

PUBLICATIONS

AEI-Brookings Joint Center Policy Matters 06-16**The Economic Facts and FAQs of National Video Franchising: Reflections on the House of Representatives Debate. John W. Mayo. June 2006.**

Over the past several months, momentum toward the passage of significant new telecommunications legislation has been building. With the June 8th passage of the House of Representative's version of the Communications Opportunity, Promotion, and Enhancement Act of 2006 (COPE) bill, the prospects for legislation in the present Congress took a significant step forward. As the Senate takes up the issue of telecommunications policy reform, it is useful to review the facts and the FAQs that emerged from the House debate.

From an economic perspective, the facts are straightforward. Indeed, as the debate over this legislation has proceeded over the last several months, a growing consensus among economic observers emerged regarding the merits of eliminating the current balkanized system of local video franchising. The economic facts all indicate that the presence of over 30,000 local franchising authorities, which must currently - one at a time - approve entry by telcos into their local video markets, stands as a significant economic barrier to entry and robust competition. Moreover, the economic facts unequivocally point toward consumer benefits (estimated to be in the billions of dollars) as a consequence of the enhanced competition that would flow from eliminating the present barriers to competition in the provision of multichannel video distribution.

These economic facts notwithstanding, some members of Congress continue to press questions regarding the COPE legislation, which would eliminate the local video franchising system and replace it with a streamlined national video franchising process. While the affirmative economic case in favor of a national video franchising system should arguably carry the day, it is nonetheless important to pause to review the most frequently asked questions regarding the legislation.

1. *Won't granting the telcos unrestricted entry into video markets create a system of "cherry picking" in which the telcos build and promote their new service to wealthy, lucrative customers, leaving the poor farther behind?*

There are at least four reasons why this "cherry picking" question and its implied policy - we ought to restrict entry - suffers. First, it is important to note that this argument has a long, if ignominious, genealogy from which we may learn. Specifically, incumbent firms have historically solicited the aid of policymakers to protect their markets by playing the "cherry picking" card.

Prior to the 1984 telecommunications divestiture, AT&T argued that opening long-distance markets to competition would allow MCI to "cherry pick". Prior to the 1996 Telecommunications Act, incumbent local telephone companies argued that entry into their local exchange markets would allow competitive local exchange companies (CLECs) to "cherry pick" their consumers. And incumbent airlines raised the argument that Southwest and Jet Blue would "cherry pick" lucrative airline markets. Fortunately, in each case policymakers saw through the efforts of incumbents to artificially insulate their markets and allowed widespread, if not totally unrestricted, entry. The results is that we have seen new and innovative services offered – with the benefits of competition being realized by more, not fewer, consumers.

Second, the economic evidence is that the poor are actually rather intensive consumers of video services. Consequently, they may very well constitute the "cherries" to be picked. For instance, studies have found that that African Americans are in fact some of the largest consumers of cable and telephony services, spending more on average than whites, Asian Americans or Hispanics. Another recent study has shown that consumption of new technologies among minorities is growing significantly more rapidly than among other segments of society. In essence, the very populations that politicians are concerned will not be served by enhanced competition in the cable market are likely to be among the first to demand, and be served by, the new entrants.

Third, because the commercial prospects for the network increase as the subscriber base grows, providers will have an incentive to offer services to as many customers as possible. Thus, it will be economically efficient to offer services to poor, under-subscribing households who reside next to poor, intensively subscribing households. Moreover, the fact that the network expansion by the telcos is incremental to an existing network also bodes well for expansion to lower income areas. Thus, this network effect works to naturally expand service to as wide a constituency as possible, so market incentives will be to provide very wide coverage. Consequently, eliminating local franchising will benefit some (likely millions) of households, with no households being made worse off. In the jargon of modern welfare economics, this constitutes the potential realization of a wonderful social welfare improvement standard - Pareto Optimality - that comes along only rarely.

