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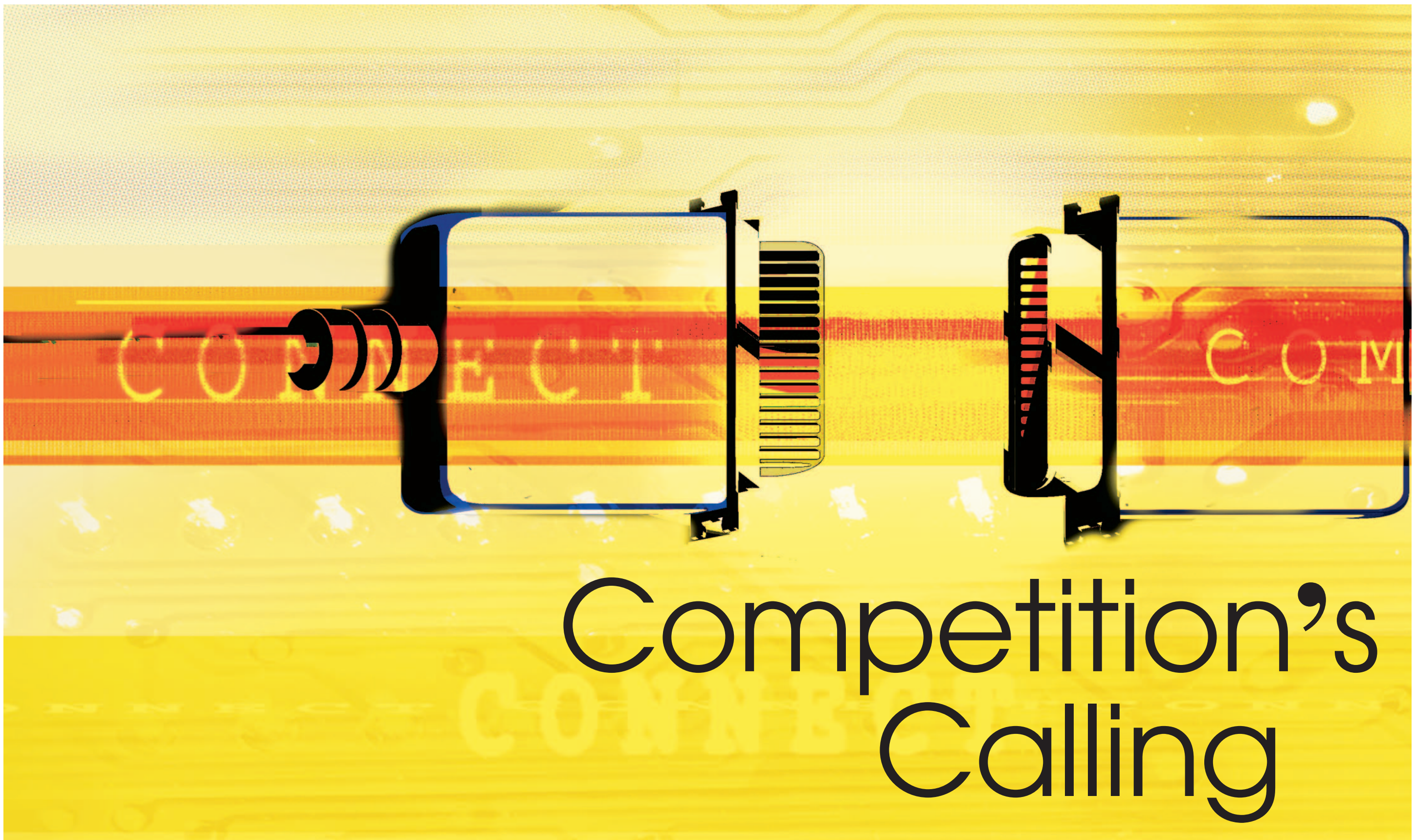

Competition's Calling

BY LAWRENCE J. SPIWAK

Last week's announcement of the megamerger between AT&T and BellSouth set off new worries about competition in the evolving telecommunications market. But the truth is that the most important competition for residential consumers is not going to come from one Bell company invading another's territory. The real wireline competition is going to come from head-to-head struggles between phone companies and cable companies for the triple play of offering voice, video, and broadband data services.

