes just outside the city today. *Paul G. Allen's Vulcan Ventures Closes $1.65 Billion Investment in RCN; Vulcan Funding Positions RCN to Continue Rapid Expansion Into Markets Which Meet Its Density and Regulatory Requirements,* PR NEWSWIRE (Feb. 28, 2000). Hence, the franchising process effectively "red-lined" Philadelphia, which features no direct cable TV competition.

[243] *After RCN, City Can't Miss Next Opportunity*, PHILADELPHIA BUS. J. (Feb. 23, 2001), *available at* http://philadelphia.bizjournals.com/philadelphia/stories/2001/02/26/editorial1.html.

> Further, the Bells' argument that obtaining franchises is an onerous, time-consuming process rings hollow to Richard Ramlall, senior vice president of strategic and external affairs at RCN, a small Herndon, Va.-based firm that provides cable, Internet, and telecom services. RCN . . . obtained 130 franchises, in Boston, San Francisco, Washington, D.C., and other places, within two years without serious difficulty, Ramlall said. "We are a tiny company with little money," he says. "We had to go through the whole franchise process, so why should the Bells, who have deep pockets, get a free pass?"[244]

¶ 199 Part of the reason that RCN is "a tiny company with little money" is that they "had to go through the whole franchise process."[245] According to RCN's 2003 10-K (SEC Annual Report), "In the City of Philadelphia, significant delays were experienced in securing authorization from the city to provide cable . . . on commercially reasonable terms. As a result, RCN withdrew from negotiations with the city and has no present plans to build out its system in Philadelphia."[246] It is also important to note that Philadelphia did not officially refuse to issue RCN a franchise. Rather, it imposed build-out terms that were considered prohibitively expensive.

> The conflict in Philadelphia goes to the heart of the overbuilders' business model—targeting selected neighborhoods with potential for high penetration rates. Instead, Philadelphia officials wanted RCN to go citywide.
>
> The Philadelphia standoff is unusual, because the federal Telecommunications Act of 1996 clearly mandates competition in all communications arenas, including cable. In Boston and New York, RCN is able to focus on high-density residential buildings, where tenants will buy bundled packages of cable video, telephone and high-speed Internet.[247]

¶ 200 "Unusual" or not, RCN wasted scarce resources in fruitless pursuit of franchises not obtained, and was subjected to costly franchise obligations in others it did. The firm has subsequently gone bankrupt, and is no longer seeking additional awards. The economic consequences of the franchising process RCN was subjected to may be avoided by more pro-consumer policies.

D. Benefits of "Triple Play" Competition

¶ 201 Bundling communications network services is a common practice. Cable TV

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[244] VAIDA (2005), *supra* note 3.

[245] In fact, RCN ran through several billions of dollars – including a $1.65 billion investment from Microsoft co-founder Paul Allen, before declaring bankruptcy in May 2004. *See* Tom Becker, *Court Approves RCN's Bankruptcy Exit Plan,* CHICAGO SUN-TIMES, Dec. 9, 2004, at 57.

[246] RCN Co., Annual Report (Form 10-K), at 20 (Mar. 30, 2003).

[247] Richard Williamson, *Overbuilders or Underachievers?,* EWEEK.COM, July 2, 2001, http://www.eweek.com/article2/0,1759,1243092,00.asp.

systems bundle video channels into large, diverse programming packages,[248] wireless operators offer "buckets" of minutes,[249] and telephone providers sell local and long distance call bundles. These practices tend to be efficiency enhancing.[250]

¶ 202 Triple Play competition – offering discounted bundles of landline voice, video and high-speed data service – is another side of this efficiency coin, and an increasingly important competitive strategy in retail telecommunications markets.[251] Spearheaded by cable operators, it is now a key element in facilities-based competition, rivalry between side-by-side networks. Bundling allows networks the opportunity to economize on capital costs when entering new markets. For example, while relatively little residential telephony service has been offered by stand alone, facilities based entrants, approximately forty percent of U.S. households can choose to subscribe to voice service provided by their local cable TV operator[252] – or over ninety percent, when VoIP service perched atop a cable modem connection is considered.[253]

1. Benefits to Carriers

¶ 203 Telecommunications carriers benefit from bundling in at least three ways. First, by increasing the volume of service provided over a given network, the operator decreases its average costs, amortizing investments over larger sales units. Second, marketing efforts are similarly extended; the fixed cost of a customer relationship now hosts additional transactions. Third, bundling reduces churn, where subscribers connect and reconnect to networks. Churn is very expensive to networks, which invest subscriber acquisition costs in the hopes of long-term customer retention.

