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Testimony of Thomas M. Koutsky
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I. Introduction

Thank you, Mr. Chairman, for the invitation to testify before you today.

My name is Tom Koutsky, I am a co-founder of and Resident Scholar for Phoenix Center for Advanced Legal & Economic Public Policy Studies. I am pleased to testify before you today on the role that video competition plays in broadband deployment and to discuss what legislatures can do to ensure that your constituents receive the benefits of a more-competitive environment for all communications services.

By means of introduction, the Phoenix Center is an international, non-profit 501(c)(3) organization that studies broad public-policy issues related to governance, social and economic conditions, with a particular emphasis on the law and economics of regulated industries. Among other activities, the Phoenix Center publishes a Public Policy Paper Series, a Policy Bulletin Series, and a Policy Perspectives Series. We also have sponsored Congressional briefings, Policy Roundtables at the National Press Club, educational retreats, as well as our Annual U.S. Telecoms Symposium. Our scholars have a long and distinguished history of examining entry into the cable and telecommunications industry.[1] Our research agenda has been consistently targeted at providing

[1] *See, e.g.,* G. S. Ford, THE CABLE TELEVISION INDUSTRY: AN ANNOTATED BIBLIOGRAPHY (Auburn Utilities Research Center, Summer 1994); G. S. Ford, *Competition in the Cable Television Industry: An Economic Analysis of Overlap Variations and Cable Prices* (Dissertation, Auburn University, 1994); J. W. Olson and L. J. Spiwak, *Can Short-Term Limits on Strategic Vertical Restraints Improve Long-Term Cable IndustryMarket Performance?* 13 CARDOZO ARTS & ENT. L.J. 283 (1995) (http://www.phoenix-enter.org/library/prog_access.doc); G. S. Ford, *Horizontal Concentration and Vertical Integration in the Cable Television Industry*, 12 REVIEW OF INDUSTRIAL ORGANIZATION (1997); G. S. Ford, *Preserving Free Television? Some Empirical Evidence on the Efficacy of Must Carry*, 13 JOURNAL OF MEDIA ECONOMICS (2000); G. S. Ford, *The Fallacy of Regulatory Symmetry: An Economic Analysis of the 'Level Playing Field' in Cable TV Franchising Statutes*, 3 BUSINESS AND POLITICS 21-46 (2001) (with T. Hazlett); G. S. Ford, *Price, Quality, and Consumer Welfare in the*

policymakers with information about the important role that pro-entry policies must play in the communications industry.

The Phoenix Center makes it a policy not to endorse or support any particular piece of federal or state legislation or proposed rule. As a result, unlike the other witnesses before you today, I am not here to speak in favor of or against the bill before you. Instead, I intend to review the empirical research that the Phoenix Center has done on the topic of video competition and cable franchising. All of our papers are available for free and posted on our website. As Senator Daniel Patrick Moynihan said, "Everyone is entitled to his own opinion, but not his own facts." My hope with this testimony is to provide you the salient facts and findings that might be useful in guiding your approach to this important issue.

There are three important points that I want to make today:

First, competition for cable services is *difficult and costly.* Simply because the Bell telephone companies now seem to be committed to entering the video market, success is by no means assured for even these large companies. Less than five percent of American households have a choice of two wireline providers of cable services—and that is not for want of firms trying. Over a decade ago, the FCC said that the "local franchise process is, perhaps, the most important policy-relevant barrier to competitive entry in local cable markets."[2] Build-out requirements unambiguously make this entry even *more difficult and costly* and have a deleterious impact on social welfare. Phoenix Center Public Policy Papers Nos. 21 and 22 explore these topics in detail.

Second, this current lack of competition is costing Florida consumers money each and every month. In 2005, the Government Accountability Office found that in communities with wireline cable competition, prices were 16.9 percent lower.[3] Importantly, the consumer welfare loss from these higher rates today persist; once a consumer spends more for cable in March 2006 than she should, that money is gone and cannot be "made up for" by subsequent entry. The Phoenix Center has released a study which quantifies this delay in competition: delaying video competition in Florida by one year will cost your constituents $626 million.