Twelve years ago the Federal Communications Commission described local franchising as "perhaps the most important policy-relevant barrier to competitive entry in local cable markets." Unfortunately, the local franchise process is still standing in the way.

A FAUSTIAN DEAL

In principle, the franchise process is supposed to allow governments to manage rights of way and prevent public utilities from digging up the streets (and disrupting rush-hour traffic) at will. In the case of the cable industry, however, the franchise process has been a Faustian deal between the local cable operator and the municipality. In exchange for an exclusive monopoly and no price regulation, incumbent cable operators agreed to build wires to provide service to every corner of the franchise territory. They also had to cover local school board and city council hearings on public-access channels. In short, every voter in town got access to cable, the local politicians got themselves on TV, and the cable companies earned high profits.

To seal the deal, the cable companies persuaded many state legislatures to pass so-called level-playing-field laws. These require entrants to acquiesce to the same aggressive build-out requirements as the incumbent cable operators, without the concurring benefit of a state-sanctioned monopoly to recover their costs. Build-out requirements clearly make entry more costly, and thus much-needed new video competition becomes less likely. For more than 95 percent of Americans, the franchising process and level-playing-field laws have cut off any choice in wireline video service.

As is to be expected when you let a monopolist go unchecked, cable rates started to skyrocket after these state laws were passed. Congress responded with the Cable Competition and Consumer Protection Act of 1992. But rather than promote entry by overhauling the franchise process, the 1992 act simply prohibited exclusive franchises. Thus, although the measure took away the cable companies' de jure monopoly, it did nothing about the inherent barriers embedded within the local franchise process—that is, the interminable (and lawfully infinite) delay of the process coupled with the imposition of onerous build-out requirements, which so hampered competition that virtually no video competition emerged.

Now flash-forward to the present day. The cable companies continue to enjoy their de facto monopoly for video, and the top five cable companies provide broadband service to more people than the current four Bell companies combined.

Most would be content with this lucrative business. But cable companies can also provide managed VoIP (voice over Internet protocol) services over their existing networks, at minimal cost and without burdensome build-out requirements (something the FCC did away with more than eight years ago for providers of competitive phone service). Now they are aggressively invading the Bells' core business with the residential triple play.

This new telephony competition is a good thing for consumers because it will keep telephone rates in check. The Bells, however, find themselves in the unaccustomed position of not only having to significantly upgrade their local networks to compete for their core phone business, but also having to make these significant capital commitments before their traditional revenues are sapped. The problem for the Bells is basic economics: Significant network investment can't be paid for with a $30-a-month voice service sold to price-conscious residential customers. The one-time long-distance giants AT&T and MCI never managed to do it, and neither will anybody else. Additional revenue streams from the sale of data and, more specifically, video services are required.

The big rub is that the minute the Bells upgrade their networks to provide video, they are automatically forced to apply for a local cable franchise—even though they already have a franchise to use the exact same rights of way for telephone and data.

Consider Verizon's protracted experience in obtaining a franchise in Fairfax County, Va., last summer. While Virginia's level-playing-field law prohibited Fairfax County from granting Verizon a franchise that is "more favorable or less burdensome" than an incumbent cable operator's franchise, Fairfax County (cleverly) noted that the law did not prohibit it from granting a franchise "on terms that are more onerous." The county had no reservations in imposing terms and conditions that were, in fact, "more onerous than those in the franchise agreements the Board awarded to either or both of the incumbent cable operators."

Although Verizon ended up taking the deal (much to the benefit of consumers in Fairfax County), this is but one example of the shakedowns that companies face when they try to enter the video-service market.

NO PARADE OF HORRIBLES

Notwithstanding the obvious benefits to consumers of allowing more competition in video services, proponents of the existing local franchise process have set forth a litany of woes to slow down any federal legislative reform.