¶ 204 Multi-channel video distribution networks are characterized by high fixed costs for infrastructure and then by low incremental costs (up to capacity) to provide service to additional subscribers. The same basic economics apply to voice communications – networks are costly fixed investments, with incremental use (up to capacity utilization) being relatively inexpensive. Network owners attempt to price services to obtain the

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[248] GAO (2003), *supra* note 6, at 30; Thomas W. Hazlett, *The Economics of Cable TV Pricing: A La Carte v. All-You-Can-Eat* (Aug. 12, 2004), submitted to the Federal Communications Commission by Turner Broadcasting System, Inc., *In the Matter of: Comment Requested on A La Carte and Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems*, MB Docket No. 04-207 (Aug. 13, 2004) [hereinafter Hazlett (2004)].

[249] A key event in the development of U.S. wireless phone service was the adoption, by AT&T Wireless, of a 'Digital One-Rate' calling plan in May 1998. The idea of buying a bucket of minutes for a flat monthly fee was so popular that all other major carriers soon embraced similar pricing menus. *See* Federal Communications Commission, *In the Matter of Implementation of Section 6002(b) of the Omnibus Budget Reconciliation Act of 1993; Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services, Seventh Report*, 17 F.C.C. RCD. 12985, 13014 (2002).

[250] Hazlett (2004), *supra* note 248, at 2; TIMOTHY J. BRENNAN, IS COMPETITION THE ENTRY BARRIER? CONSUMER AND TOTAL WELFARE BENEFITS OF BUNDLING (2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=834704. *But see* Barry Nalebuff, *Bundling as an Entry Barrier,* Q. J. ECON. 159 (2004).

[251] Indeed, "Quadruple Play" services are now being offered, which now include wireless phone service. Mike Farrell, *Sprint Nextel Service to Cross Platforms*, MULTICHANNEL NEWS, Nov. 2, 2005.

[252] Leichtman (3Q 2005), *supra* note 4, at 5.

[253] *Id.*

maximum yield on the asset, and this leads naturally to the provision of broad packages that take full advantage of the network capacity available.

2. Benefits to Consumers

¶ 205 Consumers realize benefits from bundling with reduced prices and reduced transaction costs. In fact, consumers pay considerably less for aggregate services when they purchase Triple Play bundles. See Table 7. And with reduced churn, customers avoid switching costs. Increased subscriber longevity does not, however, reduce competition, in that rival suppliers are willing to make better offers to acquire longer-lived customers. This is seen, again, in the significant price discounting associated with triple play offers.

TABLE 7. BUNDLED PRICING DISCOUNTS

Provider	*Triple Play Discount*[1]
Cablevision	33%
Cox	9%
Comcast	32%
Time Warner Cable	0% to 22%
SBC	4%
BellSouth	20%
Verizon	9%

[1]New customer discount for voice, video, and data.
Data from Lowell Singer, Doug Creutz, and Danae Ringelmann, *Cable Pricing Survey – June*, SG Cowen & Co. (July 6, 2005), pp. 9-11.

