University of California, Davis
Department of Agricultural Economics

"NATURAL MONOPOLY" AS A JUSTIFICATION FOR LEGAL MONOPOLY IN CATV

By

Thomas W. Hazlett

The author is assistant professor of agricultural economics at the University of California, Davis. This article is based upon research he conducted in writing his doctoral thesis in economics at UCLA (1984) and in his current work as an expert witness in cable franchise litigation.

The questions, both legal and economic, surrounding the rights of local government to issue exclusive licenses for the supply of cable television have long since been decided to the satisfaction of most local government officials. Hence, only a relative handful of U.S. municipalities do not franchise cable television on a de facto exclusive basis.[1] While this is often taken as evidence of the purely economic realities extant in the supply of cable television, any such inferences involve careful further argument. The one conclusion that can be inferred from the statistic is this: monopoly franchising is a very politically efficient arrangement for the regulation of cable television.

It is plausible, of course, that the political forces which combine to regulate cable are motivated, in turn, by concerns of economic efficiency (i.e., the maximization of consumer welfare). Yet, this case must be established, not presumed, and the case stated convincingly, to overcome our innate suspicion of state-sponsored private monopoly. On grounds of antitrust, free speech, and economic liberalism, we rightly exercise a general bias towards free competition except in instances of a clearly articulated and compelling rationale for governmental interference.[2] Curiously, no such

---

[1]While at least 4,826 cable systems were operating in the United States as of December 31, 1982 (see Kagan 1982), only 93 communities had been identified as issuers of multiple, over-lapping franchise awards (Pearce, Peterson, Fredrickson 1982). Additionally, many jurisdictions do not issue any franchises (that is, they maintain an open-entry policy). Twelve cable systems built in these markets are listed in Hazlett 1986, and 32 were found in a survey of Pennsylvania cable systems (Allen and Kennedy 1982 at 3-11), but no comprehensive tabulation of such jurisdictions has yet been undertaken. Still, we believe it safe to conclude that at least 8 of 10 cable systems operate under conditions of franchise monopoly.

[2]Judge Robert Bork states the presumption thusly: "[W]hen no affirmative case for intervention is shown, the general preference for freedom should bar legal coercion." (Bork 1978 at 133).

compelling economic model has been analytically established to carefully document the salubrious proconsumer consequences of local franchising. That a defense of such legal monopoly could be casually constructed is a dangerous state of affairs for public policy. And particularly so when this very economic discussion has become a key ingredient in critical ongoing litigation which will determine the rights of local officials to continue to create entry barriers (i.e., monopoly licenses) in cable TV.[3]

Several years ago in another journal, Rolland C. Johnson and Robert T. Blau (1974) constructed a defense of the issuance by municipalities of exclusive (i.e., nonoverlapping) cable television awards which neatly summarizes the line of argument that partisans of municipal monopoly (most notably the National League of Cities [NLC]) have employed in government hearings, policy statements and court challenges.[4] Curiously, the popular argument outlined therein has never been subjected to analytical scrutiny in the economics or legal literature. Hence, the first section of this article shall consist of a point-by-point critique of the major assertions of Johnson

---

[3]See, e.g., Community Communications v. City of Boulder (485 F. Supp. 1035 [D. Colo. 1980]), establishing that local governments could be sued, on antitrust grounds, for illegally creating cable television monopolies, Berkshire Cablevision of Rhode Island v. Burke (571 F. Supp. 976 [1983]), ruling that state government regulation of cable television was not a violation of the cable operator's constitutional rights, and Preferred Communications, Inc. v. City of Los Angeles (754 F. 2d 1396 [9th Cir. 1985]) where a federal appeals court overturned a monopoly franchise on First Amendment (freedom of the press) grounds.

[4]See, e.g., NLC arguments as detailed in Lee 1983, at 878-9, f.n. 48. It should also be noted that this appraisal of the Johnson and Blau analysis is confirmed by the fact that their article is often introduced as "economic analysis" demonstrating the superiority of franchise monopoly to open competition. See testimony of Jay Smith in Pacific West Cable Co. v. City and County of Sacramento [CIV 5-83-1034 MLS (CAL-E.D.)] and in Group W. v. City/County of Santa Cruz (Case No. C-84-7546-WW5 [August 30, 1985]). Also see Mark Nadel, "COMCAR: A Market Cable Television Franchise Structure," 20 Harvard Journal on Legislation 54(1983), at 546.

and Blau (J&B) seeking to demonstrate that their analysis reveals little unique about the cable television business and jumps prematurely to a franchise monopoly policy conclusion. The second section critiques the brief J&B arguments for franchise monopoly on political and social grounds, and the third portion of this paper seeks to show that the case for, as well as the practice of, monopoly franchising is best understood as a political program for redistributing income from the mass of consumers to interest groups influential with city governments.

I. The Economics of Cable Television's Local Distribution.

J&B divide their economic arguments for franchising into three categories: costs, pricing, and investment (J&B, supra, at 324). We shall follow their format in critiquing their conclusion that economic factors lead to an inevitable natural monopoly in cable which, in turn, dictates a government franchise solution.

(a) Costs:

(a-1) Scale economies. J&B argue that municipal cable franchises which allow "only one system to serve the entire market at a given time" are efficient because "if a second system is built alongside the first, an unnecessary duplication of resources is accomplished." (id. at 325). They conclude that "such competition would be wasteful." (id.)

Their rationale is what is often deemed scale economies: "there is less cost per subscriber as the aggregate number of subscribers increases." (id.) By way of example, the authors hypothesize a community cable system with the following attributes: population = 40,000; homes = 10,000; cable system capital cost = $1 million; length of cable plant = 100 miles.

To demonstrate the power of scale economies, they note that, if one firm were to capture a 25 percent penetration ratio,[5] it would cost an average of $400 (in capital costs) to service consumers. If two firms, however, were to "overbuild" and each claim a 12.5 percent penetration ratio, average cost would double to $800/subscriber.

(a-2) Scale economies: a critique. Four fundamental confusions emerge in this analysis. First, economies of density are mistaken for economies of scale. Second, the "fixed cost" rationale which the authors identify as somehow unique, is general to most every commercial enterprise and, in particular, to dozens of unregulated industries commonly identified as highly competitive. Third, the argument ignores differences between firms which provide the very rationale for competitive rivalry to begin with. Fourth, the analysis fails to explain why--if their conclusions regarding competition's inefficiency are correct--public authority is better able to prevent "wasteful duplication" than are profit-maximizing entrepreneurs operating in the (unfranchised) private sector. These objections will be explained in sequence.

(a-2.1) To argue that average cost falls with output and that, therefore, one firm is always preferred to two is to confuse the dimension over which output is measured. One quite obvious fact concerning cable television is that it is a highly localized business; hence, there are now over 6,500 separate cable systems nationally.[6] If economies of scale were

---

[5]Penetration ratio = subscribers/homes passed.

[6]6,540 systems in operation as of May 1985 (Testimony of Jay Smith, of Touche Ross, Inc., in Pacific West Cable Co. v. City and County of Sacramento [CIV 5-83-1034 MLS (CAL-E.D.)]).

pervasive, and municipal licensing were brought into existence to enable those economies to operate efficiently, why are we not left with but one (or a very small number of) cable operators?

The confusion is that the cost advantage of one firm over a given area is not, strictly speaking, an economy of scale, but one of density. If we assume that cable is a business experiencing overwhelming fixed cost and but trivial variable cost (that is, zero marginal cost for a new subscriber[7]), then we must logically deduce that average cost falls as the number of customers rises against a fixed cost outlay. This does say that average cost falls as more subscribers are added to an existing system (economies of density); it does not say that an existing system can grow to service new areas at a lower cost than a new entrant might serve them.

The difference may be subtle, but the implications for theory and policy are significant. First, economies of density do not make any case for city- or county-wide monopoly franchises, but only a theoretical efficiency argument for one cable supplier per block.[8] While we are yet to discuss the curious reasoning that local governments should be in the business of telling private firms the most economical means of operation [see (a-2.4) below], a

---

[7]This is what J&B do in their model in assuming the following: "A cable operator is able to construct the entire system for $1 million including 100 miles of cable, head-end equipment and miscellaneous costs. At the end of one year, let's assume 1,000 homes (10 percent of the total) are being served. At this point cost per subscriber is $1,000 ($1 million ÷ 1,000) minus drop costs, which are assumed to be covered by installation fees." (id. at 325). As installation fees average about $25, the assumption is that fixed costs, i.e., everything but "drop" costs, are 97.56 percent of total costs (1,000 ÷ 1,025). Yet, since "drop costs" are exactly covered by installation fees in this model, the obvious thrust of the assumption is that fixed cost equals 100 percent of total cost, which is how we will treat the analysis from this point forward.