Cable Television Industry, 20 JOURNAL OF REGULATORY ECONOMICS (2001); G. S. Ford, *Fragmented Duopoly: A Conceptual and Empirical Investigation*, 78 JOURNAL OF BUSINESS (2005); G. S. Ford, T. M. Koutsky and L. J. Spiwak, *The Economics of Build-out Rules in Cable Television*, 28 HASTINGS COMMUNICATIONS AND ENTERTAINMENT (COMM/ENT) LAW JOURNAL (Forthcoming Winter 2006).

[2] In re Implementation of Section 19 of the Cable Television Consumer Protection and Competition Act of 1992, Annual Assessment of the Status of Competition in the Market for Delivery of Video Programming, 9 FCC Rcd 7442, Appendix H at ¶ 375 (1994) (hereinafter "Appendix H")(emphasis supplied); see also R. Posner, The Appropriate Scope of Regulation in the Cable Television Industry, 3 BELL JOURNAL OF ECONOMICS 98-129 (1972).

[3] United States Government Accountability Office, "Telecommunications: direct Broadcast Satellite Subscribership Has Grown Rapidly, But Varies Across Different Types of Markets,"GAO-05-257 (2005) at 30.

Third, and most importantly, is the link between cable competition and broadband deployment. President Bush has established a goal for the deployment of "universal, affordable access for broadband" by 2007.[4] The cable franchising provisions were written at a time when a cable network was simply that—a mechanism to deliver mostly local and some national video programming. The networks being built today are integrated, multi-service, broadband access networks that support the provision of voice, video and broadband data services. Our research shows that the ability to sell a video service over this integrated network has a significant and substantial impact on the business case for broadband deployment in the first instance. This impact is felt particularly in low-income or high-cost areas. Any public policy that makes it more difficult or costly for a new entrant to sell video services over a broadband network is, in my view, *contributing to* and possibly *perpetuating* a "Digital Divide" that may exist in our neighborhoods and towns. Phoenix Center Public Policy Paper No. 23 addresses this point in detail.

II. Historical Background

State and local franchising dates back from the earliest days of the cable television industry. The principal purpose of this process was for local governments to control access to public rights-of-way that a cable company may need to build its network.

In many communities, the franchising process turned into an "auction" for locally-awarded cable television monopolies. And in these auctions, any request was fair game: "build-out" to entire communities, construction of governmental networks, provision of capacity or production services for public access channels, equipment for video studios as the local high school, parks, and the collection of a "franchise fee," which is a type of sales or revenue tax for cable services. Cable companies were willing to make these concessions in order to receive a lucrative monopoly on cable services. Most of the country's cable systems were built in this environment, before the federal government intervened in 1984 and later 1992 to remedy many of these abuses.

With *de facto* monopolies in hand, the cable industry made entry by new providers more difficult by lobbying for "level playing field" laws. Florida's law, interestingly, specifically allows LFAs to impose more burdensome obligations on new entrants than incumbents, in an essentially unchecked and standardless manner.[5] Moreover, these "level playing field laws" invite the incumbent cable operator to sue the municipality if the municipality tries to act to promote competitive video entry in its territories. A law firm representing over 50 municipalities in Florida (Liebowitz & Associates, P.A.) recently told the FCC that

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[4] President's Remarks in Albuquerque, New Mexico, 40 Weekly Comp. Pres. Doc. 13, at 484 (Mar. 28, 2004).

[5] Fla. Stat. § 166.046(5) ("Nothing in this section shall be construed to prevent any . . . city considering the approval of an additional cable service Franchise in all or any part of the area of such . . . city from imposing additional terms and conditions upon the granting of such Franchise as such . . . city shall in its sole discretion deem necessary or appropriate.").

