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Whither to Regulate?

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BOOK REVIEW

Whither to Regulate?

Public Policy Toward Cable Television: The Economics of Rate Controls, by Thomas W. Hazlett and Matthew L. Spitzer, The MIT Press and The AEI Press, 1997, 253 pages.

Reviewed by Patrick A. Miles, Jr.*

To paraphrase William Shakespeare: to regulate or not to regulate, that is the question. Legislators, regulators, economists, and policy analysts have struggled with that question in connection with cable television rates for some time. The struggle is demonstrated by the pendulum swings from no regulation, to local regulation, to deregulation, to reregulation, and—as of March 31, 1999[1]—back toward deregulation. Why the regula-

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1. In the Telecommunications Act of 1996, Congress eliminated rate regulation of cable programming services (the tier of service composed of satellite channels—such as CNN, ESPN, A&E, MTV, or USA Network—which is sometimes called "Tier II," "expanded basic," or "enhanced basic") effective March 31, 1999. 47 U.S.C. § 543(c)(4) (Supp. II 1996). Basic cable rate regulation was not to be affected by that sunset provision. In general, the Cable Television Consumer Protection and Competition Act of 1992 bifurcated rate regulation responsibility: Local franchise authorities have jurisdiction over basic cable rates, and the Federal Communications Commission handled regulation of cable programming services tier rates. Pub. L. No. 102-385, 106 Stat. 1460, § 3(a) (codified at 47 U.S.C. § 543(a)(2)(A) (1994)). Premium channels like HBO, ShowTime, and pay-per-view movies

tory indecision? At least two factors contribute to a possible answer. First, the cable television industry affects several important constituents—all with disparate interests. Consumers, broadcasters, programmers, local governments, and cable operators have strong voices and opinions that are heard and followed at different times by policymakers. Second, cable is a unique growth industry with an ever-changing product. Some view cable television operators as monopolists that provide an essential utility service.[2] Others view cable television as a luxury item in competition with movie theaters or video rental stores for entertainment spending. Regardless of which viewpoint is taken, the history of cable television rate regulation, deregulation, and reregulation shows that political winds can shift dramatically in a relatively short period of time.

Rather than asking the Shakespearean question of whether to regulate, *Public Policy Toward Cable Television: The Economics of Rate Controls*[3] asks and attempts to answer what its authors consider to be the two most relevant questions: (1) "What can regulators regulate?" and (2) "What is the effect of price controls on consumer welfare?"[4] In doing so, the book uses the empirical results of rate regulation to conclude that an unregulated cable monopoly is better than a regulated monopoly.[5]

This assiduously written book by economics professor Thomas W. Hazlett and law professor Matthew L. Spitzer gives a fairly sound, but mostly esoteric, economic analysis of the deregulatory effect of the Cable Communications Policy Act of 1984 (1984 Cable Act). The book provides a similarly detailed economic and financial analysis of the immediate effect of cable television rate regulation implemented by the Federal Communications Commission (FCC) under the Cable Television Consumer Protection and Competition Act of 1992 (1992 Cable Act). The book then comes down from the Ivory Tower of economic analysis and examines some of the ground-level political forces and policy decisions that led to the 1992 Cable Act as well as the subsequent calls for legislative action, which resulted in the Telecommunications Act of 1996. The book also contains a succinct glossary of relevant terms for those uninitiated to cable television industry jargon. The authors state their purpose as follows: "We

and events are not subject to rate regulations.

2. Indeed, cable system delivery of television developed in the 1950s in the remote mountainous areas of the United States where broadcast signals could not easily reach television set antennas. Community antenna television (CATV) was the only means by which people in such areas could receive television broadcasts.

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

4. *Id.* at 1-2.

5. *Id.* at 216-17.

have tried to write a book that will be accessible to the wide range of individuals who have an interest in the subject matter."[6] In this regard, they succeeded. The book, by its own admission in the preface, was written for "policymakers, journalists, telecommunications industry analysts, and academic economists."[7] Given the lack of insight into specific cable television laws and FCC regulations, however, experienced practitioners of cable television law most likely will not find the book of much practical use other than as an interesting and general background reference. The book seems aptly suited as a complementary textbook or industry case study in an administrative law, cable television law, or undergraduate economics class.

