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COMMISSION AUTHORIZED

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July 5, 1990

The Honorable Frank S. Sawyer
Ohio House of Representatives
State Capitol
Columbus, Ohio 43215

Dear Mr. Sawyer:

The staff of the Federal Trade Commission is pleased to respond to your invitation to comment on House Bill 622.[1] This bill defines conditions under which municipalities may grant additional cable franchises in areas with an existing cable system. The FTC staff believes that enactment of HB 622 might result in the insulation of incumbent cable systems from beneficial competition. Previous experience with similar forms of entry regulation suggests that consumers' interests are rarely served when prospective entrants are required to demonstrate, in a regulatory setting, the competitive benefits of entry.

Franchising authorities have a legitimate interest in regulating access to public rights-of-way. However, experience suggests that even regulations designed to address legitimate policy objectives may have adverse, if unintended, competitive consequences. The Assembly may wish to take these possible consequences into account when evaluating the merits of HB 622.

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[1] These comments are the views of the staff of the Cleveland Regional Office and the Bureau of Economics of the Federal Trade Commission. They are not necessarily the views of the Commission or any individual Commissioner.

I. EXPERIENCE OF THE STAFF OF THE FTC

The FTC is an independent regulatory agency responsible for maintaining competition and safeguarding the interests of consumers.[2] In response to requests by federal, state, and local government bodies, the staff of the FTC often analyzes regulatory or legislative proposals that may affect competition or the efficiency of the economy. In the course of this work, as well as in antitrust and consumer protection research, nonpublic investigations, and litigation, the staff applies established economic principles to competition and consumer protection issues, including efficiency rationales for rate and entry regulation.[3] In particular, the FTC staff has commented on rules relating to whether cable television systems "must carry" television broadcast signals,[4] and has submitted a comment in response to the Federal Communications Commission's (FCC) recent Notice of Inquiry on competition, rate deregulation, and policies relating to the provision of cable television service.[5]

II. COMPETITION AMONG CABLE SYSTEMS

The Cable Communications Act of 1984, 47 U.S.C. 521 *et. seq.*, began a process of deregulating basic cable rates and more clearly delineating the regulatory power of federal, state and local governments. To that end, the Cable Act provided for a phase-out of rate regulations on basic cable service whenever the incumbent cable system was subject to "effective competition." In implementing this portion of the Cable Act, the FCC was required to establish criteria for identifying the existence of effective competition. The FCC ultimately adopted what has come to be known as the "three signal rule," whereby a cable system is considered to be subject to effective competition if the entire community it serves can receive three or more unduplicated broadcast television signals. The FCC

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[2] 15 U.S.C. §§ 41 - 59.

[3] *See, e.g.*, Mathios and Rogers, *The Impact of State Price and Entry Regulation on Intrastate Long Distance Telephone Rates*, Bureau of Economics Staff Report to the Federal Trade Commission, November 1988.

[4] MM Docket No. 85-349.

[5] *See* Comment of the Staff of the Bureau of Economics and the San Francisco Regional Office Before the Federal Communications Commission In the Matter of Competition, Rate Deregulation and the Commission's Policies Relating to the Provision of Cable Television Service, MM Docket No. 89-600, April 20, 1990 ("FTC staff Cable Comment"). A copy of this comment has been appended to this submission.

recently issued a Notice of Proposed Rulemaking (NPRM) to consider revisions to the three signal rule.[6]

As we noted in our recent comment to the FCC, it seems unlikely that over-the-air (OTA) broadcasts (as currently available in most markets) impose a fully effective competitive constraint on cable systems.[7] Rather, we believe that such competition can only come from video distribution technologies that can offer an array of programming similar to that offered by a cable system. One possible source of effective competition for an incumbent cable system obviously would be the existence of a second cable system, a situation commonly referred to as "overbuilding."

