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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 the 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 you 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 is consistently targeted at providing policymakers

[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*

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. Our mission is not to tell you *what* to think about an issue but *how to think* about it. To the extent you detect any preference in our work, our preference is and has always been on promoting entry: seeking to promote competition in the telecommunications industry necessarily requires that new firms be able to enter the market.

In my testimony today, I will review the research on video competition and franchising that the Phoenix Center has recently conducted. While you certainly will hear debate today and in the coming months from the industry, I suggest that you keep our findings in mind. As Senator Daniel Patrick Moynihan said, "Everyone is entitled to his own opinion, but not his own facts."

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

First, competition for cable services is *difficult and costly.* In fact, if you take away only one fact from my testimony, let this observation be it. Wireline video competition is hard—numerous companies have tried and most have failed. 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. Because the business case for wireline video entry is difficult, the choices you make with regard to entry regulation (such as franchising) have a significant impact on whether firms will even bother to try and enter the market. As a result, 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 and franchising requirements unambiguously make this entry even *more difficult and costly* and therefore 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 Pennsylvania consumers money each and every month. In 2005, the Government Accountability Office found that in

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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).

communities with wireline cable competition, prices were 16.9 percent lower.[3] The consumer welfare loss from these higher rates persist; once a family spends more for cable in April 2006 than it 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 Pennsylvania by one year will cost your constituents $329 million, and a four-year delay will cost Pennsylvanians $1.206 billion.

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 and it is striking. In Pennsylvania, our research shows that if an entrant is limited it its ability to sell video services over a new, integrated fiber optic network, it may only expand to 3-4% of the poverty and minority households. But if it is able to sell cable services over that network, the business case improves *dramatically* and it would build out to 91-92% percent of the poverty and minority households.

As a result, *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 using data from Texas. Attached to this testimony is a similar calculation for Pennsylvania.

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. 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

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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.

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

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 Congress intervened in 1984 and later 1992 to remedy many of these abuses.

Many local governments originally tried to promote competition in their cities, but the incumbent cable industry refused to cooperate. Philadelphia established four cable franchise areas within its borders in 1984 with the intent of encouraging cable companies to offer better service in competition with one another. Yet Philadelphia has insisted that new entrants satisfy build-out requirements, and the only company that has pursued entry in the city abandoned its plans after the city insisted on a five-year build out schedule.[5]

It is important to understand that the situation of a cable company bidding for what is effectively a *monopoly* will make certain commitments and concessions to a local community that are far greater than what a new entrant, entering a market with large fixed and sunk costs and no guaranteed market share, faces. When you hear the cable industry today talk 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 where incumbents made commitments that represent, in essence, the sharing of a monopoly profit with local franchising authorities. To expect a new entrant to make those same concessions will unequivocably result in less competition and entry—if you have entry at all.

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

As explained in PHOENIX CENTER POLICY PAPER NO. 21,[6] 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.

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5 Comments of the City of Philadelphia, FCC MB Docket No. 05-311 (Feb. 13, 2006) at 2.

6 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.

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. Franchising limits the ability of a firm to sell video services over a network and increases the costs of doing so.

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.[7] We recently released an Addendum to this paper which breaks these numbers out on a state-by-state basis. For Pennsylvania, one year of video entry delay costs consumers $329 million, and four years costs consumers over $1.2 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 Satellite 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.[8]

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.[9] 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 last year, in the *Brand X* decision,[10] which affirmed the cable industry's position that their cable modem services were not subject to control by local franchising authorities.

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7 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.

8 *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.

9 *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).

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

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.

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.[11] 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 Commonwealth of Pennsylvania would be a boon for Pennsylvania 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 Pennsylvania 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 effectively 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.[12]

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[11] 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.

[12] *Supra* n. 9.

It is important to understand what a build-out requirements mandates. A build-out rule means that a company cannot, for example, operate a cable system directed only at retirement communities. The programming on a retirement community video system plan would likely be very different than much fare available on cable today, and that business is now technologically possible with the development of IPTV. But requiring that this type of service provider obtain a franchise that includes commitments to build-out to all homes and businesses in a franchise area (and not just retirement homes) and meet the same standards would render this business plan impossible. The franchising system essentially forces all entrants to enter with "cookie-cutter" networks and services. As a result, build-out rules not only help keep cable rates high, they also deny consumers the promise of programming diversity. The new entrants most hurt by build-out requirements are the entrepreneurial firms that you have not heard off, because their entry plans are effectively made illegal.

A build-out rule is a limit on Liberty. The government says that a firm cannot offer a service *anywhere* unless it offers it on the same scale, scope and conditions that firms already in the market offer service. We would scoff at a law that bans the opening of small, independent bookstores in a town that already has a Barnes & Noble. Would we take seriously a claim by Barnes & Noble that a small bookstore would "cherry pick" lucrative French literature sales? Is it a bad idea to ban the sale of power tools and sheetrock by a store that is not as large as Home Depot or does not sell kitchen cabinets as well? The arguments made in support of build-out rules stand as an antithesis to the very concept of limited government.

As a matter of policy, a build-out requirement is a risky gamble. If you support such a rule, you are gambling that even with a build-out requirement, a firm like the telephone company will still decide to build a network in your community. The Phoenix Center analysis certainly shows that entry will certainly happen under these conditions in some communities. But our simulation shows that it such entry will not happen in all communities and that the overall extent of network construction will be lower. A build-out rule creates the very real possibility that a new entrant will bypass the community altogether—a worst-case scenario for consumers in the affected areas.