The information and data presented by the authors are impressive and provide a useful resource for members of the intended audience. Yet, one drawback is that most of the compiled information was garnered from cable industry-friendly publications. Results of government studies are also utilized occasionally.[8] The authors appear to have not undertaken the task of developing their own independent empirical research studies; and, for whatever reason, there is a dearth of information generated by proconsumer groups or associations. Nevertheless, economists will find sufficient graphs, tables, and charts supporting and analyzing the authors' data to suppress any allegation that this book is merely an anecdotal, qualitative position paper. But the lack of diverse and independent research is disappointing, especially since the book's research effort appears sincere and diligent.

The book begins by reviewing the recent debate over cable rate regulation, including reciting arguments and positions from applicable economic literature and studies.[9] It notes with some dismay that the critical question of "What can regulators regulate?" was never posed or answered in any of the legislative debate over cable television regulation.[10] The authors take some umbrage that the answer to that question was simply assumed:

> Indeed, the burden of proof is not upon those who seek regulation to lower prices, but upon those who would assert competition as an alternative short- or long-term policy. As we shall see, where head-to-head rivalry does exist in cable, rates are substantially lower in quality-adjusted terms.[11]

6. *Id.* at xi.
7. *Id.*
8. *Id.* at 15, 53.
9. *Id.* at 7.
10. *Id.* at 5.
11. *Id.*

Next, the book examines cable operator market power in multichannel video markets.[12] The authors go to some length to prove quantitatively that cable is a profitable business. They note, "The evidence strongly suggests that, at least since the mid- to late 1980s, cable operators price well above marginal and average costs and earn returns significantly above competitive levels."[13] The conclusion is that "[c]able would thus appear to be a prime candidate for rate regulation that would lower consumer prices and expand the volume of sales."[14]

Hazlett and Spitzer even make a strong argument that cable, although exhibiting "marked tendencies toward monopolistic market structure,"[15] is not a natural monopoly.[16] "[M]arket demand for cable is able to financially sustain two competitors at current (or recent) prices in the typical U.S. market."[17] They note that contrary to conventional thought, facilities-based cable competition actually can *increase* total subscribership (known as penetration) in a particular community.[18] This conclusion runs counter to typical thinking, which posits that an incumbent (and entrenched) cable service provider operates at or near the maximum penetration level.[19] Thus a potential competitor must plan on "stealing" cable subscribers from the incumbent, and to do so, the competitor must offer a better product at a lower price. Because the costs of obtaining a return on the capital expenditures required to construct a competing cable system are so high, competition is curtailed. This capital spending requirement, the thinking goes, creates a barrier to entry because earning a likely and sufficient return on investment is too difficult. The book uses empirical studies to show that cable competition can create a win-win-win situation for the incumbent, the new entrant competitor, and consumers.[20] This book makes a compelling and sound argument that cable competition can generate additional demand.

Instead of looking at the financial barrier to entry discussed in the preceding paragraph, the book focuses on regulatory barriers to entry—namely, state and local franchising.[21] It relies on federal government re-

12. *Id.* at 20.
13. *Id.* at 21.
14. *Id.* at 41.
15. *Id.*
16. *Id.* at 38.
17. *Id.*
18. *Id.*
19. *Id.* at 208.
20. *Id.* at 95, 208.
21. State and local governments can grant franchises (or permission) to cable companies to use public rights-of-way to provide cable service. Public rights-of-way (i.e., streets,

ports that conclude local franchising creates a significant barrier to entry for competing cable companies.[22] But this conclusion is never supported with firm data or reasoning and, frankly, is debatable. Most state laws and the 1992 Cable Act specifically *prohibit* exclusive cable franchises.[23] Indeed, many state and government officials desire cable competition because it generally results in constrained cable rates and improved customer service, which benefit constituents. The authors concede that cable operators disdain competition and use tactics such as exclusive programming contracts and predatory pricing in an attempt to defeat a new entrant.[24] The authors blame franchising as a barrier to entry without acknowledging that the apparent monopoly of cable could be viewed as an implicit non-aggression pact among the handful of cable operators to avoid encroaching another's service territory. In any event, this ancillary issue is not examined deeply.