[8]Even this argument requires certain strong assumptions which are likely to be unwarranted (see below).

municipal rule simply disallowing overbuilds would be the most that such a rationale could suggest on economic efficiency grounds. Indeed, it is entirely consistent with the erroneous "scale economies" argument advanced by J&B to claim that municipal franchising promotes diseconomies of scale in either of two ways:

(1) In divvying up geographic areas served by cable lines so as to conform to political jurisdictions, scale economies are sacrificed. Indeed, a look at the cable franchise mosaic in any major metropolitan region reveals that, should large-scale production be a prime source of economic efficiency, it is being dutifully thwarted by local politicians who refuse either to coordinate franchising decisions with neighboring jurisdictions, or to act in the interests of local consumers by franchising the lowest-cost (presumably adjacent) provider.

(2) Should the optimal size of a cable system be relatively small (i.e., average cost increases beyond some relatively modest efficient-scale level), then cities which issue only one city-wide cable award condemn its consumers to higher prices. In that J&B feel strongly that one of the monopoly franchise's great merits is in forcing a system to serve an entire community (id. at 340), their analysis is particularly vulnerable on this count.

We note that in large political jurisdictions, in fact, the area is routinely split into several cable franchise areas: the City of Los Angeles is subdivided into fourteen franchises.[9] This indicates that cable firms, or political regulators, or both, see significant diseconomies of scale in supplying cable services. Even accepting the J&B cost argument as true, then, makes no case for an exclusive city-wide franchise.

---

[9]Decker 1985 at II-1.

(a-2.2) But we do not accept the J&B cost analysis as anything more than an exercise in pure logic. If all costs are assumed to be fixed,[10] then serving a higher number of customers must reduce per-unit costs up to the point of maximum plant utilization. But this is an entirely sterile analysis; nothing of actual industry costs are known or investigated. For instance, if two firms compete head-to-head (i.e., in an overbuild scenario) they will not have to spend twice as much on marketing to achieve the same total subscribers as an identical monopoly firm, nor on transmission fees, royalties, servicing, direct hook-ups, billing, administrative expense, etc. All of these inputs vary directly with the level of output.

Some empirical evidence is now available to illustrate the severity of the 100 percent fixed cost assumption. In a study prepared for the City and County of Sacramento in a lawsuit challenging the municipality's exclusive cable franchise,[11] the accounting firm of Touche Ross constructed a projection of industry costs under both a one-firm and a two-firm overbuild scenario. Their analysis forecast operating plus capital expenses for a one-firm monopoly of $59,775,000 in 1989, the first "mature" year for the hypothetical system analyzed. Each of two firms in an overbuilt duopoly show total costs of $37,032,000. The two firms combine, then, to show costs 23.9 percent higher than those predicted in the monopoly scenario.[12]

---

[10] Other implicit assumptions are discussed in (a-2.3 and a-2.4).

[11] Pacific West, supra note 6.

[12] See Testimony of Jay Smith in Pacific West, supra, Exhibit 2 (lines 265, 284, and 287) and Exhibit 3 (lines 265, 284, and 286). These cost differences overstate the monopoly's cost advantage in that the study assumes a 50 percent penetration ratio for the duopoly scenario as opposed to a 45 percent ratio under one-firm supply. It is realistic, of course, to assume that two rivalrous firms will appeal to at least a slightly higher market share than one firm under monopoly conditions, but this does increase the cost of cable--as well as increasing its value to consumers as a class.

In a similar Touche Ross report prepared for the City of Denver in its 1982 lawsuit[13] the projected cost difference between two firms offering identical products over identical areas and one firm offering that same package over the area was estimated at between 23 and 28 percent.[14]

As these studies were contracted for by municipalities defending monopoly franchising in serious court challenges, these should be taken as top-end estimates of the empirical evidence of wasteful duplication.[15] It is highly significant, then, to note that using the Sacramento projection, truly fixed costs are no higher than about 11 or 12 percent, when the higher subscriber base (50 percent penetration for two-firm competition vs. 45 percent penetration in the sole seller scenario) is factored into the equation.[16] Perhaps the largest variable cost, unnoticed in the J&B model, concerns royalty payments to cable television programmers; the Touche Ross estimate

---

[13] Mountain States Legal Foundation v. City of Denver (No. 82-C-1738 [D. Colo., filed 1 Nov. 1982]).

[14] Touche Ross 1984 at i.

[15] These studies also employed inappropriate methodology in mistaking density for scale economy (as discussed above), in entirely ignoring issues concerning the heterogeneity of firms and consumer preferences (discussed below), and in counting all fixed costs as, essentially, sunk capital (see Waterson 1984 at 68-9).

[16] In general: Total Cost = Fixed Cost + Variable Cost. Using the Touche Ross Sacramento projections, where the ratio of total costs under duopoly to total costs under monopoly is 1.24, but the competitors serve $\frac{50}{45}$ times as many customers, we have

$$2 \text{ firm: } \left(\frac{45}{50}\right) 1.24 = (2)\ FC + VC$$

$$1 \text{ firm: } \qquad 1 = FC + VC$$

by substitution and arithmetic

$$FC = 11.6\%$$

assumes that this one expense will constitute 29.9 percent of total costs.[17] Since such fees are routinely charged on a per-viewer basis by satellite signal providers, this cost is entirely variable and helps to quantify the magnitude of the leap of faith embodied in the 100 percent fixed cost assumption.[18]

This fixed cost component then, may be seen as very 'competitive' with many industries often thought to be highly rivalrous. In particular, any retail business is likely to experience a similar level of fixed cost; all such localized enterprises must devote substantial sums for "fixed" investments such as a store or office, advertising, insurance, security, personnel training, etc. These costs all may be expected to vary, on a unit basis, strongly and inversely with the volume of business transacted by a given outlet. This fixed cost component logically leads retailers to spread themselves out geographically; going into regions of less competing investment tends to reduce cost per customer served (and hence, to increase profits and

---

[17]These payments include compensation to pay program owners (45 percent of total pay revenue) and copyright payments to basic programmers. (See Touche Ross 1985, Exhibit 1, lines 191, 196, 200, 265, 284, 287, for the year 1989.) Other important costs that vary significantly with the number of subscribers are franchise fees, administrative and maintenance personnel, billing costs and bad debt expense. Some capital costs, as the expense of a 108-channel system vs. a 54-channel cable, are also variable in the sense that head-on competitors will not have to individually offer as many channels to give consumers as much choice in the aggregate.

[18]To argue that, in a 1974 projection, the authors could not be blamed for failing to appreciate the dramatic impact pay cable programming would make in ensuing years is to beg the regulation question. In seeking to justify the imposition of long-lived municipal franchises, the regulator must either correctly anticipate future circumstances or develop a flexible arrangement yielding to them. Despite rapidly changing technologies and products in the dynamic cable television market, we see little flexibility in the monopoly award solution--nor do cities which award them. They have not changed their arguments for them, nor sought to dispense with their entry restricting nature, even as their own arguments--whatever their original merit--have been proven obsolete on their own terms. Most important for our purposes here is the simple fact that municipalities <u>still</u> offer the scale economies argument, even as its empirical plausibility has evaporated.

consumer welfare). Still, the argument for erecting barriers to entry in such markets is exceptionally weak; even if but one supermarket exists in a community, the possibility of entry is valued as an effective constraint upon the monopolistic intentions of the incumbent.[19] Scale economies, even if found to the degree that municipalities claim are extant in cable, do not generally suggest a franchise monopoly solution when observed in other markets.

(a-2.3) The J&B analysis essentially poses this question: What would it cost Firm X to deliver Y consumers in a given community Product Z, as opposed to having two Firm X's deliver Y consumers in a given community Product Z? The explicit assumption is that variable cost remains constant over all outputs,[20] and the implicit assumption, of course, is that everything remains constant between the two scenarios excepting the number of suppliers. This leads to the conclusion that one Firm X is better at producing Z for Y than two Firm X's.