3. Bundling is Pro-Competitive

¶ 206 Beginning in the late 1990s, bundling of video, voice and data services was an important competitive offering for cable overbuilders as they attempted to compete with incumbent cable companies.[254] BSPs now focus on their "customer connections," counting voice and high-speed data subscriptions along with video. By self-description, they are not in the "video," but in the "broadband network," business. The largest BSP, RCN, identifies itself thusly: "RCN Corporation (NASDAQ: RCNI) is a 'triple play' provider offering customers a bundle of cable, phone and internet services over a state of the art fiber optic broadband network."[255]

¶ 207 Prior to March 2001, telecommunications common carriers, such as telephone companies, were prohibited from offering bundles of services at discounted prices. Most ILECs were also restrained from offering long distance phone service prior to state-by-

[254] FCC, *Tenth Annual MVPD Competition Report*, *supra* note 8, at 1658.
[255] Press Releases, RCN Co., Comments of Richard Ramlall, RCN Strategic & External Affairs VP Regarding Broadband Consumer Choice Act of 2005 Legislation Introduced Today by Senator John Ensign (R-Nevada) (July 27, 2005), http://investor.rcn.com/ReleaseDetail.cfm?ReleaseID=169842.

state Bell Operating Company "271 certification," 1999 to 2003.[256] To supply triple play bundles, Bell South, SBC, Verizon and Qwest have each partnered with DBS providers to be able to add a video component to their bundled service offering. "While these agreements do not represent new, facilities-based competition, they may allow both LECs and DBS operators to become more competitive with cable operators' bundled offerings."[257] This indicates that phone carriers are eager to provide the triple play, driven by its competitive advantages.

¶ 208 While the integration of inter-modal service packages may constitute the most efficient service delivery, it likely does not. BSPs choose to provide integrated services over the same network, suggesting that there are substantial economic advantages to this practice. Eliminating franchise barriers that make wireline multi-channel video artificially expensive to include in the standard "triple play" package allows market competition to discover the low cost way to best satisfy consumer demand.

VII. POLICY REFORM

¶ 209 Local cable television franchises create a significant barrier to entry. Their *raison d'etre* – to regulate natural monopoly – has dissolved into a sea of actual and potential competition. Other justifications, such as rate regulation, were found unworkable. The local franchise regime's remaining justification – to protect incumbent cable operators from "unfair competition" – provides no pro-consumer justification. Competition, not extended regulation, is most likely to produce the optimal video delivery marketplace. Under current rules, competitive entry is deterred.

A. Problem to Be Overcome: Local Cable Television Franchise Barriers

¶ 210 The justification for local cable franchises, never compelling, no longer *exists.* The cable franchising regime is best described as a "naked restraint" of trade, an entry barrier having no ancillary, offsetting efficiency justification[258] that reduces competitive enterprise. Overbuilders, from Telesat in the late 1980s to RCN and others in the late 1990s, have often been thwarted by the franchising process. When not denied licenses outright, their entry has been stalled, and costs increased, by franchise regulation.

¶ 211 Regional build-outs of new competitive video distribution are now possible with the (long heralded) emergence of local telephone carriers. These companies already have much of the needed network infrastructure in place, and possess well-regulated franchise

[256] Under terms of the 1996 Telecommunications Act, Bell Operating Companies were permitted to offer long-distance voice service in areas where they owned local exchanges by agreeing to open their markets to competitive entry, a process certified in a Sec. 271 application. *See RBOC Applications to Provide In-region, InterLATA Services Under § 271*, *available at* http://www.fcc.gov/Bureaus/Common_Carrier/in-region_applications/.

[257] FCC, *Tenth Annual MVPD Competition Report*, *supra* note 8, at 1679.

[258] The classic "naked restraint" is horizontal price fixing, where firms collude to restrict output. This is a per se violation of Section 1 of the Sherman Act, because without integration of productive facilities (as is possible in a merger, for instance) there is no efficiency rationale for the conduct that the courts find plausible. *See* ROBERT H. BORK, THE ANTITRUST PARADOX 263–79 (1978).

rights allowing them to access public ROWs, putting them in an advantageous position to compete in local video distribution markets.