The authors do provide support for the claim that the 1984 Cable Act did little if anything to stimulate competition. They argue that the 1984 Cable Act actually solidified many cable operators' monopoly position.[25] Further, they characterize the cable industry as "blessed" in the mid-1980s with a favorable regulatory environment consisting of: (1) broad First Amendment rights to select programming; (2) complete rate deregulation by the end of 1986; (3) secure property rights in cable franchises including a presumption or expectation of renewal; (4) passage in many states of "so-called level playing field laws" to create regulatory hurdles for new entrants; and (5) codification in the 1984 Cable Act of the FCC's 1970 telephone company/cable television cross-ownership ban prohibiting telephone companies from competing in delivery of local video service.[26]

The book zeroes in on the second "blessing." The Cable Communications Policy Act of 1984 effectively deregulated cable television rate regulation with an expansive view of "effective competition."[27] The 1984 Cable Act "preempted local, state, or federal rate controls in any community where the FCC found 'effective competition' to exist."[28] "Effective

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alleys, easements, etc.) are the most efficient land-based means to construct and operate a cable system throughout a community.

22. *See, e.g.*, HAZLETT & SPITZER, *supra* note 3, at 39 ("The National Telecommunications and Information Administration concluded that municipal franchising was responsible for significant [cable operator] market power . . . .").

23. *See* Cable Television Consumer Protection and Competition Act of 1992, Pub. L. No. 102-385, 106 Stat. 1460, § 7(a)(1) (codified at 47 U.S.C. § 541(a)(1) (1994)).

24. HAZLETT & SPITZER, *supra* note 3, at 29.

25. *Id.* at 56.

26. *Id.* at 57-58.

27. *Id.* at 55-56.

28. *Id.* at 55.

competition" was present "whenever three over-the-air broadcast television systems were available"—a very low threshold met in about 96.5 percent of U.S. cable systems.[29]

In Chapter Five, *The Economic Effects of Deregulation, 1987-1992*, the authors assert that although "the nominal price of cable television service rose in the post-1986 period . . . [by] nearly 61 percent for basic cable," during the "fifty-two-month interval between November 30, 1986, and April 1, 1991,"[30] such "price increases were driven—and matched—by quality improvements."[31] The authors cite to cable network subscriber growth[32] as well as expanded penetration rates as indicia of the quality improvements.[33] The authors conclude that the data evidences regulation "influenc[ing] the level of [cable] business risk, which influences investments in program and infrastructure quality, and those, in turn, influence consumer demand for cable television service."[34]

Unfortunately, the authors only give cursory mention to so-called exogenous factors as possible alternative (or associated) reasons for the growth.[35] In other words, the book looks to superficial cable operator activity in response to deregulation, such as increased investments vis-à-vis subscriber behavior, without analyzing the underlying motives. The book, which shows a commanding use of academic economics, never addresses the presence or lack of utils[36]—a basic economic concept—to demonstrate or measure the value customers place on cable services. The book relies on price changes, revenue growth, and penetration rates to show the results of deregulation. No survey data or other consumer information is proffered to confirm that in subscribers' collective view, the quality of cable television service increased, which caused more people to subscribe to cable television in the deregulatory period. The authors leave the question unanswered of whether and to what extent, if any, exogenous factors, such as consumers' desire for better reception, full use of cable-ready television sets, or technology improvements, contributed to subscriber and network expansion.

29. *Id.* at 55-56.
30. *Id.* at 69.
31. *Id.* at 101.
32. *Id.* at 86.
33. *Id.* at 80.
34. *Id.* at 76.
35. *See id.*
36. The term "utils" or "utility" is used by economists as a measure of satisfaction. H. CRAIG PETERSEN & N. CRIS LEWIS, MANAGERIAL ECONOMICS 467 (3d ed. 1994).