This is uninteresting from a consumer welfare perspective. On these grounds, production in any industry exhibiting any fixed cost component should be subject to state-licensed monopoly.[21] If two or more competitive firms are duplicating fixed costs (and if they aren't duplicating "fixed costs" then

---

[19]Franklin Fisher, professor of economics at MIT and a leading antitrust analyst, notes that: "Even a firm with 100 percent of the market, only able to maintain that share by so-called 'limit pricing,' in which it must keep the prices below the cost of potential entrants is not by that fact alone engaging in monopoly" (Fisher 1979 at 32).

[20]I.e., their assumption that all costs are fixed, excepting that "drop costs are assumed to be covered by installation fees" (J&B at 325), which are not said to vary.

[21]Provided we make the constant variable cost assumption which, in the J&B analysis (as elsewhere), is nowhere demonstrated as representative of actual market conditions in the cable industry.

those costs are not "fixed") and serving just the same customers with the very same products at constant variable cost as a government selected monopolist would, then "competition" (so defined) is clearly wasteful. The implication, of course, is that state-issued monopoly is the efficient solution in automobile manufacturing, oil drilling and refining, steel, construction, motion pictures, chemicals, textiles, retailing, insurance, banking, wood products, publishing. . .

There is, of course, a consumer welfare argument for competition in these fields--i.e., in the economy generally--but it must be made in violation of the J&B assumptions: X, Y, and Z must be allowed to vary between scenarios, and VC (variable cost) with output. The general argument for competition rests on just two basic propositions, in fact:

(1) That whatever cost advantages accrue from spreading a larger number of sales out over the fixed investment component, the variable per-unit costs of producing and selling are likely to rise with output. This results from the increasingly complex organizational requirements that accrue to larger scale enterprises. Growing chains of command increasingly removed from direct profit and loss incentives, more data for top decision-making managers to assess, and all the traditional problems of bureaucratic organization provide diseconomies of scale that offset the decline in average costs achieved from spreading fixed costs further and thinner.

(2) The more global and compelling argument for competition, however, directly concerns information and incentives. If we knew who should supply the market (X), and if we knew who was willing to pay its cost (Y), and if we knew exactly what product(s) was (were) appropriate to produce (Z), then the public selection of a single seller might be appropriate, but it would clearly

be trivial. The great contribution of competition to consumer welfare is as a process which discovers what consumers would like and how to most efficiently give it to them.

Such information is not, most emphatically, known a priori to consumers, entrepreneurs, industry experts, or to government officials. In a world of costly information, the monopoly franchise solution must be evaluated not as a proposal to eliminate competition (which critics deem "wasteful"), but to shift the rules of the competition. In that the information as to the "optimal" cable system is still unavailable under a real-world public franchising process, the analysis which merely proclaims competition as anti-social and recommends that a city commission select the "best" franchise arrangement, has failed to complete a logical argument for the public "auction."[22] The pro-franchising argument which has been entirely skipped is: Will competition for a politically-awarded legal monopoly better approximate the optimal X, Y, and Z than will an open market competition?

The importance of this question can scarcely be underestimated in the cable television equation. Any costliness of market rivalry must be weighed, not against a free public solution, as J&B implicitly assume, but against a costly competition for the franchise. As Richard Posner detailed a decade ago, the competition for an above-normal profit, as guaranteed by a position of monopoly, will generate an investment to achieve that protected position which can be expected to cost society, in terms of real resources sacrificed,

---

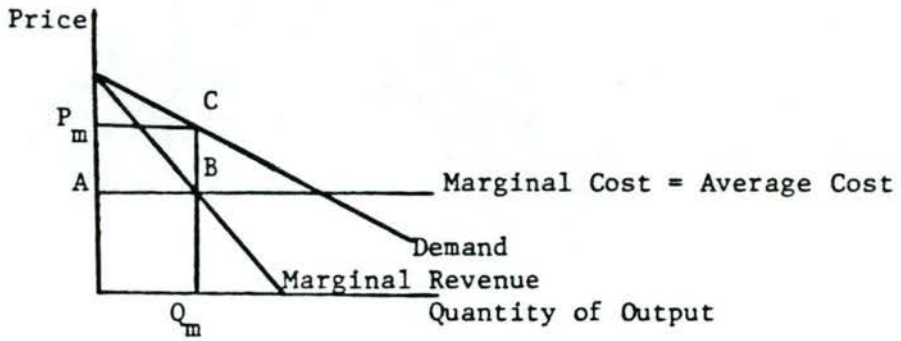
[22]As Judge Sneed calls the franchise selection process in Preferred, supra, at 4.

the entire (private) value of the monopoly.[23] I will later argue that protected positions of monopoly are created by political bodies to <u>create</u> this socially wasteful (but politically fortuitous) competition.

It is clear in this discussion of the standard implicit assumptions made on the way to "proving" that cable is an industry where competition is ineffectual as a consumer protector, that the very rationale for competition <u>anywhere</u> in the economy has been removed by assumption. There is no <u>prima</u>

---

[23]Posner 1975, at 807. If a legally-issued monopoly, for instance, guaranteed above-normal returns equal to $ABCP_m$, then potential suppliers



would have an incentive to expend up to $ABCP_m$ to <u>gain</u> the monopoly. Collectively, they would be willing to 'squander' up to the present value of the income stream generated by the franchise acquisition. This is calculated as:

$$PV_{monopoly} = \int_0^t ABCP_m(e^{-rt})dt = \sum_{i=1}^{n} F_i$$

where r = real rate of interest, t = length of franchise monopoly, and $ABCP_m$ = annual economic profit, F_i is the amount spent by i^{th} firm to obtain the franchise, and n = the number of firms which enter the competition for the market (i.e., for which $F_i > 0$ obtains). We may further note that $F_i = (p_i)ABCP_m$, where p_i equals the probability that the i^{th} firm will win the franchise award. (Additional assumptions needed to obtain these results are that firms be risk-neutral and possess symmetric expectations.)

facie case for the assertion that variable costs decrease over output or density in cable; and there is, most emphatically, no costless way for politicians to (a) determine what consumers want, and (b) select the firm most able to deliver it. More importantly, perhaps, is the realization that consumers have no costless way to police the politicians: what is to constrain the political selection to economic (i.e., proconsumer) criteria? While George Stigler bluntly lays out a first approximation that "as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit,"[24] this vast problem is, again, wholly ignored in the J&B treatment. This agency dilemma, as we shall see, forms a formidable empirical challenge to academic theories of public monopoly selection.

In sum, the primary advantage of free competition as an allocator in the economic sphere is to allow the profits and losses of the market discover the best suppliers--in the eyes of consumers. If the knowledge as to what, precisely, was proconsumer were readily available, competition itself would be wasteful, in that it necessarily entails duplication of industrial effort: Wang and Digital both advertise to people who buy only one computer; Toyota and Fiat will both employ engineers to figure out the same braking system; Paramount and Warner Brothers will simultaneously employ Stanford MBA's to read the same potential movie scripts. If the scramble for consumers avails us of nothing valuable, the J&B argument against wasteful duplication snares virtually all private economic activity within its net.

(a-2.4) The municipal defense of monopoly franchising forms a non sequitor. The argument's premise is: Competition is expensive, and will inevitably result in duopolistic cable firms losing lots of money. The

---

[24]Stigler 1971 at 3.

conclusion is: We must prevent all sorts of multiple competitors from entering the market. How is it that political (and academic) analysts can predict economic reality with such complete confidence from afar, and fear that business entrepreneurs will foolishly risk millions of their own dollars in pursuit of the impossible?

The fact is that all such competitive losses come straight out of the pockets of the business actors who create them. Hence, no externality problem exists: private self-interested individuals lose at their own risk.[25] If the monopoly franchise is now advanced as a means whereby foolish investors are deterred from taking large capital losses, care must be taken to note the dramatic departure from earlier claims as to the pro-consumer spirit of such laws. For it is surely to the benefit of consumers that "over-investment" put cable firms in hopeless head-to-head combat--assuming the natural monopoly argument. This would lead to a low-price competition for business, with cable suppliers unable to charge prices high enough to recoup sunk costs (as discussed below).