> One of the major impediments to the grant of competitive franchises [in Florida] is the threat of being sued by the incumbent or the subsequent Grantee under the Level Playing Field Statute.[6]

When the cable industry today talks about wanting new entrants to build competing systems on a "level playing field," this is the playing field we are talking about—a playing field in which municipalities have to watch their step for fear of being sued by cable companies merely for wanting to foster a pro-competitive and pro-broadband environment in their communities. Moreover, one cannot expect to ask a new entrant to make the same concessions and commitments that an incumbent cable firm would make when the incumbent firm had the expectation of a monopoly or dominant market position. Indeed, Phoenix Center research shows that *entry into these markets will be exceptionally difficult* and that imposing a "level playing field" rule on new entrants will result in *less competition* and other perverse outcomes.

III. The Impact of Franchise Requirements on the Entry Decision and the Cost of Delay

As explained in PHOENIX CENTER POLICY PAPER NO. 21,[7] policymakers need to recognize at the outset that competition between integrated voice, video and broadband networks is costly, expensive and risky. Phoenix Center and other academic research shows that because it is costly to build and operate communications networks, even in a "best case scenario," only a few firms will be able to provide the complete package of voice, video and data services over their own network.

Policymakers as a result need to begin with the assumption that there will, at best, be only a "few" facilities-based firms. With that realistic assumption, the policies you adopt will hopefully maximize the potential for competition between the few firms that the market can actually support. The number of firms that a market can sustain is directly related to the size of potential addressable market and the cost of entering that market.

This simple and perhaps obvious observation leads to some interesting implications. Most notably, it should tell you that if you want more "facilities-based" entry, you need to do what you can to either *increase* the size of the addressable market and to *lower* the cost of entering that market. In both instances, cable franchising rules do the exact opposite, as Phoenix Center Policy Papers No. 21 and 22 describe.

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6 Comments of Leibowitz & Associates, P.A., In the Matter of Implementation of Section 621(a)(1) of the Cable communications Policy Act of 1984 as amended by the Cable Television Consumer Protection and Competition Act of 1992, FCC MB Docket No. 05-311 (Feb. 13, 2006) at 5.

7 G. S. Ford, T. M. Koutsky and L. J. Spiwak, *Competition after Unbundling: Entry, Industry Structure and Convergence,* PHOENIX CENTER POLICY PAPER NO. 21 (July 2005), available at http://www.phoenix-center.org/pcpp/PCPP21Final.pdf.

The Phoenix Center has also analyzed the cost of policy decision that has the effect of delaying video competition. In Phoenix Center Policy Bulletin No. 13, "*In Delay there is No Plenty:" The Consumer Welfare Cost of Franchise Reform Delay,* we estimated that delaying video entry by one year would cost Americans $8.2 billion in consumer welfare and that these losses increase with each year of delay, to nearly $30 billion for four years.[8] We recently released an Addendum to this paper which breaks these numbers out on a state-by-state basis. For Florida, one year of video entry delay costs consumers $626 million, and four years costs Florida consumers over $2.2 billion.

There is no question that the local franchising process contributes to this delay. It should come as no surprise that the only competitors that have made any significant inroads into the multichannel video programming market are Direct Broadcast Staellite firms, which are specifically exempt from the local franchising process. Nevertheless, the FCC and the GAO have repeatedly found that DBS competition does not provide consumers with lower prices to the same degree that direct wireline video competition presents.[9]

Moreover, with regard to voice and broadband services, there is no functional legal requirement equivalent to the local cable franchising process. In fact, for voice and broadband service, there are no "build-out" requirements. In 1997 the FCC explicitly preempted all such requirements for voice services.[10] The cable industry has successfully launched a bevy of legal challenges to efforts by states to place limitations or requirements on its cable modem service. That litigation campaign reached ultimate success in the Supreme Court earlier this year, in the *Brand X* decision,[11] which affirmed the cable industry's position that their cable modem services were not subject to control by local franchising authorities.

As a result of these legal victories, the cable industry faces no significant legal or technological barrier to offering a bundle of voice, video and broadband services. Incumbent cable operators can offer this package of services to any customer or customer class they like, without any obligation to "serve the entire community." In contrast, incumbent local telephone companies still have "carrier of last resort" obligations for voice services and also must obtain a local cable franchise (oftentimes with an explicit build-out requirement) to offer cable video services.