The book merely asserts that increased subscribership and penetration imply product quality improvements.[37] It may or may not, but the question is never addressed. The level of analysis and detailed economic and financial data that the authors used elsewhere could have been used in this regard to confirm a direct causal link between cable growth (i.e., consumer satisfaction) and quality. For example, statements like the following demonstrate that the authors are adept at ascertaining the *effect* on consumers, but do not delve far into the murky waters of explaining consumer behavior:

> Under the assumption that linear demand curves shift parametrically, however, it is clear that penetration rate changes are perfectly correlated with consumer surplus changes. When price and quality rise (or fall) together, the net effect on consumers can be gleaned from whether penetration rises or falls. An increase in penetration indicates that consumers consider the price-quality package preferred in the instance where penetration is rising; the reverse is indicated when penetration declines.[38]
>
> The continuing price increases in the postderegulation environment then suggest that demand was shifting outward over time. The most straightforward explanation of that is that new channels were added to basic cable packages while more desirable programming was being telecast on existing channels. That can explain the annual price increases in excess of inflation beyond 1987 and 1988 and is consistent with the rapidly rising expenditures for programming inputs into cable service. Moreover, it is the only explanation consistent with the rising penetration rate.[39]

The book adequately explains the supply-side of the equation, but fails to fully examine the forces underpinning the demand. The analysis appears to support the view that cable subscribers were willing to pay higher rates as long as the product's quality increased. Hence, deregulation should have led to a well-balanced market and price-quality equilibrium, but it did not.

Indeed, no accounting is made of the consumer dissatisfaction with cable pricing following deregulation, which created tremendous political will to pass the Cable Television Consumer Protection and Competition Act of 1992. In fact, such legislation was the only veto by President Bush that was overridden by Congress.[40] The 1992 Cable Act was adopted in an election year, and politicians surely felt compelled to act, presumably from consumer concerns or complaints and not just by lobbyists for special in-

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37. HAZLETT & SPITZER, *supra* note 3, at 76.
38. *Id.* at 83.
39. *Id.* at 76.
40. *Id.* at 102.

terest groups such as the telephone industry, programmers, and broadcasters. The authors acknowledge this and note that Congress was "[s]purred by customer complaints concerning poor service, high prices, and monopoly arrogance."[41] Again, the authors do not fully explain why consumers perceived that escalating cable rates were not justified by the improved service quality their data allegedly supports.

In contrast, the inability of the 1992 Cable Act, as implemented by the FCC, to cause a decrease in rates with service improvements is amply shown.[42] The book even contains a footnote reference to a 1995 poll by a cable industry magazine that showed that 62 percent of U.S. citizens did not "think the 1992 Cable Act in fact accomplished what it was supposed to."[43] Curiously, Chapter Six, *The Economic Effects of Reregulation, 1993-1994*, concedes that "[t]he evidence suggests that the first of the two criteria necessary for successful, proconsumer price controls—price ceilings that bind on market prices—was met."[44] The book argues, however, that the FCC-imposed rate freeze and rate decreases totaling 17 percent went too far and caused a slowing of subscriber and programming growth.[45] The chapter also closely examines "whether controls were sufficient to lower effective, quality-adjusted prices, prompting sales to rise."[46] The authors conclude that they were not.[47] The authors imply this failure was caused at least in part by the ineffectiveness of the FCC to implement rate rules.[48] On the other hand, the book does not criticize the numerous examples it gives of cable companies' attempts to evade rate regulation by exploiting potential loopholes in the law and regulations.[49]

The authors argue that the FCC, with its high turnover and sudden bureaucratic growth, was not up to the task of "rein[ing] in the profit-maximizing behavior of 11,000 cable systems, each with its own managerial staff—all with far greater knowledge of the cable television industry than all but a handful of FCC employees."[50] In fact, the book goes on to cite many FCC rule reversals, policy inconsistencies, and even typographi-

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41. *Id.* at 59.
42. *See id.* at 194.
43. *Id.* at 102 n.l.
44. *Id.* at 110.
45. *Id.* at 114, 128, 132-33.
46. *Id.* at 110.
47. *Id.* at 194.
48. *Id.* at 175.
49. *Id.* at 144. The book also does not mention that Congress gave the FCC authority to prevent cable operator evasions of the 1992 Cable Act. *See* 47 U.S.C. § 543(h) (1994). In practice, however, the FCC has shied away from using this power.
50. HAZLETT & SPITZER, *supra* note 3, at 170.

cal errors by the FCC's Cable Services Bureau in its regulations and forms.[51]