But it is just here, of course, that the argument for government intervention is at its weakest. The notion that cable suppliers should be protected by public agencies from giving away their fortunes to consumers in the form of over-investment--and the resultant low prices--is uncompelling. Normatively, it is bad consumer policy; positively, it lacks credibility: that public officials realize such economic realities more fully than self-interested economic agents is an argument that fails to persuade.

---

[25] J&B do not raise the argument of irrationality. It is exceedingly difficult to do so: if individuals irrationally lose their own money, why (or how) should policy makers rationally conserve the resources of others? In fact, withdrawing the assumption of rational self-interest makes analytical treatment itself problematic.

(b) Pricing:

J&B identify essentially three pricing problems in an unregulated cable television market. (1) There exists a monopoly price by the nature of a sole seller's rational behavior in a free market. (2) Should multiple entry irrationally occur, a temporary price war will result, and prices will increase post-competition, back to monopolistic levels. (3) Quality predictably deteriorates under the price-wars of competition. We will take up these issues in order.

(b-1) That the existence of a single seller in a market constitutes a per se case of monopoly (i.e., supracompetitive or above average cost) pricing is a notion that has been thoroughly discredited in the economics literature. One quick way to establish this critique is to merely note that, in that any particular market may be defined as narrowly as "the customers who buy brand K from firm J," every j^{th} firm is a monopolist--by that market definition. This arbitrary formulation, indeed, is no more contrived than the blanket presumption that a sole survivor in a market can automatically price above cost.[26]

The principle elements, in fact, in determining the behavior of a monopoly supplier (however the market over which a monopoly is alleged may be

---

[26]Hence, a contemporary definition of monopoly power is given by Franklin Fisher et al., 1983: "Monopoly power is the ability to raise prices above competitive levels or to market inferior products while excluding competition." (at 20; emphasis in original) Contrast this with the nonequivalence of monopoly market structure and monopoly pricing in Fisher et al., supra note 19.

defined) are (1) the elasticity of demand,[27] and (2) the competition for the market (also known as elasticity of supply).

(b-1.1) Elasticity of demand. A monopoly seller is identified by his market power: can he restrict his output and drive prices up above costs without having competitors abscond with his customers? A firm with monopoly power is able to restrict output from the so-called perfectly competitive level and, hence, to raise price.

The question of elasticity of demand concerns the willingness of consumers to substitute out of the "market" (again, defined arbitrarily) altogether. If Acme Wholesale Liquor, Inc., has the sole legal franchise to sell Pabst Beer in Bakersfield, the monopoly is the cause of monopoly pricing only if demand for Pabst in Bakersfield (i.e., the monopolized market) is somewhat inelastic. If consumers are indifferent between Pabst and Olympia, Miller or Schlitz, or can easily shop in Delano, demand is said to be highly elastic and, thus, Acme has no monopoly power. A monopoly price would simply squander the "monopoly."

Hence, discussions of monopoly power routinely turn to the question: Is the good a necessity? This is an imprecise way of addressing the question of

---

[27] Elasticity of demand = $E_d = \frac{\partial Q_d}{\partial P} \cdot \frac{P}{Q}$, measuring the sensitivity of consumers to a change in product price. If demand for a product is inelastic ($E_d < 1$), meaning that substitution away from a good is relatively difficult monopoly power may be the result; high elasticity, conversely, is a sign of robust competition no matter the "market shares" of industry suppliers. (Care must be taken in applying these measurements at a point in time, however, for a rational firm with monopoly power will increase price until consumer demand becomes elastic.)

substitutability (which is to say, of elasticity). Only when a good is inelastically demanded can a sole seller hope to capture supranormal returns, and this requires the absence of reasonably close substitutes. But just here the cable discussion turns on itself. Cable is an information and entertainment product competitive with all forms of substitute media. Over-the-air television, satellite master antennae television, direct broadcast satellites, video cassettes, over-the-air pay television, movies, and telephone data services form just the beginning of a long list of competitive media. As Charles L. Jackson comments of cable's future market:

> Cable will be surrounded by a host of other video distribution systems and information systems. These alternative systems will put economic pressure on cable to carry the most attractive package of programming for its subscribers, and they will limit denial of information flowing from an abuse by cable of its central position in local electronic information distribution. (Jackson 1985 at 169)

In formal, legalistic terms, in fact, the question of "effective competition" has recently been resolved by the Federal Communications Commission. In the recent cable policy amendment to the Communications Act of 1934, Congress legislated that local or state regulation of basic cable rates could continue only where the FCC found "circumstances in which a cable system is not subject to effective competition." ("Cable Communications Policy Act of 1984," Public Law 98-549, Sec. 623.) The Commission has since established that the existence of just three B-contour grade over-the-air television stations signifies "effective competition" to a community's cable system.[28] Thus defined, the overwhelming majority of U.S. cable systems are deemed to

---

[28]Federal Communications Commission, MM Docket No. 84-1296 (April 11, 1985), at 32, 35.

face an "effectively competitive" substitute, examining just one dimension of substitutability (i.e., broadcast television).

(b-1.2) Competition for the market. While the monopoly supply-demand graph and scenario neatly eliminates this possibility of rivalry by assumption, the unsatisfying conclusion concerning monopoly markets is that rational profit-maximizing firms are left spinning their wheels in competitive markets for normal returns while some select groups of (lucky?) monopolists sit down to a predictably fat monopolistic feast. Why are the competitors so willing to sit out the race for monopoly?

In fact, the assumption of rational profit-maximization (which J&B rightfully employ) mandates that these firms compete for the allegedly lucrative one-seller market. This rivalry may be contrasted to competition within the market, which occurs whenever economic conditions dictate a multi-seller market, but does not dispense with competition, however, nor does it necessarily send price above cost. It simply shifts the competitive battle to a new ground. Moreover, this discrete rivalry for the entire market may exhibit proconsumer effects equally as salubrious as competition of a continuous (i.e., day-to-day) nature.

Take, for instance, a housing developer who constructs 1,000 condominium units. Suppose, as well, that everything that J&B assert regarding the impossibility of head-to-head, unregulated competition in cable television is correct. The question arises: Do the consumers of the condos face a monopoly cable television problem?

The answer, clearly, is no. In marketing her units, the developer must provide all manner of ancillary conveniences to the "essential" condo: parking, street access, plumbing, wiring, insulation, carpeting, life-guarding at the pool, ad infinitum. Should these consumers value cable services, the

developer has every economic incentive to contract for a cable television system priced at a competitive level, and delivering a level of quality and services compatible with the demands of the market. Any monopoly pricing or inefficiency in the cable system will merely lower demand by the consumers (and, hence, price) for the developer's units.[29]

In contracting for cable for 1,000 potential customers then, the developer internalizes all consumer costs and benefits of whatever "monopoly" is selected and, hence, has a clear incentive to seek out the most "competitively priced" service provider.[30] And cable suppliers have every incentive to constrain prices to competitive (or average cost) levels, as they have no monopoly over other bidders in gaining the market.

The difficulty with cable, then, is clearly not that a monopoly seller inherently causes monopoly pricing. Monopoly sellers may surely price at competitive levels, if the competition to win the market is effective in arranging a discrete, once-for-all, long-term cable contract. (This, in fact, routinely happens as private housing developments have currently entered into literally thousands of contract arrangements with cable and so-called "private

---

[29]This form of competition is discussed generally in Demsetz 1968 and Baumol et al., 1982. For an application of "Competition for the Market" to the cable television industry, see Posner 1972, and Hazlett 1985b.

[30]If it is alleged that the developer will not "pass along" cost savings from discovering a lower-priced supplier, this is still no evidence of a cable monopoly problem. If the developer or landlord can get away with overcharging for any service (i.e., to charge a price above competitive cost and still sell all units), it is either due to her market power in the real estate market, or to her special (i.e., "monopolistic") superiority in finding a low-cost cable supplier. There may also be a price-discrimination aspect to the private contract solution. For a full explanation of these possibilities, none of which constitute a failure of competition in cable television, see Hazlett 1985b at 91-3 and 111-2, notes 52, 53, 55, 56.

cable"--satellite master antennae television--suppliers.[31]) The problem that may exist is different altogether from the one posited by J&B: How difficult (i.e., costly) is it for consumers to effectively bargain with suppliers on a for-the-market basis? When a private developer is not to be found, can a homeowner's association, consumer cooperative, potential competition,[32] or a local government efficiently perform this function? Key here, of course, is to see public agency as one alternative among many, and to treat the question of efficient proconsumer regulation as an open empirical one, so as to avoid dispensing with private market institutions in favor of public franchises simply by assumption.