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8 G. S. Ford and T. M. Koutsky, "*In Delay There is No Plenty:" The Consumer Welfare Cost Franchise Reform Delay,* PHOENIX CENTER POLICY BULLETIN PAPER NO. 13 (January 2006), available at http://www.phoenix-center.org/PolicyBulletin/PCPB13Final.pdf.

9 *See, e.g., supra* note 3 (2005 GAO Study); G. S. Ford and T. M. Koutsky, *Franchise Fee Revenues After Video Competition: The "Competition Dividend" for Local Governments,* Phoenix Center Policy Bulletin No. 12 (November 2005), available at http://www.phoenix-center.org/PolicyBulletin/PCPB12Final.pdf, at nn. 16, 27.

10 *See In the Matter of The Public Utility Commission of Texas*, CC Policy Docket Nos. 96-13, 96-14, 96-16 and 96-19, Memorandum Opinion and Order, FCC No. 97-346 (rel. Oct. 1, 1997).

11 *National Cable & Telecommunications Assn. v. Brand X Internet Services,* No. 04-277, 545 U.S. ___ (2005).

Our research shows increasing the costs of entry for a firm has an unambiguous and dramatic effect on the network deployment decision by a firm. This entry deterrence has an important deleterious impact on consumers.

IV. Build-Out Requirements Impede New Video Entry

Phoenix Center Policy Paper No. 22 looks in detail at one particularly important component of the local franchising process—the requirement that a new entrant "build-out" to serve essentially all of the local franchise area.[12] We show that a "build-out" mandate has an important impact on the firm's decision and results in *far less network construction* than not having such an entry.

There is no doubt in my mind that cities and towns have the best interest of their constituents at heart when they review franchise applications. And there is no doubt that having a new entrant deploy a new alternative network over the entire State of Florida would be a boon for Florida consumers. But our research shows that *ex ante* build-out requirements implemented on a municipality-by-municipality basis are, in our view, a poor way of achieving this goal and, in fact, are substantially counterproductive. This is because the cost characteristics and demographics of each LFA are different and build-out requirements implemented on an LFA-by-LFA basis pit Florida communities against one another. A "build-out" policy forces a firm bypass certain communities entirely, even if it might have been profitable to serve a portion or much of that community. The result of a "build-out" policy is to "solve" the problem of a company "redlining" *within a community* by encouraging that company to "redline" *between communities*.

Build-out mandates for new entrants not only drive up the costs of entry, but they actually *reduce* consumer welfare and increase the profits of incumbent providers in many communities. For these reasons, as noted above, in 1997 the FCC preempted state "build-out" requirements for firms offering competitive local telephone service, like the cable firms.[13]

For a policymaker, a build-out requirement is a risky gamble. You are betting that if you impose a build-out requirement, a firm like the telephone company will still decide to build a network in your community. And our simulation shows that that entry will certainly happen in some communities. But our simulation shows that it such entry will not happen in all communities. There is a very real possibility that a new entrant will bypass the community altogether—a worst-case scenario for consumers in the affected areas.

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[12] G. S. Ford, T. M. Koutsky and L. J. Spiwak, *The Consumer Welfare Cost of Cable "Build-out" Rules,* PHOENIX CENTER PUBLIC POLICY PAPER NO. 22 (July 2005), available at http://www.phoenix-center.org/pcpp/PCPP22Final.pdf.

[13] *Supra* n. 10.

You also should think about the motivations of incumbent cable firms that insist that new entrants "build-out" to an entire community with a 100% overlap of its existing cable network. The "worst-case" scenario for consumers is that no entry occurs; the "worst-case" scenario for the incumbent cable providers is that 100% overlap entry *does occur*. Why would an incumbent firm, with a dominant market share, want to see that—unless it knew that to insist on a 100% "build-out" would *deter much more competition than it would invite*? To ask that question is to answer it.