¶ 212 The current municipal franchising regime balkanizes regulatory oversight. Not only is telco infrastructure not aligned with franchise boundaries, but franchises are generally much smaller than natural video marketplaces. A simple metric shedding light on this is to note that, while there are 210 distinct over-the-air broadcast TV markets in the U.S., there are about 33,000 cable franchise jurisdictions.[259] One of the major trends within the cable TV marketplace over the past fifteen years has been "clustering," where cable operators swap systems so as to aggregate within particular markets, lowering costs. As a general matter, the efficiency of standard regulatory rules in cable mimic those motivating national pre-emption of local regulation in such areas as broadband, cellular telephony, food labeling, and trucking.[260]

¶ 213 The implications of patchwork franchises are evident. Firms intending to offer service to large areas, as when a telephone carrier makes plans to integrate into video across its local service area, rely on economies of scale. When pieces of the network cannot fit together, efficiencies are sacrificed. In essence, cable franchises become complementary inputs, and the hold-up exercised by one or more franchising authorities constitutes a tragedy of the anti-commons.[261] The "tragedy" thwarts rational business undertakings because the rights (in this case franchises) are too widely dispersed. Humpty Dumpty cannot be reconstituted in a financially viable manner.

¶ 214 The costs imposed by balkanized franchises on incumbent operators were, in many cases, substantial as well. Hence the build-out of cable, which did take some decades, was slowed. But the uneconomic use of regulation in one generation should not be "grandfathered." Subsequent generations deserve the opportunity to devise more efficient rules. Moreover, the standard asymmetry is again apparent: first entrants' financial expectations are less easily made unprofitable than competitive entrants'. Thus far, competitive cable entrants have been able to establish only a modest beachhead in the national market, despite overbuilding strategies (using Telesat's business development as a marker) dating back over twenty years. This is testimony to the larger impact of this relatively more formidable barrier for video competitors.

¶ 215 Two basic policy options exist to potentially remedy this non-market failure. Larger geographic areas, either national or state in scope, can be made the basis for video franchise licenses. Alternatively, local cable franchising can be reformed so as to invite, rather than deter, entrants. After noting the efforts made to invite competitive entry in certain parts of the 1992 Cable Act, I will discuss these current policy options.

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[259] Warren Communications News, Stations Volume, A6 (2005); FCC, *Report on Cable Industry Prices* (1997), *supra* note 14, at ¶ 10.

[260] Hazlett (2003), *supra* note 51, at 174-82.

[261] *See* Heller (1998), *supra* note 58. *See also* James M. Buchanan & Yong J. Yoon, *Symmetric Tragedies: Commons and Anticommons,* 43 J.L. & ECON. 1 (2000) (presenting an algebraic illustration and several applications of discussion).

B. 1992 Cable Act: Promise and Failings

¶ 216 The 1992 Cable Act[262] was enacted after deregulation pursuant to the 1984 Cable Act,[263] and was largely a response to the earlier law. In addition to laying out a rate regulation regime, the 1992 Cable Act was supposed to promote competition in ways the 1984 Cable Act did not. It did this through both mandates and incentive mechanisms designed to reward market competition. The following provisions of the 1992 Cable Act are particularly relevant:

a. Cities cannot unreasonably refuse to issue competitive franchises.

> [A] franchising authority may not grant an exclusive franchise and may not unreasonably refuse to award an additional competitive franchise.[264]

b. No build-out requirements that are unduly onerous to entrant.

> In awarding a franchise, the franchising authority… shall allow the applicant's cable system a reasonable period of time to become capable of providing cable service to all households in the franchise area.[265]

c. Uniform pricing rules.

> A cable operator shall have a rate structure, for the provision of cable service, that is uniform throughout the geographic area in which cable service is provided over its cable system.[266]

d. Access to programming for overbuilders.

> PROHIBITION.—It shall be unlawful for a cable operator, a satellite cable programming vendor in which a cable operator has an attributable interest, or a satellite broadcast programming vendor to engage in unfair methods of competition or unfair or deceptive acts or practices, the purpose or effect of which is to hinder significantly or to prevent any multichannel video programming distributor from providing satellite cable programming or satellite broadcast programming to subscribers or consumers.[267]

e. Exemption from rate regulation for competitive franchises.

> If the Commission finds that a cable system is subject to effective competition, the rates for the provision of cable service by such system shall not be subject to regulation by

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262 1992 Cable Act, *supra* note 50.
263 1984 Cable Act, *supra* note 50.
264 1992 Cable Act, *supra* note 50, at § 7.
265 *Id.*
266 *Id.* at § 3.
267 *Id.* at § 19.