(b-2) The fear of a price war is a curious emotion. The existence of such connotes a certifiably proconsumer phenomenon, but its detractors argue that either (a) the war is temporary, or (b) its inevitability will prohibit entry altogether, (c) it will surely lead to lowered quality of service, or (d) all three. While the low-quality argument is to follow this discussion, points (a) and (b) are discussed here.

---

[31]This technology can deliver high-quality television signals with a much smaller "fixed capital" than can traditional (CATV) cable. It is not able to send its signals great distances, however. It is, hence, very popular with apartments, condos, hotels, and trailer parks. The SMATV industry served at least 350,000 customers by early 1984 (see Wines 1984 at 317) and has been rapidly growing since. "Many experts rate the infant service as a serious economic threat to urban cable systems because of its ability to siphon off customers in densely populated areas." (Id.)

[32]It is important to note that even where no one bargaining agent stands ready to negotiate a competitive arrangement (as in the developer did in the previous model), potential competition may perform a low-cost "regulatory" role. If an incumbent stands to lose large amounts of nonsalvageable capital should he price above cost, an overbuild need never occur to keep a monopoly supplier in line.

A temporary price war, clearly, is better than none at all. (Certainly air travelers under CAB deregulation have come to enjoy "temporary" price competition as a seemingly permanent part of life.) If the economy's fruits are to be judged on the basis of everlasting benefits, we would discover little of merit whatsoever. So this contention is logically uncompelling.

However, it is even more uncompelling when empirical evidence is examined. We have several U.S. cable systems which have operated under the "impossibly" competitive environment of head-to-head overbuild whose markets appear anything but unstable or short-term. Table 1 shows data from the 1984 Touche Ross analysis for 12 overbuild systems.

If we exclude Community Service, Inc. of Frankfort, Kentucky, which is a municipally owned system, we find that eight of the 10 systems for which the basic rate is known have prices below state averages, and that the 10 systems taken together average 16.3 percent (or $1.36 per month) less than their respective state averages. Moreover, their basic packages also appear state-of-the-art: the 11 private systems offer, on average, better than 10 satellite services in the basic package despite having an average system age of nearly 14.5 years (newer systems generally carry more capacity and services).

The average age statistic is quite significant in its own right, of course: the temporary price cut charge has difficulty in explaining how these presumably rational, profit-maximizing firms could engage in impossible combat all these years and live to tell about it. The overbuilds listed have existed for 19, 13, 8, 5, 32, and 4 years.

(b-3) The deterioration of quality under competiton is a contradiction of the rate war argument. If a market is being bitterly contested, consumers may

Table 1

COMPETITION OF OVERBUILT CABLE SYSTEMS

	Allentown, PA		Bryan and College Station, TX		Paramus and Hillsdale, NJ		Chester, PA		Frankfort, KY		Clackamas, OR	
	Service Electric	Twin County Cable	Midwest Video	Community Cablevision	UA - Columbia	Cablevision of New Jersey	Southeastern Cablevision	American Cablevision	Community Service, Inc.	Consolidated TV Cable Service, Inc.	Storer Cable TV	Liberty
Size of service area of the system												
- Population	400,000	N/A	49,000	92,000	N/A	N/A	120,000	100,000	23,000	35,000	N/A	N/A
- Homes passed	120,000	100,000	18,000	N/A	275,000	63,000	27,000	57,000	13,000	6,000	9,800	15,400
- Plant miles	1,687	1,500	222	310	2,350	750	310	479	150	75	149	163
Size of overbuild area												
- Population	400,000	N/A	49,000	49,000	N/A	N/A	N/A	50,000	N/A	N/A	N/A	N/A
- Homes passed	120,000	N/A	18,000	18,000	11,000	11,000	21,000	21,000	8,000	6,000	7,700	14,500
- Plant miles	1,687	N/A	222	N/A	75	N/A	180	N/A	75	75	125	134
Date of system turn-on	1965	1962	1955	1971	1967	1976	1979	1979	1952	1952	1980	1979
Channel capacity	36	36	27	35	36	36	35	35	19	17	23	35
Channels used	33	28	24	35	36	36	34	32	16	17	23	35
Local origination hours per week	1	18	None	None	20	6	10	30	None	None	10	50
Number of public access channels	None	None	None	None	2	3	2	2	2	None	1	4
Number of satellite basic services	12	7	4	9	11	8	15	12	5	5	8	22
Number of pay services	3	2	2	5	2	6	4	3	2	2	3	4
Number of basic subscribers	51,000	57,000	8,200	15,000	106,000	30,700	8,200	19,775	8,500	4,000	3,700	4,100
Basic penetration %	43%	57%	46%	N/A	39%	49%	30%	35%	65%	67%	38%	27%
Number of pay subscribers	15,000	15,000	1,000	N/A	5,000	N/A	7,700	23,000	900	4,000	N/A	4,700
Basic rate	$8.50	$7.65	$6.00	$6.00	$8.50	N/A	$8.45	$7.50	$3.50	$3.50	$6.00	$7.50
*State Av. price for Basic	----- $7.68 -----		----- $8.80 -----		------ $8.94 -----		------ $7.68 ------		----- $8.07 -----		----- $8.91 -----	

Key

N/A = Not Available

Source: Touche Ross (1984) at 25.

*Source: Paul Kagan and Associates: Annual Cable TV Census (December 31, 1982), adjusted by 1983 change in Consumer Price Index (3.5 percent increase).

be captured by either price cuts or quality increases. In fact, these notions are analytically identical, in the sense that the consumer weighs his expenditure, quite rationally, in value/dollar terms. To increase the size of a candy bar, while leaving price fixed, is to effectively lower the price of the candy. Quality changes work in precisely analogous manner. Hence, it makes little sense to speak of firms lowering their quality as a result of intensified competition.

Moreover, if, under a hotly contested battle for market supremacy, we observe firms lowering prices and cutting quality, we can safely conclude that consumers desire a lower-quality, lower-priced product. Such a phenomenon has recently overtaken the airline industry with a vengeance, as no-frills carriers are slashing prices, price cuts made possible by cheaper service. The point here is that there is no objective optimum level of service to serve as a standard; the judgment of firms actively competing for consumers should be deferred to on the question of what quality service consumers are willing to pay for.

One very interesting sense in which it is readily conceded that competitive firms offer less "service" is in the local origination/public access channels and programming, and in the area of cash grants to community organization. (See the minute contributions to such programming listed in Table 1.) But these are politically demanded services; they obviously are worth less to actual rate-paying consumers than their opportunity cost, else the profit maximizing overbuilt competitor would be eager to load the menu with public access. Again, however, there is no efficiency argument for holding out a monopoly franchise as quid pro quo for special interest programming. This is political cross-subsidization which could,

alternatively, be overtly achieved by the City Council simply voting to tax citizens $T to pay for S programs.

(c) Investment:

J&B argue that a free-entry policy, which they assume to result in overbuilt (as opposed to "potential" or "for the market") competition, will produce an inevitable consolidation (via merger or bankruptcy) of all overlapping firms. This, they believe, will make the post-competitive firm less able to provide quality services for having been through a destructive period of competition. They allege that the formerly competitive monopolist will be less willing to subsidize unremunerative services for the community, such as "participatory democracy." Operating on the premise that a "service may be beneficial to the public at large, [while] individual subscribers are unwilling to incur the costs," (at 338) and asking if anyone should "have to pay a fee to become a better, more active citizen," they explicitly state the case for subsidization of alleged public goods. What they fail to note is that their normative case that certain goods should be provided over cable need have no part of the discussion on cable regulatory policy: they state only a case for some form of subsidy to support the investment in these public goods. That local governments prefer to tax by regulation and cross-subsidy, rather than to tax and spend explicitly, is merely further evidence that the public would not want such goods--if they knew their full social cost--at all. (We cannot fail to note the irony in arguing that democracy is to be promoted by hiding public expenditures from the view of the electorate is interesting, indeed.)