Overbuilding currently is rare. Of the more than 9,000 cable franchises currently in existence, less than one-half of one percent face any direct competition for subscribers from other cable companies. There are some indications that the number of "overbuilds" has recently increased,[8] but overbuilding nonetheless remains relatively uncommon.

The paucity of cable overbuilds should not be surprising if, as is widely believed, cable distribution is a natural monopoly.[9] Even if cable television is a

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[6] *See* FCC Notice of Proposed Rulemaking in the Matter of Reexamination of the Effective Competition Standard for the Regulation of Cable Television Basic Service Rates, MM Docket No. 90-4, January 22, 1990 ("Effective Competition NPRM"). As of December 29, 1986, basic cable television rates in most communities were deregulated.

[7] *See* FTC staff Cable Comment, pp. 15-24. As we explain in greater detail in our comment to the FCC, we are also doubtful that cable systems' market power can be constrained by regulation as long as the regulatory power is limited to the regulation of basic service. This is because cable systems would be free to shift many of their programs from the regulated basic service tier to unregulated higher service tiers if basic rates were re-regulated. *See* FTC staff Cable Comment, pp. 21-24.

[8] The October 31, 1989 issue of *Cable TV Franchising* lists 78 pending overbuilds, and 21 actual overbuilds. *Cable TV Franchising* estimates that there are 41 percent more overbuilds now than one year ago.

[9] Virtually all discussions of the properties of cable technology assume that the cost of serving a given geographic area is lowest when it is served by a single firm. The reason is that single firm production avoids duplicative investments in receiving equipment (*e.g.*, the "headend") and in the cable itself. Although this is a reasonable argument, there exist only a few econometric studies of cable television costs (*see, e.g.*, Owen and Greenhalgh, "Competitive Considerations in Cable

(continued...)

natural monopoly, however, it does not necessarily follow that competition from overbuilding could not, under some circumstances, be both profitable and beneficial to consumers.[10] The infrequency of overbuilds may also be partly attributable to statutory and regulatory policies that have insulated incumbent cable operators from competition. Although local governments have a recognized interest in regulating access to public rights-of-way,[11] there is a possibility (discussed further below) that these regulatory mechanisms have been used to impede beneficial entry by a second cable system, thereby reducing benefits to the consumer.

Accordingly, the Assembly may wish to exercise caution in crafting legislation that might shield incumbent cable systems from entry. While eliminating regulatory entry barriers will not necessarily ensure competitive behavior in every cable market, it seems unlikely that significant competitive risks would be posed by the removal of these barriers.

III. HB 622 Could Discourage Competition

A. The Benefits of Free Entry

House Bill 622 establishes conditions that franchising authorities must satisfy before granting additional cable franchises in areas already receiving cable service. Section 4931.52 would prohibit municipalities from approving "overbuilds" without a public hearing. At this hearing the municipality would be required to consider the implications of entry with regard to a number of different issues.

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[9](...continued)
Television Franchising," *Contemporary Policy Issues* 4 (1986), 69-79). These studies appear to confirm, however, the hypothesized natural monopoly properties of cable television. The economics of cable television would seem to have similarities to the economics of electricity and gas distribution, which also are natural monopolies. One possible difference, however, is the fact that two different cable systems could potentially provide differentiated products (*e.g.*, two competing cable systems might offer differing sets of channels), while gas and electric companies could not.

[10] As we discuss in greater detail in our comment to the FCC (*see* pp. 4-14), economic theory suggests that under some circumstances long-run competition between two cable systems can occur even when total production costs would be minimized by single-firm production. *See* A. Smiley, "Direct Competition Among Cable Television Systems," U.S. Department of Justice Economic Analysis Group Working Paper No. EAG 86-9, June 5, 1986, for a more detailed discussion.

[11] *See, e.g., Video International Production, Inc. v. Warner-Amex Cable Communications, Inc.*, 858 F.2d 1075, 1081 (5th Cir. 1988), *cert. denied*, 109 S.Ct. 1955 (1989).