> the Commission or by a State or franchising authority . . . .[268]

¶ 217 The fourth provision listed above – access to programming for competitors – has been seen to have materially assisted the efforts of DBS operators.[269] Other reforms proved weak, however, doing little to assist overbuilders surmount entry barriers. In practice, it kept the local franchising regulatory regime in tact. While adding pro-competitive provisions – a. through c. above – it simultaneously defanged enforcement of the local franchising provisions by removing monetary damages in suits against franchising authorities that failed to implement the Act's pro-competitive provisions.[270] This essentially made those provisions non-binding, and alternative enforcement mechanisms have not offered a remedy.

¶ 218 This may be addressed by policy makers, as the FCC has opened a proceeding to examine the local franchising process. "The *Notice* seeks input on what can be done to ensure that local franchising authorities (LFAs) do not unreasonably refuse to award cable franchises to competitive entrants."[271] The first round of Comments closed February 13, 2006, and the regulatory proceeding is ongoing.

C. National Licenses

¶ 219 One solution to the problem of local cable TV franchise barriers is to create a national license. This has the obvious advantage of overcoming balkanization and local franchise hold-ups. Municipalities could continue to reasonably control the time and place of construction along rights-of-way and police public disruption. But these would be regulated according to general rules established for use of ROWs as well as construction projects that involve aerial attachments and underground conduits. Franchise fees could be imposed.[272] Regardless of the merits of such fees, they cannot be a justification for local franchising because such fees could be collected without local franchises. Indeed, the current maximum franchise fee rate, five percent, was established in the 1984 Cable Act, pre-empting local discretion precisely because this was seen (by

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[268] *Id.* at § 3.

[269] The Museum of Broadcast Communications, *Direct Broadcast Satellite,* http://www.museum.tv/archives/etv/D/htmlD/directbroadc/directbroadc.htm.

[270] "Suits for Damages Prohibited.—In any court proceeding pending on or initiated after the date of enactment of this section involving any claim against a franchising authority or other governmental entity, or any official, member, employee, or agent of such authority or entity, arising from the regulation of cable service or from a decision of approval or disapproval with respect to a grant, renewal, transfer, or amendment of a franchise, any relief, to the extent such relief is required by any other provision of Federal, State, or local law, shall be limited to injunctive relief and declaratory relief." 1992 Cable Act, *supra* note 50, at § 24.

[271] *FCC Initiates Rulemaking to Ensure Reasonable Franchising Process for New Video Market Entrants*, FCC NEWS (Nov. 3, 2005).

[272] Franchise fees, paid annually to municipalities, are generally set at 5% of gross annual video revenues. This form of taxation tends to discourage competition. As a political matter, the issue may be moot, but it is clear that franchise fees compensate municipal governments for more than for the incremental cost of local regulation or the use of rights-of-way. *See* Century Federal, Inc. v. City of Palo Alto, 648 F. Supp. 1465 (N.D. Cal. 1986).

Congress, and by the cable industry) to be a responsibility that city officials could not be trusted with.

¶ 220 Satellite TV service providers are issued national licenses that imbed certain "public interest" obligations such as educational programming requirements. A national cable franchise could do likewise. Notwithstanding the merits of such requirements or the optimal regulatory involvement, the rules do not justify local rather than national rules. Local rules can be customized, but that non-uniformity raises costs to entrants. Without such entrants, there will be no competition to regulate.

¶ 221 Federal regulation or pre-emption of local cable franchising authorities is a regular feature of U.S. telecommunications policy. The 1984 Cable Act mandated that municipalities franchise cable systems, something many towns, cities, or unincorporated county areas had expressly refrained from doing. It also set rules for PEG (public, educational, and government) channels, franchise fees, leased access rules, and rate regulation – which it largely abolished.[273] The 1992 Cable Act then imposed a different set of federal franchising mandates, including several described above, as well as rate regulation and must-carry rules.[274] The 1996 Telecommunications Act pre-empted state and local governments, as well, opening up local exchange carriers' markets to competition by abolishing franchise barriers protecting legacy LEC monopolies.[275]

¶ 222 A national franchise is under consideration in Congress. Senator John Ensign (R-NV)[276] and Representative Joe Barton (R-TX)[277] introduced bills in the Senate and House of Representatives, respectively, in 2005. Whatever set of rules is most consistent with consumer welfare is actually the *next* debate. The first policy cut is that dealt with here: the possibility of a national solution to the local franchise entry barrier.