J&B argue for politically mandated services without acknowledging that in purporting to solve one free rider problem they create a Pandora's Box of additional free riders. By allowing political interests to distribute special

taxes and subsidies under the complexity and protection of the cable franchise (wherein consumers are rationally ignorant as to what percentage of their monthly fees are devoted to some service subsidy or other), these interests pay only a tiny fraction of the cost (borne mainly by the mass of rate-payers) while reaping all of the service subsidy benefits. Hence, they have every incentive to demand franchises supply vast amounts of public access channels, e.g., even if those channels go largely unviewed and even unprogrammed.[33] This ability to play politics while leaving cable consumers the tab creates an over-investment in nonremunerative services which is entirely predictable when rational political self-interest is factored into the analysis.

II. Social and Political Considerations.

1. J&B offer the following "noneconomic" considerations favoring franchise monopoly: (a) it is more likely to serve all of a community's

---

[33]One survey of a system with nine 24-hour local origination-public access channels found that but 3.7 percent of the available "air" time was utilized. (Ernst and Whinney 1982 at 29). Another study found such excess capacity an expensive proposition, indeed. "Denver's approach to cable regulation appears to have induced the promise of a larger capacity system and more access support than would be likely to be provided under an unregulated approach." (Touche Ross 1984 at 39). The study estimates the over-investment as costing $1.4 million annually through the franchise life. They quote the chairman of the firm whose subsidiary won the franchise award as declaring:

> It's been a mistake to build two-way plant with 100 channels when 50 channels delivered on a one-way system can get the job done. Those 50 channels give us all we need to distinguish ourselves, to make ourselves appealing to all segments of the public within a cost structure that makes sense. We as an industry have too much capital tied up in nonproductive assets--two-way plant and too many channels.

(id. at 40). All told, including excess channel capacity, capital investment in production facilities for local origination, and in programming operating expenses and grants, average costs were raised an estimated 14.5 percent per subscriber (id. at 41).

customers, (b) interconnection is likely to be a problem without monopoly,[34] and (c) competition is, essentially, unruly.

(a) J&B allege that only "a noncompeting system can afford to go into areas of low population density as well as low-income areas" (at 340), revealing an interesting (if implicit) assumption. The unregulated competitor would serve any consumer willing to pay (at least) the marginal cost of supplying the service; the notion that service will be denied some areas is either testimony to the fact that the cost of providing that service is greater than it is valued by the consumers (in which case it is inefficient to force it on them and/or the supplier), or that all customers must be charged identical prices.

In fact, municipal cable franchises routinely stipulate fixed community-wide prices as well as universal service.[35] But, again, this is clearly inefficient economically. It is a politically-motivated cross-subsidy largely benefitting the low density suburbanites, generally speaking, at the expense of the high-density urbanites (particularly apartment dwellers). On average, the universal service mandate is overwhelmingly a transfer from poor to rich. Charging the wealthy homeowner sitting on three acres precisely the same monthly and installation fees as an apartment tenant in a 300 unit building, where the fixed cost ratios (using the J&B cost analysis) are likely to be a small fraction of the suburbanite's, is a predictably regressive wealth reallocation.

---

[34]It is interesting that, while J&B assert that monopoly is inevitable in a free market, interconnection between head-to-head competitors is listed as a problem.

[35]This regulation is not rendered obsolete by the Cable Communications Policy Act of 1984, under which local governments continue "prohibiting discrimination among customers of basic cable service . . ." (section 623-f).

(b) In a competitive scenario, cable firms might program on different channels or broadcast different shows. While the first problem is inordinately simple to fix by fiat (just legislate a uniform channel code amendable by mutual agreement of the firms) and a regulation to assure interconnecting compatability need not mandate monopoly (the post Bell break-up long-distance telephone competition is all interconnected but not monopolistic), the reality is that firms might broadcast different program menus.

J&B are concerned by the following possibility: "[S]uppose System A received the rights to carry area high school sports; those people on System B would thus be prohibited from watching televised high school sports for that season unless the systems were interconnected" (at 341). Of course, the high schools did not have to restrict their athletic showings to one firm; moreover, under monopoly it might be that no one would get to watch high school sports. One could argue that the competitive pressure moved System A to explore this new product. One cannot assume that, should one firm dominate this market, it would take A's program, rather than B's. It seems quite basic to observe, then, that competition will involve some product differentiation, which is why many consumers would like to have the opportunity to try it out.

(c) The public disruption argument, which J&B fashion so as to encompass consumer confusion as to too many product choices ("Which system is cheaper this week? What services are being offered? Which system provides sports?" [at 341]) can only be taken as an attack on free competition generally. If choices are complicated or confusing, as in many markets, individual buyers commonly come to rely on brokers, agents, or brand names to lower information

costs.[36] Hence, firms compete not only on the product quality frontier, but in the provision of reliable information about their product.

The street disruption issue involves the public domain: "Who wants another thick wire to look at on the city's poles and streets." (id.) Certainly, there exist some external costs to competitive cable investments, but this, again, is hardly unique to the medium. Rival newspapers clutter sidewalks with their newstands, and all genre of new construction (commercial, industrial, or residential) increase the burden on public thoroughfares, conduits, utility poles, on-street parking, and public schools.[37] The costs of growth and competition, however, may be most fairly and effectively dealt with via a system of nondiscriminatory fees: impose private charges on those who impose public costs. A monopolist should also face such charges so as to have an incentive to minimize (down to some "optimal" level of public disruption) its public nuisance factor. Here, too, it appears as though a general social complaint has been summoned forth as a municipal pretext for monopoly-creation.

2. There exists, conversely, an entire panoply of "social and political" considerations suggesting that government not get involved with the issuance of exclusive franchises in cable. Most fundamentally, the idea of city councils licensing any profitable business according to arbitrary political criteria are cause for nervousness; the nervousness turns to acute anxiety

---

[36] See Stigler 1961.

[37] That local governments are quick to seize on externality problems as a reason to exclude new development which threatens vested economic interests, rather than dealing with the external effects, is an established fact of the municipal regulatory game, and is suggestive in our search for an explanation of why monopoly franchises so commonly exist for cable. (For an excellent survey of rent-creation by local governments in the housing market, using environmental concerns as a cover, see Frieden 1980.)

when the business so licensed is an integral part of the press. Indeed, recent court decisions have interpreted the First Amendment as grounds for invalidating the "must carry" rule of the F.C.C.[38] (requiring a cable to re-transmit all local broadcast T.V. signals) as well as a city's right to exclude nonfranchised cable competitors.[39]

This concern is entirely omitted from the J&B defense of franchising. It is, however, a matter of paramount social importance. As Harold Farrow, an attorney who has successfully litigated such important challenges to cable franchising as Community Communications and Preferred, has noted:

> The concept of a licensing process takes us back 300 years to the days of the Tudors and the Stuarts. To the days of "patent" press monopolies and all the grief of a licensed press which we thought we were finished with in the 18th Century . . . What's to be gained by taking us back over 300 years into the past? What's to be gained by creating some 10,000 little city-states around the country with the power to auction off the right to speak, and to still control that right after it has been bought and paid for? (Farrow 1984 at 5, 7).

Farrow argues that giving local politicians control over franchising and re-franchising will chill--or freeze--the adventurousness of the cable press. He borrows from Supreme Court Justice Stevens' League of Women Voters' opinion:

> The court jester who mocks the King must choose his words with great care. The child who wants a new toy does not preface his request with a comment on how fat his mother is. Newspaper publishers have been known to listen to their advertising managers. Elected officials may remember how their elections were financed. (id. at 9; emphasis in text).

---

[38] Quincy Cable TV, Inc. v. FCC, 768 F. 2d 1434 (D.C. Cir. 1985).

[39] Preferred, op. cit.

Certainly our experience with the franchising process in practice highlights the sterility of the franchising theory. Where J&B can summarize the general case for licensed monopoly without direct reference to any single franchise extant, any survey of that phenomenon in action must reveal precisely what Stephen R. Barnett's investigation found early-on in the cable business:

> Slovenly procedures, political favoritism, and the other shortcomings of the franchising process would be expected to produce franchise provisions less than fully attuned to the public's interest in cable television. They generally have. (Barnett 1972 at 694).