These issues include, *inter alia*, "the likelihood and impact of short-range and long-range competition in the provision of cable service,"[12] and "the capacity of the public rights-of-way and the utility infrastructure to accommodate the proposed cable system."[13]

The procedure that would be established by Section 4931.52 appears similar in some important respects to the Certificate of Need (CON) proceedings formerly conducted by various federal regulatory agencies (*e.g.*, the Interstate Commerce Commission and the Civil Aeronautics Board), and still conducted by numerous state regulatory commissions. In such proceedings, parties wishing to enter a market typically face the burden of proving that their entry would be "necessary" and not harmful to the public. Often, the applicant is required to meet and rebut allegations - no matter how unfounded - that the applied-for service is unnecessary and inappropriate. These proceedings raise the cost of entry, and have often effectively deterred entry and deprived consumers of the benefits of price and service competition. When these barriers have been lifted, as when Congress deregulated the interstate motor carrier market,[14] the result has been increased competition, better service, and lower prices.[15] In industries where CON programs continue to be used to regulate entry, experiences have often been unfavorable.[16]

A recent study of competition in cable television markets provides case study evidence illustrating the potential benefits from overbuilding. *See* Hazlett, "Duopolistic Competition in Cable Television: Implications for Public Policy," 7

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[12] § 4931.52(A).

[13] § 4931.52(B).

[14] Motor Carrier Act of 1978, 49 U.S.C. § 10923 *et seq.*

[15] *See* Owen, *Deregulation in the Trucking Industry*, Bureau of Economics Issues Paper, May 1988; Statement of Reese H. Taylor, Jr., Chairman of Interstate Commerce Commission, Before the Senate Committee on Commerce, Science, and Transportation (Sept. 21, 1983); Staff Report, Interstate Commerce Commission, *Highlights of Activity in the Property Motor Carrier Industry* (March 1986); and United States General Accounting Office, *Trucking Regulation: Price Competition and Market Structure in the Trucking Industry*, 8-10 (Feb. 1987).

[16] For example, many states still use CON laws to restrict entry into hospital markets. A substantial body of empirical research has demonstrated, however, that the effect of these programs has been to raise, not lower, hospital costs and prices. *See* Statement of the Federal Trade Commission by Keith B. Anderson, Before the Subcommittee on Health, Committee on Ways and Means, U.S. House of Representatives, on Certificate of Need Regulation of Health Care Facilities as Related to H.R. 712 (The Medicaid Inpatient Hospital Capital Expenditures Amendments of 1989), March 13, 1989, and the references cited therein.

Yale Journal on Regulation 65-119 (1990). For example, in Orange County, Florida (which contains the city of Orlando), Hazlett reports that in 1987 entry induced the incumbent operators to reduce the price of basic service from $12.95 to $6.50 per month. Pay service prices were reduced by a similar magnitude. In Riviera Beach, Florida, prior to entry the incumbent operator had been serving the market with a 12-channel system with basic service priced at $8.40 per month. A second firm entered with a 26-channel system, offering basic service at price of $5.75 per month. Hazlett reports that the incumbent responded to this entry by lowering its price and upgrading its service quality.

In light of these considerations, the Assembly may wish to consider the impact of a policy that might require entrants to demonstrate, in a regulatory setting, the likely competitive benefits of entry into cable markets. Earlier experiences strongly suggest that consumers' interests would be better served by a policy that permits free entry, to the extent that such a policy is compatible with other legitimate state and local interests.

B. The Risks From Other Entry Requirements

In addition to requiring the franchising authority to consider the impact of entry on competition, Section 4931.52 of the Bill also requires the franchising authority to assess (and, presumably, the applicant to make affirmative establishments regarding): (1) the capacity of the public rights-of-way and the utility infrastructure to accommodate the proposed cable system; (2) the impact on present and future uses of the public rights-of-way and utility infrastructure proposed to be used by the proposed cable system; (3) the potential disruption to existing users of those public rights-of-way and to the residents of the area from construction and operation of the proposed cable system; (4) the aesthetic impact of the proposed cable system; and (5) the financial and technical qualifications of the franchise applicant to provide the additional cable service and his demonstrated compliance with cable service and other laws of the franchising authority and other authorities.