Moreover, you 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 provider is entry throughout its service area *does occur*. Faced with ubiquitous wireline competition, the incumbent's profits would drop dramatically. Why would an incumbent firm invite that type of competition—unless it knew that a 100% "build-out" requirement would *deter much more competition than it would invite*?

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.[13]

President George W. Bush has established a goal of "universal, affordable access for broadband technology by the year 2007,"[14] 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.[15]

The networks being built today support a number of different services—typically voice, video and broadband services. The business case for building these integrated, fiber-rich networks depends on being able to sell all three of those services. As a result, a barrier to the provision of one service (video) therefore acts as a barrier to the provision of another service (broadband). If you believe that "universal, affordable access for broadband" is an important goal, you need to be concerned about barriers to video and voice competition.

Phoenix Center Policy Paper No. 23 examines the extent of the interrelationship between broadband and video services, with a particular focus on low-income and poverty households. 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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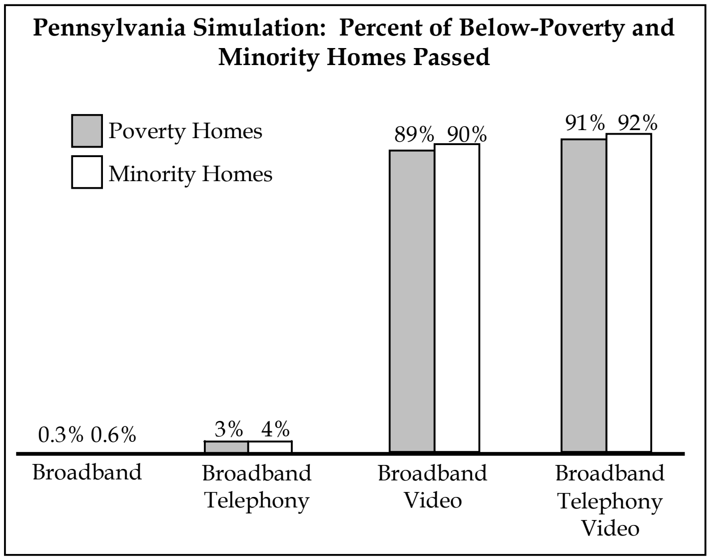
[13] G. S. Ford, T. M. Koutsky and L. J. Spiwak, *The Impact of Video Service Regulation on the Construction of Broadband Networks to Low-Income Households,* PHOENIX CENTER PUBLIC POLICY PAPER NO. 23 (September 2005), available at http://www.phoenix-center.org/pcpp/PCPP23Final.pdf.

[14] 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).

[15] 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).

Our findings are striking. For my testimony today, we have prepared an analysis of the importance video services is to the business case for broadband deployment to minority and poverty households in Pennsylvania, the details of which are attached.



This chart shows that in Pennsylvania (as in the other states we have reviewed), video service is a "silver bullet." When the network company can bundle video, the percentage of poverty and minority homes with access to the network rises significantly. If policy limits the ability of a company to sell video services over an advanced fiber network, that policy does nothing to bridge a "Digital Divide" and in fact might perpetuate one.

The reason for this effect is because low-income households subscribe to video service at roughly the same rate as higher income households.[16] The ability of entrants to offer video services substantially improves the financial case for deployment of these new, integrated fiber networks in low-income neighborhoods. This finding also greatly undermines the policy argument for "anti-redlining" rules. "Redlining" of video service will not happen for video services because low-income households consume video services to the same extent as middle and high-income households.

This stands in marked contrast to broadband services, where consumption, at least currently, does track household income. In 2003 the U.S. Census Bureau surveyed the communications consumption patterns of American households. The following chart

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16 *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).

shows the subscription rates for telephone and Internet access services, both dial-up and broadband. This table shows that households with incomes over $150,000 per year purchased broadband Internet access at a rate of five to ten times the rate of households with incomes of less than $25,000 per year.

Census 2003, Subscription Rates

Income	Telephone	Internet	Dial-up	Cable/DSL
5000 To 7499	94.2	20.3	14.0	5.9
7500 To 9999	96.5	19.6	14.2	5.0
10000 To 12499	97.1	22.8	16.5	6.2
12500 To 14999	97.2	24.6	18.2	5.8
15000 To 19999	96.8	29.5	21.5	7.8
20000 To 24999	97.8	36.9	26.7	9.9
25000 To 29999	98.3	42.6	29.6	12.0
30000 To 34999	98.4	49.0	35.1	13.2
35000 To 39999	98.7	57.7	41.9	15.0
40000 To 49999	99.2	66.3	45.2	20.2
50000 To 59999	99.2	71.9	47.0	24.0
60000 To 74999	99.4	79.9	49.8	29.1
75000 To 99999	99.3	84.2	48.0	35.2
100000 To 149999	99.7	90.4	42.3	46.4
150000 and Over	99.7	92.4	36.4	54.2

Phoenix Center Policy Paper No. 23

Our analysis in Policy Paper No. 23 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. Make no mistake—if public policy makes it more difficult or costly to sell video services over an integrated voice, video and broadband network, that policy is *creating an incentive* for the entrant to enter only high-income and middle-income areas. The key component of the business case for deploying new broadband networks in low-income areas is video service. Stated simply, if you are worried about a "Digital Divide," you should trip over yourself to find ways to make video competition as easy as possible. And you certainly would not want to adopt a policy framework that makes video entry *more difficult and costly* than voice and broadband entry. Yet that is the policy framework that exists in Pennsylvania today: there are virtually no legal barriers to voice and broadband entry but the franchising process stands as a pervasive and expensive video entry barrier.

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.