While Barnett's lengthy survey had no problem citing instances of illegal efforts to obtain municipal franchises,[40] the more fundamental problem is that the arbitrary political selection process invites subversion of the consumer's interest even where all laws are followed to the letter. One demonstrative instance occurred in Tacoma, Washington, where the city's only newspaper (the Tacoma News-Tribune) was one of two applicants for the City's cable franchise. The battle evolved as follows:

> In its attempt to get the local cable TV franchise, the paper reportedly agreed to hold down on criticism of incumbent officials as they went into last year's elections. A political reporter with a reputation for attacking the local administration was shifted to writing obituaries and innocent features.
>
> After the election, the city split its grant of the franchise between the Tribune and another group. Two days later the Tribune alleged in a front-page expose that the other grantee had improper business ties with a city councilman. Next, the new deputy mayor charged the paper with trying to discredit the other group, and the council withdrew the Tribune's cable franchise. (Barnett at 692 citing Straus Editor's Report [Jan. 24, 1970]).

---

[40] Indeed, the chairman of the largest cable operator in the nation, Teleprompter, was convicted (with the town mayor and others) on federal charges of "buying" the Johnstown, Ohio franchise. Similar scandals had surfaced in at least three New Jersey jurisdictions (Barnett at 691) by 1972.

The Tacoma franchise action was so appalling that, indeed, five city councilmen were recalled in a September 1970 election. Yet, the recall ballot is an inordinately weak weapon on which to pin our hopes for free expression: What if the losing applicant had been other than an institution so powerful as the city's sole daily? And what clout did the other seven nonselected cable applicants have to air their grievances? An open-entry policy has the significant "noneconomic" advantage of removing the state as an arbiter of what communication medium citizens should be allowed to supply or demand.

III. Franchise Cable Monopoly--An Alternative Explanation.

A contrary explanation of monopoly franchising begins with the realization that open competition in cable does not, where permitted, create the anticonsumer consequences predicted by the J&B argument. It then goes on to explore the incentives which political actors possess for imposing monopolistic cable franchises upon consumers on the premise that such monopoly arrangements are anticonsumer.

(1) Review of competitive markets in cable television. While this author has examined direct evidence in a comparison of competitive cable versus monopoly franchise cable elsewhere[41], one conclusion of this research can be inferred from the Touche Ross overbuild data presented in Table 1. The simple fact is that the chaos and anticonsumer consequences predicted by defenders of monopoly franchising simply are not consistent with empirical observation where competition is legally permitted. In fact, overbuild cable rates are below same-state rates, on average in the Table 1 data, an outcome which is consistent with my statistical findings elsewhere. When adjusting for

---

[41]Hazlett 1984, 1985b, 1986.

differences in cost-of-living, number of channels on basic, city taxes and other variables, systems in multiple franchise jurisdictions were found to have rates, for a package consisting of basic and one premium channel, $1.82 a month lower than monopoly franchises--a difference statistically significant at the 97.5 percent level.[42]

Moreover, monopoly franchises inherently involve two major costs to consumers which are wholly overlooked in traditional municipal defenses. First, there is the cost of delaying cable service as the political franchising process is far from instantaneous. Franchise proceedings stretching several years are not uncommon in the industry. This political delay occurs as cable firms, constituencies, and politicians haggle over the precise terms of the arrangement.

Secondly, consumers who face licensed monopoly cable services suffer an inherent loss of flexibility in their options. In such a dynamic, technologically innovative field as cable television, this wedding to a single politically-selected firm may exact a very high price. As new technologies come on-line, monopoly franchising can turn even an initially pro-consumer regulatory regime into a blatantly protectionist measure with clearly detrimental consumer effects.

In fact, not only is the franchise itself an impediment to entry, but local governments come to perceive their interests, once a monopolist is chosen, as tied to that firm's individual welfare. Hence, when SMATV suppliers began wiring high density cable markets (such as large apartment buildings, hotels, hospitals, trailer parks, etc.) in the early 1980s, local governments rushed to ban this competitive entry even when it existed solely

---

[42]Hazlett 1984 at 345.

on private property or involved no public disruption.[43] This reveals that local politicians seek to extend their power over cable operators even where no natural monopoly problem exists (in fact, where any monopoly power is being dissipated), and suggests that efficiently overcoming the market failure inherent in open competition is not the motive force behind the monopoly franchise in cable television.

Given our assumption that individual behavior is governed by rational self-interest, it would be odd, indeed, if political authorities acted to maximize an undefinable "public interest." The realistic alternative is that franchising agents act to create profitable opportunities so as to encourage a political competition in which bidders for the profits pledge to reward selected interest groups. To the extent that cable television franchise agreements are highly complex affairs, and in that consumers have no direct information as to what services--or prices--would be offered to them in the absence of a monopoly franchise contract, political agents are irresistably drawn to the cable franchise as an influence-buying program which rewards incumbents who correctly create and target monopoly profits to the most influential community interest groups.[44] Indeed, those elected officials who refused to deal with powerful constituent groups would very likely be displaced by challengers who had no qualms about dealing with potential

---

[43]See Hazlett 1986. Courts have generally denied local government regulation of cable on private property, but, until the recent first amendment standing accorded cable in Preferred, upheld municipal regulation of systems involving public property.

[44]Transfers to interest groups have three basic forms in the industry. (1) Programming subsidies and channel space for community organizations; (2) Cash grants to community organizations; (3) Stock ownership distributed at below-market prices to community organizations and wealthy political contributors. All three means to achieve political support for a firm's franchise bid are known in the industry as "rent-a-citizen."

monopolists in a manner which made such an agreement lucrative enough (i.e., sufficiently protectionist in raising competitive entry barriers) to justify campaign contributions, payments in-kind and cash from the winning cable franchise to cooperating political interests.[45]

Hence, monopoly-creation makes good political sense. That we see, then, such franchises in cable but not in, say, the supermarket business, is not a product of any economic (namely, scale economies) distinction between franchised and unfranchised industries, but due to the geographic substitutability of the service. For instance, cities routinely regulate local taxi service. Yet, this business has trivial sunk costs[46] and would not satisfy any contemporary definition of naturally monopolistic. The presence of widespread municipal franchising, including highly restrictive licensing which can drive the monopoly rights to drive a cab to up over $50,000[47] is

---

[45]The "requests" of local governments have been a source of great controversy and litigation under the First Amendment. The plantiff's attorney (Harold Farrow) in Community Communications vs. City of Boulder, called them "e-x-t-o-r-t-i-o-n." (Cablevision, Dec. 7, 1981, at 128). Cash grants offer one simple measure of the extent of such demands. In the Sacramento, California franchise (City and County), annual payments to such organizations as the local public television station are in excess of $3.59 million annually (for 20 years). This amounts to virtually one-half of the system's total projected net pre-tax earnings (which average $7.27 million annually), according to the Touche Ross estimate prepared for the City and County. On average, a 1982 Ernst & Whinney study found that typically about 22 percent of franchise revenues (or $5.60 per subscriber per month) went to cover politically-demanded services.

[46]The "contestability" literature correctly identifies fixed costs as those investments which cannot be easily transferred to another market. Since taxis can be "salvaged" from one market--i.e., redeployed elsewhere--at virtually zero cost, sunk fixed costs (e.g., the value of local [non-resellable] street maps) are trivial. Hence, no monopoly element exists and the market is said to be fully contestable.

[47]New York City issued 13,566 taxi licenses in 1937, and has not issued a single "Medallion" since; in fact, approximately 2,000 licenses were withdrawn in World War II and have never been replaced. This has resulted in a market value, for the right to drive a cab, between $67,000 and $74,000. (See Frankena and Pautler 1984, and Eckert 1973).

seen by economists to be a blatant instance of anticonsumer monopoly creation costing cab customers $790 million annually, and depriving the economy of 232,000 jobs. It is unsurprising, then, that this case serves as the text-book example of special interest legislation at the public's expense.[48]

The connection between taxi licenses and cable franchises--and their common distinction from the supermarket business--is that both of the former services are geographically-specific. If a monopoly supermarket franchise was to increase food prices, for example, consumers could easily substitute into food products sold at markets just outside city limits. Hence, any monopoly-creation would be fruitless.