Local authorities have a valid interest in regulating access to public rights-of-way, and Section 4931.52 appears to address such considerations. Nevertheless, even when a regulatory institution is created to serve an entirely legitimate function, situations may arise where the institution can be used to facilitate anticompetitive behavior. There is, therefore, a risk that the regulatory procedure that would be established by HB 622 could, like any procedure that regulates entry into a market, be used to impede beneficial entry, and thereby harm consumers.

Part of the danger from entry regulation arises from the ability of the incumbent to use (or misuse) the regulatory system to obtain protection from competition. For example, the Federal Trade Commission has characterized the CON process as used in hospital markets as a "classic 'barrier to entry' under every definition of that term,"[17] noting in particular the ability of incumbents to use this process to forestall entry.[18] Even when entry regulation is motivated by objectives other than the prevention of "excessive competition" (the ostensible rationale for CON programs), there nonetheless persists a danger that the incumbent will be able to exploit this process to insulate itself from competition that would benefit consumers.

The history of cable franchising in Sacramento, California, illustrates how the franchising process may have been used for anticompetitive purposes.[19] There, the city granted the initial franchise to an affiliate of a large multiple system operator. Another firm later applied for a franchise to "overbuild" the city, but its franchise application was denied. The potential overbuilder then brought suit against the city and the incumbent cable operator alleging, *inter alia*, a violation of Section 1 of the Sherman Act.[20] The jury found, and the judge agreed, that the city had conspired with the incumbent operator to exclude the overbuilder in exchange for increased cash payments and provision of free cable services to the city government.[21]

The details of the review process that would be created by HB 622 are not

[17] *See Hospital Corporation of America*, 106 F.T.C. 298, 491 (1985), *aff'd*, 807 F.2d 1381 (7th Cir. 1986), *cert. denied*, 481 U.S. 1038.

[18] *Id.* at 492.

[19] For a more expansive factual account, see *Pacific West Cable Co. v. City of Sacramento*, 672 F. Supp. 1322 (E.D. Cal. 1987).

[20] *Id.* at 1325.

[21] *Id.* at 1328. The court adopted this finding of fact from the jury's special verdict despite its decision to dismiss the plaintiff's antitrust claims against the city as immune under the state action doctrine. *Id.* at 1325. *See also Preferred Communications, Inc. v. City of Los Angeles*, 754 F.2d 1396, 1411-15 (9th Cir. 1985) (interpreting California statutes to be sufficiently specific so as to constitute a "clearly articulated and affirmatively expressed" state policy to displace competition in the cable television industry), *aff'd on other grounds*, 474 U.S. 979 (1986).

necessarily identical to those that characterize hospital CON regulation, or that existed in the Sacramento market at the time the aforementioned events took place. However, these examples are suggestive, in a general way, of the types of competitive risks that can be created by the franchising process. In creating a regulatory mechanism to assess a legitimate policy issue (*e.g.*, potential disruption to public rights-of-way), there is a trade-off between ensuring that the issue is adequately addressed and ensuring that the system itself does not become a means to impede beneficial entry. The Assembly may wish to take account of this trade-off when considering the merits of the Bill.

IV. CONCLUSION

Enactment of HB 622 may result in the protection of incumbent cable systems from socially beneficial competition. Previous experience suggests that consumers' interests are unlikely to be served by requiring prospective entrants to demonstrate the benefits of competition in a regulatory proceeding.

Franchising authorities have a legitimate interest in regulating access to public rights-of-way. However, experience suggests that even regulations designed to address legitimate policy objectives may have adverse, if unintended, competitive consequences. The Assembly may wish to take these possible consequences into account when evaluating the merits of HB 622.

Sincerely,

Mark D. Kindt