The book ascribes much of the problems of rate regulation to what it calls a "regulatory dance" between the FCC and cable operators.[52] This entails at the same time both the collusive, self-serving behavior between the cable industry and the FCC as well as a chase of multiple foxes (cable operators) by the single hound (the FCC). The book points to the FCC's timing of the issuance of its "going-forward" rules, which generally loosened rate regulation, until after the 1994 congressional elections as evidence of political motivations and less than pure regulatory intentions.[53] This is described as the "'dirty little secret'" between the FCC and the cable industry: "to behave publicly as though rate regulation is working splendidly" in order to avoid a public outcry for additional regulation.[54]

The book determines that regulatory capture is present in the cable industry.[55] The authors clearly set forth the inherent tension at the FCC, which is not unique to that agency, of regulating an industry on one hand while trying to promote it on the other. This dichotomy probably exacerbated ineffective rate reregulation.

In addition, the book is replete with instances of cable operator efforts to, in some cases, mute the effects of rate regulation and in others to outright thwart it.[56] For example, the book identifies the following 1994 quote from an interview of John Malone, the chief executive officer of Tele-Communications, Inc. (TCI), the then-largest cable company:

> These noxious FCC rules are not going to be able to constrain the economics of entertainment for very long. What's gonna [sic] happen is there'll be a shift from [regulated] basic to [unregulated] á la carte services. . . .
>
> We'll continue to diversify away from the regulated government-attacked core. And meanwhile, we'll continue to slug it out in the trenches in the domestic cable business, recognizing that the government's got to kill a lot of smaller cable operators before they can really hurt us much.[57]

Although not quite a Winston Churchill call to arms, the authors use the preceding quote to exemplify what they call "conventional wisdom

51. *Id.* at 170-75.
52. *Id.* at 102.
53. *Id.* at 151.
54. *Id.* at 151 n.92.
55. *Id.* at 216.
56. *Id.* at 179.
57. *Id.* at 136-37.

within the cable television industry."[58] What is ironic is that two months before Mr. Malone made his statement, the cable television industry stock index began a steady rise including a 50 percent increase from April 20, 1994 through July 1995.[59] Further, the book does not mention that several large investors, such as Microsoft and Microsoft co-founder Paul Allen have recently invested billions of dollars in cable companies. The cable industry thus appears to have weathered the regulation storm fairly well.

The book offers no solutions to the regulatory conundrum it presents: If regulation was ineffective and consumers are not well served by regulation, then what is the alternative when consumers are not satisfied (contrary to the economic indicators) during deregulation? Although competition is seen as the regulator's panacea, the book does not give any indication as to how competition can be stimulated. Many hoped multichannel video competition was made more likely by the Telecommunications Act of 1996 (particularly by removal of the telephone company/cable television cross-ownership ban), but it has yet to produce what most observers believe are significant results.[60]

In sum, the book answers the question it poses of "what can regulators regulate?" by stating that "quality-adjusted cable rates are one item they cannot effectively regulate in the U.S. economy."[61] Moreover, the authors argue that the burden of proof should be shifted so that regulation must be defended as a feasible alternative in the absence of competition.[62] But to consumers, that is academic and misses the point. The real world question is: What is the best means to achieve the desired outcome of

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58. *Id.* at 137.

59. *Id.* at 150.

60. The FCC issued a news release on December 17, 1998, prior to releasing its Fifth Annual Report on competition in markets for the delivery of video programming. The news release indicates:

> The *Report* finds that competitive alternatives and consumer choices are still developing but that cable television continues to be the primary delivery technology for the distribution of multichannel video programming and continues to occupy a dominant position in the multichannel video programming delivery ("MVPD") marketplace. As of June 1998, 85% of all MVPD subscribers received video programming service from local franchised cable operators compared to 87% a year earlier. The cable industry has continued to grow in terms of subscriber penetration, channel capacity, the number of programming services available, revenues, audience ratings, and expenditures on programming.

Cable Services Action; Commission Adopts Fifth Annual Report on Competition in Video Markets (CS Docket No. 98-102), *News*, Rep. No. CS 98-18, 1998 FCC LEXIS 6366, at *1-*2 (Dec. 17, 1998).

61. HAZLETT & SPITZER, *supra* note 3, at 216.

62. *Id.* at 217.

lower (or constrained rates), better quality, and improved service? This book does not hazard a guess.