With both cable and taxis, however, consumers require the service to be brought to them. To move to a neighboring jurisdiction is very costly in the case of cable, and self-defeating in the instance of taxi service. In a sense, customers of cable television and taxi-cab service are geographic hostages of whatever firm(s) is (are) licensed by the local government. It is this source of (legal) monopoly power which local politicians alertly exploit in the one set of markets, and not in the other.[49]

---

[48]See e.g., Roger Leroy Miller, Economics Today Fourth Edition (New York: Harper & Row 1982) at 500-2 ("The Creation of Monopoly Profits, or How to Get Taken By a Taxi-Cab"); Donald McCloskey, The Applied Theory of Price (New York: MacMillan 1982) at 314; Robert Main and Charles Baird, Elements of Micro-Economics (St. Paul: West Publishing 1981) at 275-6.

[49]Interestingly enough, federal regulators have come to appreciate the inherent tendency of local government to opportunistically regulate cable television against the consumer's interest. The Federal Communications Commission, concerned with the municipal realization that cable franchises were, as New York Mayor John Lindsay put it, "urban oil wells under our City street" (in Lee 1983 at 896), limited municipal taxes to a maximum of between 3 and 5 percent of gross revenues (47CFR Sec. 76.31), depending upon local circumstances. (The Cable Communications Policy Act of 1984 has now legislated this 5 percent tax cap into statute and bars new franchise agreements from including cash payments to community organizations, as discussed in note 40, supra.)

IV. Conclusion.

That relatively few examples of long-lived cable overbuilds can be found is a product of essentially three factors, none of which support the monopoly franchise conclusion.

First, we may be witnessing the market's efficient allocation of investment capital if, as a general rule, cost conditions are such as to make overbuilds uneconomic. As all duplicative costs are internalized--and not wasted in an externalities sense--they will discipline entrepreneurs to avoid over-investment.

Second, multiple entry is illegal in the great majority of jurisdictions. The expense of challenging such licensing exclusions in court acts as a significant entry barrier.

Third, we may be seeing the effect of a large disincentive to competitive entry: franchising costs. As local governments realize their market power as licensers of legally-protected cable monopolies, they wish to encourage a lively and generous bidding for such economic power. As William Lee points out concerning these latter two entry barriers associated with the municipal franchise:

> The assumption that cable is a natural monopoly permeates the franchising and refranchising process in most communities. Further, this notion has become a self-fulfilling prophecy since most communities fail to award multiple franchises or to encourage entry of new firms. Since communities award only one franchise, they believe that conditions in the form of access channels and rate regulation in exchange for the franchise are necessary. These conditions are very expensive to the consumer. Nonetheless, the awarding of only one franchise enhances the city's power to extract these conditions. Thus bids contain offers that companies would not submit if the city were to award multiple franchises.[50]

---

[50]Lee 1983 at 872-3).

We can also, however, look at it from just the reverse vantage point from that of Professor Lee--and see, perhaps, a more coherent picture. Rather than local governments regulating cable because they are constrained to issue but one franchise, they seek to limit their franchises to one so as to increase their regulatory leverage over cable. By creating market power, and essentially putting the monopoly up for auction, bids from potential suppliers will distribute the resultant supranormal profits to selected interest groups. Indeed, the winning cable franchise is the firm that most efficiently targets its excess profits to influential constituencies.

The average consumer "who cares only about his movies and sports" (as franchising personnel chastize the subsidizer in the cable market) is delivered as a rate-paying hostage to the winning monopolist, in exchange for a lucrative payment scheme to the local government's political allies--or most demanding patrons.

This model of monopoly power, while leading to testable hypotheses that should be explored in further empirical research, has one very large advantage over the J&B view of regulation: it imputes the realities of limited information and rational self-interest to <u>all</u> actors. Rather than creating utopian regulatory schemes whose public officials are assumed to know what's efficient, and assumed to selflessly sacrifice political profits to impose such efficiency, it may be of greater usefulness to public policy to discuss models featuring symmetric assumptions and actual political institutions.

At bottom, open entry and franchise monopoly do not represent the polar positions on a competitive continuum. Both entail vigorous competitive forces. But not all competitive roads lead to the same consumer welfare destination. The selection process of an open market differs in its rivalrous dynamics in marked ways from the selection process of the public franchise

hearing. Whatever our continuing empirical investigations reveal as to the optimal promotion of consumer welfare, our analysis of economic and political markets deserves to be framed in models featuring real economic incentives and real human beings.

References

Allen, David N. and Daniel J. Kennedy. 1982. "Municipal Regulation of Cable Television in the Commonwealth of Pennsylvania" (Pennsylvania State University Institute of Public Administration).

Barnett, Stephen R. 1972. "State, Federal, and Local Regulation of Cable Television," Notre Dame Lawyer 47 (April), pp. 685-814.

Baumol, William J., John C. Panzar, Robert D. Willig. 1982. Contestable Markets and the Theory of Industry Structure (New York: Harcourt, Brace, Jovanovich).

Bork, Robert. 1978. The Antitrust Paradox (New York: Basic Books).

Decker, Cathleen. 1985. "Doing Battle in the L.A. Cable Wars," Los Angeles Times (Oct. 13) at II-1, 10, 11.

Demsetz, Harold. 1968. "Why Regulate Utilities?" Journal of Law and Economics 11, No. 1 (April), pp. 55-66.

Eckert, Ross. 1973. "On the Incentives of Regulators: The Case of Taxicabs," Public Choice 14 (Spring).

Ernst, and Whinney, I. 1982. "The Cost of Cable Television Regulatory and Franchise Requirements: A Preliminary Analysis" (April).

Farrow, Harold. 1984. "Remarks Before the Practicing Law Institute Seminar on Communications Law" (November 8).

Fisher, Franklin M. 1979. "Diagnosing Monopoly," Southern Economic Journal 45, No. 4 (April), pp. 7-33.

Fisher, Franklin M., John J. McGowan, and Joen E. Greenwood. 1983. Folded, Spindled, and Mutilated: Economic Analysis and U.S. vs. IBM (Cambridge, MA: MIT Press).

Frankena, Mark and Paul Pautler. 1984. An Economic Analysis of Taxicab Regulation (Federal Trade Commission, May).

Frieden, Bernard J. 1979. The Environmental Protection Hustle (Cambridge, MA: MIT Press).

Hazlett, Thomas. 1984. "Three Essays on Monopoly," UCLA Dept. of Economics, Ph.D. Thesis.

_____. 1985a. "The Curious Evolution of Natural Monopoly Theory," in Robert Poole, ed., Unnatural Monopolies (Lexington, MA: Lexington Books), pp. 1-25.

_____. 1985b. "Private Contracting vs. Public Regulation as A Solution to the Natural Monopoly Problem," in Unnatural Monopolies, op. cit., pp. 71-114.

_____. 1986 (forthcoming). "Assessing the Efficiency Defense for Public Utility Regulation: Competition v. Monopoly Franchising in Cable Television," in Contemporary Policy Issues (Spring).

Jackson, Charles L. 1985. "Cable and Public Utility Regulation," in Unnatural Monopolies, op. cit., pp. 153-171.

Johnson, Rolland C. and Robert T. Blau. 1974. "Single versus Multiple System Cable Television," Journal of Broadcasting 18, No. 3 (Summer), pp. 323-346.

Kagan, Paul and Associates. 1982. The Kagan Census of Cable and Pay TV (December 31).

Lee, William. 1983. "Cable Franchising and the First Amendment," Vanderbilt Law Review 36, No. 4.

Pearce, Alan, Roger Peterson, Mary Fredrickson. 1982. "Competitive Cable Franchising: Analysis of Economic Theory and Empirical Data," study conducted for the City of Monroe, Georgia.

Posner, Richard. 1972. "The Appropriate Scope of Regulation in the Cable Television Industry," Bell Journal of Economics and Management Science 3 (Spring), pp. 98-129.

_____. 1975. "The Social Costs of Regulation and Monopoly," Journal of Political Economy.

Stigler, George. 1961. "The Economics of Information," Journal of Political Economy LXIX, No. 3 (June).

_____. 1971. "The Theory of Economic Regulation," Bell Journal of Economics and Management Science (Spring).

Touche Ross. 1984. "Financial and Economic Analysis of the Cable Television Permit Policy of the City and County of Denver" (January 20).

Waterson, Michael. 1984. "Issues in the Regulation of Cable TV," International Review of Law and Economics 4, pp. 67-82.

Wines, Michael. 1984. "Cable Companies Fall Victim to Overpromises, Competition for Viewers," National Journal (February 18), pp. 314-319.