D. State Licenses

¶ 223 State franchises constitute another approach currently under consideration. A state is a more natural jurisdictional boundary than a locality for many entrants, particularly for those planning large regional build-outs and for LECs currently regulated

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[273] 1984 Cable Act, *supra* note 50.

[274] *See* 1992 Cable Act, *supra* note 50, at §§ 3 & 4.

[275] 1996 Telecom Act, *supra* note 50, at §§ 251, 259.

[276] "Prohibits a video service provider (VSP) from being required to: (1) obtain a state or local video franchise; (2) build out its video distribution system in any particular manner; or (3) provide access to its distribution facilities and equipment to any other VSP. Authorizes state and local government charges against VSPs for the cost of managing public rights-of-way used by VSPs." Ensign Bill, *supra* note 16, at § 13.

[277] "The video franchising provision would require each broadband video provider to register with the FCC, the state commission and local franchising authority where service would be provided. If there's no local franchising authority, the provider can begin offering service 15 days after the registration is filed with the state commission. The bill would give franchisees the right to build over public rights of way within the service area. Many cable video requirements would be applied to broadband, including equal access, retransmission consent, emergency alerts, carriage of significantly viewed signals, ownership limits, basic tier content, equal employment opportunity and closed captioning." Anne Veigle, *Barton Bill Would Establish Federal Franchising for Video*, COMM. DAILY, Sept. 16, 2005.

by state public service commissions (PSCs). PSCs already regulate many aspects of the telecommunications industry and LECs avoid the costs of duplicate regulatory regimes. This, as noted, is analogous to cable TV systems' entry into broadband under standard cable TV franchises, while federal pre-emption of local franchising is analogous to the manner in which the 1996 Telecommunications Act prohibited local or state regulations that raised barriers to entry in the supply of telephone network access.

¶ 224 Some states have considered state-wide video franchises, but Texas is the only state to implement such an option. Enacted in September 2005,[278] the Texas statute mandates fast-track approval of qualified parties applying for franchises, and allows franchisees to elect the jurisdictions within the state that they intend to serve, subject to anti-discrimination rules, provision of PEG channels, and payment of franchise fees to local governments.[279] Localities continue to manage rights-of-way and to regulate quality of service.

¶ 225 It is instructive to see the immediate impact of the law. SBC (now AT&T) was widely reported to have lobbied hard for the measure. Meanwhile, the first applicant was the largest incumbent telephone operator in the state, Verizon, which was building high-capacity fiber-to-the-premises (FTTP) systems in selected cities, including Keller, Texas. It received its statewide franchise in just 17 working days.[280] Two days after Verizon's application, Texas BSP Grande Communications Networks, Inc. filed for its state franchise,[281] also beating SBC. Grande Communications, which serves video and telephony customers between Austin and San Antonio, noted the importance of the state franchising option:

> "Those local city franchises often had requirements that called for Grande to pay the same fees – not just the 5 percent access fees, but additional fees to the city for public education, governmental access, channels and for support of local city networks, whatever, frankly, the city wanted us to pay for … on the same basis as the incumbent cable provider," [Grande vice president Martha] Smiley explains.
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> With the passage of Senate Bill 5, statewide franchising calls for requirements "that made sense and were uniform," says Smiley. Because new statewide entrants such as Grande have fewer subscribers, they now pay fees proportionate to cable revenue. Grande still will pay each city a 5 percent franchise fee, Smiley says, but other fees are doled out on a per-subscriber basis, "so it's more rational in relation to your growth and subscriber base in comparison to the incumbent."

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[278] *Telecom Law Passed*, *supra* note 18.

[279] David Tewes, *Telecommunications Bill Effects Remain to Be Seen*, VICTORIA ADVOC., Aug. 30, 2005.