V. The Franchise Process Exacerbates a "Digital Divide"

Rules that make video competition more difficult will also have a significant and adverse impact on the availability of broadband services in low-income areas. Phoenix Center Policy Paper No. 23 examines this relationship in detail.[14]

President George W. Bush has established a goal of "universal, affordable access for broadband technology by the year 2007,"[15] and influential policymakers, both Republican and Democrat, almost universally share the aspiration that no community or group of citizens should be without robust broadband network alternatives.[16] Low-income households subscribe to video service at roughly the same rate as higher income households.[17] As a result, the ability of entrants to offer video services substantially improves the financial case for fiber deployment in low-income neighborhoods. Using publicly-available data from the U.S. Census Bureau, we employed a simple graphical analysis and a simulation of network deployment to show that a new entrant will pass substantially more households—and in particular low-income households—if that entrant can readily offer video with voice and broadband Internet access services than it will if its ability to sell video services is sharply curtailed or delayed.

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[14] G. S. Ford, T. M. Koutsky and L. J. Spiwak, *The Impact of Video Service Regulation on the Construction of Broadband Networks to Low-Income Households*, PHOENIX CENTER PUBLIC POLICY PAPER NO. 23 (September 2005), available at http://www.phoenix-center.org/pcpp/PCPP23Final.pdf.

[15] The White House, *A New Generation of American Innovation* (April 2004), available at http://www.whitehouse.gov/infocus/technology/economic_policy200404/innovation.pdf, at 11. Current FCC Chairman Kevin J. Martin has made achieving this goal one of his "core priorities." Statement of Chairman Kevin J. Martin, *In the Matter of Petition of SBC Communications Inc. for Forbearance from the Application of Title II Common Carrier Regulation to IP Platform Services*, WC Docket No. 04-29 (May 5, 2005).

[16] Concern over a "digital divide" appears to be bipartisan. A recent report by the Congressional Research Service lists more than a dozen legislative proposals, introduced by Republicans and Democrats alike, that share the goal of promoting more broadband deployment, particularly in disadvantaged areas. CONGRESSIONAL RESEARCH SERVICE, *Broadband Internet Access: Background and Issues*, IB10049 (June 9, 2005). For two different viewpoints on the "digital divide," *see* United States Department of Commerce, National Telecommunications and Information Administration, FALLING THROUGH THE NET: DEFINING THE DIGITAL DIVIDE (1999) (describing problems of a rich-poor "digital divide") and United States Department of Commerce, National Telecommunications and Information Administration, A NATION ONLINE: ENTERING THE BROADBAND AGE (2004) (expressing concern over potential rural-urban divide for broadband services).

[17] *See* R. Kieschnick and B. D. McCullough, *Why Do People Not Subscribe to Cable Television: A Review of the Evidence*, Presented at the Telecommunications Policy Research Conference (1998), available at http://www.tprc.org/abstracts98/kieschnick.pdf (summarizing research).

Video service is somewhat of a "silver bullet"—*i.e.,* when the network firm can bundle video, the percentage of poverty and minority homes with access to the network rises significantly. Accordingly, our analysis indicates that policies that make video competition more difficult will lead to significantly lower deployment of advanced broadband networks in low-income areas than would occur with pro-entry video policies. In so doing, our findings provide empirical support for the assertion by FCC Chairman Kevin J. Martin that additional multichannel video competition also would "stimulate broadband deployment."[18]

VI. Summary and Conclusion

The issues raised by franchise reform are complex and must be viewed carefully and comprehensively. It is particularly important to move beyond rhetorical argument and develop a common baseline of understanding that is based on solid empirical research and study. That is the goal of the Phoenix Center: to provide you, the policymaker, with the tools to make your own judgments.

With regard to cable franchising, there is no question, as an empirical matter, that the process—

- Raises the cost of entry, which results in less-extensive new network deployment;
- Delays entry, which results in higher prices for cable services and dramatic losses of consumer welfare, because those losses are irretrievable; and
- Can contribute to a "Digital Divide" by destroying the business case for deploying an integrated broadband network into low-income and minority areas.

Thank you for inviting me to appear today, and I look forward to answering your questions.

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18 L. Cauley, *FCC Chief Considers Forcing Cable TV Competition*, USA TODAY (22 August 2005).