Finally, while economic logic suggests that low income consumers will benefit from telco entry, the current version of the COPE legislation imposes significant fines (three-quarters of a million dollars per day) for income-based discriminatory provisioning of video services. With such steep fines in the balance, the country can be assured that the benefits of telco entry into video markets will be realized by all classes of society.

2. Isn't it likely though that competition won't lower prices? After all, haven't telephone executives themselves indicated that that they intend to enter with "competitive, but not discounted" prices relative to cable incumbents?

Virtually every shred of evidence from the field of business economics

indicates that – rhetoric aside - entry causes an increased focus on customer service, forces lower prices, and drives quality improvements as firms face a heightened need to vie for customer patronage. In the case at hand, the General Accountability office found that the limited amount of traditional cable overbuilding to date has caused cable prices to decline significantly. And the evidence from the nascent telco entry into local video markets is equally striking with numerous indications that despite the market participants' affinity with high prices, competition forces lower prices.

3. *But might competition result in quality degradation in non-competitive areas? For instance, didn't cable industry officials indicate recently at Congressional hearings that, absent a buildout restriction being imposed on the new telco entrants, cable operators couldn't guarantee that they wouldn't withdraw from certain areas or might increase rates to non-competitive areas to subsidize competitive areas?*

Economic analysis indicates the threat by cable companies to withdraw services or raise prices in certain areas if they don't get their way (viz., having policymakers place restrictions on telco entry) is not credible. Cable's financial margins are extraordinarily healthy virtually everywhere they serve making withdrawal of service the economic equivalent of a self-inflicted wound. Indeed, the presence of enhanced competition will force them to embrace rather than retreat from customers. Moreover, any attempt by the cable companies to raise prices in non-competitive markets will disenfranchise consumers and – guess what – invite quicker entry by the telcos into those areas. Thus, the cable officials' rhetoric notwithstanding, the prospects for service deterioration or price increases even to limited areas as a consequence of telco entry is virtually nil.

4. *But might not telco entry leave rural consumers without access to new, broadband and video services?*

On the contrary, once telco entry into video markets is broadly authorized and these firms have incurred the significant contracting and set up costs associated with entry into video markets via wireline deployment, the prospects for accelerated deployment to rural customers increases dramatically. In all likelihood, the economically efficient means for accessing these consumers will be new small-dish satellite capacity that is becoming available. Indeed, AT&T has recently accelerated deployment of broadband via a partnering with Wildblue (a Ka-band satellite firm) to provide broadband access in rural areas underserved by terrestrial networks. For instance, rural broadband service is slated for, or already present, in Arkansas, California, Connecticut, Kansas, Nevada, Oklahoma, Texas, Illinois, Indiana, Missouri, Michigan, Ohio, and Wisconsin.

5. *But doesn't establishing a national franchising process for entry into video markets eviscerate the ability of local franchising authorities to control their rights –of-way effectively requiring local communities to come to Washington, D.C. to justify every rights-of-way decision they make before the FCC?*

It is true that the adoption of national video franchising will dramatically reduce the transactions costs and governmentally imposed barriers to entry for firms by reducing the authority over entry from over 30,000 to 1. At the same time COPE legislation unequivocally provides local authorities with the ability to manage local rights-of-way. Indeed, the bill explicitly states, "Nothing in this Act affects the authority of a State or local government (including a franchising authority) ... to manage, on a reasonable, competitively neutral, and non-discriminatory basis, the public rights-of-way, and easements that have been dedicated for compatible uses." Thus, it couldn't be more clear that while the COPE legislation efficiently transfers authority over the entry decision to the federal level, control over important operational issues associated with new entrants' build out will be managed locally.

In conclusion, given the central role of the converging local, long-distance, video and wireless networks to the US economy, it is certainly worth pausing to assure ourselves that the latest legislative effort to refine policy is meritorious. In this case, both the facts and the answers to the FAQs regarding the COPE legislation's effort to streamline the video franchising process favor its passage.

The writer is a professor of economics, business and public policy at Georgetown University's McDonough School of Business.