[280] David Cohen, *Texas PUC OKs Verizon Franchise,* MULTICHANNEL NEWS, Oct. 21, 2005 [hereinafter Cohen (2005)].

[281] *Id.*

> As Grande competes against Verizon – and, soon, SBC – Smiley says the advantage it has over the RBOCs is customer focus . . . .
>
> Grande is gearing up to expand its reach and Smiley likens the opportunity to the time 10 years ago when telecommunications competition was unleashed. "What the state law has done, I think, is created an equitable basis for new entrants to come into the market. The existing, or the prior, framework was simply extraordinarily burdensome, both in terms of process and in terms of financial and economic burdens," she says. "So I think that, like telecom, the state of Texas has recognized that if they want competitive options for consumers, they're going to have to address the inherent imbalance between the incumbents and new players in the marketplace, and that's what they've done."[282]

E. Local Open Entry

¶ 226 Under this policy approach, cities adopt cable ordinances imposing only generic access rules, and light (if any) cable service and system regulations. Access rules would be limited to time and place restrictions, bonding requirements, etc., enforced through Public Works Departments and standard construction permitting. System regulation may include franchise fees, PEG channels, and anti-discrimination provisions. To further increase the possibility of competitive entry, some jurisdictions have imposed uniform pricing rules (which limit an incumbent's ability to lower prices only in the areas first served by an entrant) and access to programming rules, limiting the use of exclusive contracts that tend to reduce competition.

¶ 227 This option has been followed in many communities; in general, those localities that have succeeded in attracting successful overbuilders have instituted policies that have (by implication) not extinguished the economic viability of competitive entry. Yet, pro-consumer policies pursued in individual jurisdictions do not solve the general problem of franchise barriers because it leaves the problem of balkanization intact. In that the creation of regional or national networks involves the construction of cable systems across franchise areas, obtaining favorable franchise agreements in some areas still subjects the entrant to the delays, costs, and uncertainties of gaining favorable terms across all jurisdictions complementary to the firm's business enterprise.

VIII. CONCLUSION

¶ 228 The municipal cable television franchise has always been a dubious proposition. In its earliest days, it was casually applied, and many jurisdictions left the regulation of potential externalities to generic public works rules. When cable television became a more lucrative business proposition, the cable franchise "gold rush" produced a more

[282] Kelly M. Teal, *Grande Ready to Compete Against RBOCs in Cable Market*, XCHANGE, Oct. 10, 2005.

intense form of rent seeking. Standard political transactions emerged, including the widespread use of "rent a citizen" schemes to imbue private monopolies with the public interest.

¶ 229 The infirmities of the franchising process were clearly evident, both in the spectacle of franchise auctions and in the not unrelated question of First Amendment rights. With local regulators exercising such arbitrary control over the life and death of communications systems, the issue of press licensing – clearly a Constitutional violation if applied to traditional print media – arose. The debate became heated, and a series of federal court cases in the 1980s brought the issue to the attention of the U.S. Supreme Court. While litigants asserting First Amendment rights to build cable TV systems without monopoly franchises generally prevailed in these cases, remedies were insufficiently potent to curtail exclusive franchising. Provisions enacted in the 1992 Cable Act, ostensibly intended to boost these remedies, proved only marginally effective.

¶ 230 It is now instructive to re-examine the institution of local cable franchising. The franchise has been premised on two broad assertions. The first is that cities must regulate firms that use public rights-of-way and cause potential disruption for local citizens. The second is that the economics of the market are such that monopoly is inevitable. Not only will government franchising not cost much, given that competition is likely to be short-lived, at best, but also that the lack of rivalry creates a "market failure" that local franchise regulation may address. Rules governing customer service, public interest channels and build-out provisions will substitute for the protections of competitors in the marketplace.

¶ 231 The first of these rationales has never been compelling. A wide range of builders and service suppliers utilize public streets and rights-of-way, while posing potential disruption to residents, and are yet regulated without a cable (or any other) franchise. Indeed, many cable companies were successfully regulated without a cable franchise prior to the 1984 Cable Act's mandate that all systems obtain one. Today, the delays and costs of franchises constitute a "naked restraint," given the opportunity for other franchises – including statewide cable franchises (as are offered now in Texas) or state telephone licenses held by phone companies wishing to offer video – to impose regulatory constraints protecting community interests. State and federal rules could be enacted to bypass municipal franchise authorities, extending such franchise-level efficiencies.