One popular argument is that cable franchise reform will cost local governments at least $300 million in revenue per year. But this is simply not true because the end of the local franchise process need not mean the elimination of franchise fees.

To the contrary, the introduction of competition for video services promises to increase gross industry revenues significantly and, therefore, could substantially increase local franchise fee collections. Indeed, recent research reveals that if phone company entry into TV services is successful, then gross taxable revenues from the multichannel video industry will increase by an estimated 30 percent.

The other popular argument is that franchising reform will somehow lead to economic redlining by new entrants, who will bypass poor and minority neighborhoods in deploying broadband. Empirical research also does not support this claim.

Ironically, research at the macro level reveals that build-out requirements create a new form of intercommunity redlining. Companies will, if possible, seek to bypass those communities with onerous entry restrictions for those that embrace pro-entry policies. As such, build-out provisions are self-defeating and deter competition for rich and poor communities alike.

More significant, recent research at the micro level reveals that policies, such as local franchise requirements, that hinder new entrants' ability to sell video service will strongly diminish the entrants' incentive to deploy fiber to low-income households.

This might sound counterintuitive. But because low-income households subscribe to TV service at roughly the same rate as higher-income households, the ability to offer such service substantially improves the business case for investing in advanced broadband networks for low-income neighborhoods. Given that President George W. Bush's stated policy goal is the deployment of advanced broadband networks to all Americans by 2007, then video service takes on the role of a "killer app." That is, when new entrants can bundle video with other services, the percentage of poor homes with access to the network will rise significantly.

PLEASE DON'T UPGRADE?

The local cable franchise process is also inhibiting technological development, particularly as companies start to deliver video over the Internet.

That is to say, (1) if the phone companies already have a franchise that freely allows them to upgrade their existing networks to provide voice and broadband data services over public rights of way, and (2) they want to leverage their existing assets by providing video over that broadband capacity (much as the cable companies can now provide VoIP services over their networks with minimal regulation), then (3) forcing new entrants to seek government approval a second time if their upgraded networks will be used to provide video service only discourages such upgrades.

But there's more. As bandwidth expands, application providers such as Akimbo, Google, Microsoft, and Yahoo! are starting to provide interactive video products over the Internet. If we take the cable industry's argument for "symmetrical regulation" to its logical conclusion, then not only would phone companies have to seek local franchises where consumers can access third-party video over their current connections, but so would Akimbo, Google, Microsoft, and Yahoo!.

THE COSTS OF DELAY

Finally, yet perhaps most important, as cable prices continue to skyrocket, head-to-head wireline competition for the incumbent cable operators is badly needed.

As even municipal advocates of the existing franchise system concede, satellite TV, despite its noble efforts to penetrate the market, has had little effect on cable pricing behavior. In stark contrast—as demonstrated by a 2005 Government Accountability Office study—terrestrial cable overbuilding by just one company produces demonstrable price savings for consumers.

If this is not proof enough, look at the recent experience in Keller, Texas. Soon after the Texas Legislature radically overhauled local franchise requirements to facilitate competition and create choices for consumers, Verizon started to offer a competitive video service in Keller. Twenty-four hours later, the local cable company dropped its prices by almost 50 percent. And one recent survey shows that more than one in five households in Keller has switched from the incumbent cable company to the phone company in just six months. Clearly, consumers have an appetite for choice.

Consumers outside Keller cannot wait any longer, either. Recent empirical research demonstrates that consumers stand to lose $8.2 billion if policy-makers delay by just one year the removal of barriers to entry in the video-service market. Total losses increase for each year of delay and would climb to a total of almost $30 billion if market entry was delayed for four years.

In the 1990s we received a clear lesson that entry into local telecom markets is extremely expensive, with no guarantee of success for new entrants that try to deploy their own fiber. Today, telecom companies that hope to survive need a reasonable business incentive to invest in competitive broadband networks, and that incentive is the chance to offer video service. If policymakers fail to remove barriers to video entry, then we may have no new competitors at all.

Lawrence J. Spiwak is president of the D.C.-based Phoenix Center for Advanced Legal & Economic Public Policy Studies (www.phoenix-center.org).