¶ 232 The second of these rationales, natural monopoly, is the presumption of a bygone era. The current strategy of virtually all cable TV companies is provision of the "triple play" – voice, video, and high-speed data. Phone carriers seek to respond in kind. Local fixed line telecommunications markets today are structured as head-to-head rivalry between cable and telephone networks – where they are legally permitted to compete. The historical defense of cable franchising is now unavailable: the argument that cable systems enjoy natural monopolies is not a credible empirical premise, let alone a justification for regulations making entry barriers steeper.

¶ 233 The shift in market realities has not gone unnoticed in the contemporary political

debate. The defense of franchising is now largely based on fairness to cable TV incumbents. If existing networks had to surmount the costly barriers of the cable TV franchise, so ought newcomers. To reduce barriers to entry would, on this logic, be discriminatory.

¶ 234 In reality, many incumbent cable systems were built without such regulation. A 1982 survey of Pennsylvania's cable systems, for instance, found that sixteen percent of those systems queried reported having no cable franchise.[283] Moreover, systems granted local franchises typically have not provided universal coverage, the paradigmatic regulatory requirement incumbents aim to impose on entrants. Industry data reviewed in this paper suggest that full build-out in a community may typically take well over a decade. System build-out requirements for second entrants into local video markets are often much shorter than those imposed, or actually instituted, for first entrants.

¶ 235 The source of the equity argument is, perhaps, its most valuable informational component. That incumbent operators advocate the imposition of tight build-out rules on competitors reveals the anti-competitive effect of such rules. Incumbents are left worse off by an entrant that serves all, rather than some, of the areas it serves; rules mandating complete "overbuilds" are only in the financial interest of the incumbent network when they increase the probability that no competitive network will be constructed at all.

¶ 236 There is no doubt that such regulatory requirements do, in fact, suppress entry. Even regulations nominally identical to those levied on incumbents can have a profoundly asymmetric impact on new rivals. That is because the challenger enters a video market where prices are fifteen to twenty percent lower, and market shares at least fifty percent lower in the benchmark case. As shown in the economic simulation conducted above, the expectation of lower profits per mile of plant constructed makes the imposition of a fixed burden relatively more onerous.

¶ 237 Policy reforms to overcome these barriers are worthy of consideration. State or national authorizations may be used for the provision of video service, extending federal preemptions contained in the Cable Acts of 1984 and 1992 as well as in the Telecommunications Act of 1996. Cable operators have been permitted to enter broadband markets without separate franchises or additional regulation, and have obtained the right to offer voice telephone service without being subject to the terms imposed on incumbent local exchange carriers. Both policies have facilitated competitive entry, producing consumer benefits, while allowing new rivals to operate with less burdensome constraints than those borne by their competitors, the incumbent telephone networks.

¶ 238 State or federal rules to similarly standardize the legal framework for video entry can facilitate competition as well. Currently, only about five percent of U.S. households have a choice between two cable television operators. Rules that induce nationwide competition in video would produce impressive social gains, driven by the empirical

[283] D. Allen & D. Kennedy, *Municipal Regulation of Cable Television in the Commonwealth of Pennsylvania 3-11*, PENNSYLVANIA STATE UNIVERSITY, INSTITUTE OF PUBLIC ADMINISTRATION (Dec. 1982).

observation that prices are consistently lower in areas of wireline rivalry. The opportunity is large. In aggregate, annual consumer gains from enhanced head-to-head competition are estimated to equal about $9 billion, with approximately $3 billion constituting an efficiency gain.

¶ 239 These substantial social payoffs reflect lower prices and better service. In addition, improvements would flow from innovation, when competitive forces are given free run to provoke new products and more compelling applications. And in eliminating the traditional franchising process, democratic values will benefit. Permitting market forces to replace insider bargains in determining the mix of services and operators delivering the communications bundles demanded by customers restores a proper role for government – as referee, not coach.