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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before The
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992	)	MM Docket 92-266
	)	
Rate Regulation	)	

JOINT COMMENTS OF BELL ATLANTIC,[1] GTE,[2]
AND THE NYNEX TELEPHONE COMPANIES[3]
IN RESPONSE TO FURTHER NOTICE OF PROPOSED RULEMAKING

1. Introduction and Summary

The Commission has asked whether it should exclude the rates of low penetration systems in constructing a competitive benchmark. There is only one sensible answer. Because low penetration systems face no multichannel video competition, and because their exorbitant rates in fact reflect the exercise of market power, the Commission must exclude them from the calculation in order to fulfill its statutory duty of ensuring reasonable cable rates.

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[1] The Bell Atlantic telephone companies ("Bell Atlantic") are The Bell Telephone Company of Pennsylvania, the four Chesapeake and Potomac telephone companies, The Diamond State Telephone Company, and New Jersey Bell Telephone Company.

[2] GTE is the GTE Service Corporation on behalf of the GTE Domestic Telephone Operating Companies and GTE Laboratories Incorporated.

[3] The NYNEX Telephone Companies include New England Telephone and Telegraph Company and New York Telephone Company.

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would both contravene Congressional intent and thwart the FCC's purpose in establishing the benchmark.

Although the statute defines "effective competition" to include low penetration systems, the definition focuses on which cable systems should be exempt from regulation, not on which systems should be included in a competitive benchmark. The exemption does not reflect a determination that low penetration systems lack market power. Rather, its purpose was to minimize regulatory burdens on small and rural operators and on newly built systems in the early stages of development. The cable industry's own witness testified that low penetration implies nothing about the absence of market power, and Congress concurred. It expressly found that only competition from another multichannel video distributor prevents a cable system from exercising market power.

The statutory provision directing the Commission to "take into account" the rates of systems subject to effective competition does not compel the inclusion of low penetration systems in the competitive benchmark. To "take into account" is to consider judiciously, not to apply mechanically. Because the rates of low penetration systems do not reflect the operation of competitive market forces, they <u>must</u> be excluded from the calculation to comply with the statute. Otherwise, the benchmark would confer presumptive validity on cable rates that exceed competitive levels and that allow cable systems to continue exercising market power contrary to the fundamental Congressional purpose.

2. Excluding the Rates of Low Penetration Systems Is Necessary to Protect Consumers From the Exercise of Market Power

Congress determined in the 1992 Cable Act that cable rates had increased drastically and unreasonably following rate deregulation in 1986.[4] The cause of that phenomenon was obvious. Congress found that the vast majority of cable television subscribers "have no opportunity to select between competing cable systems"; that "[w]ithout the presence of another multichannel video programming distributor, a cable system faces no local competition"; and that "[t]he result is undue market power for the cable operator as compared to that of consumers and video programmers."[5] Congress entrusted the FCC with the responsibility to protect subscribers against the exercise of such market power by ensuring that the rates of monopoly cable systems are no higher than they would be in a genuinely competitive marketplace.[6]

With that as its fundamental goal, the Commission determined to use a benchmark approach to cable rate regulation based on competitive rate levels.[7] The benchmark is the level below which a cable system's rates will be

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[4] Cable Television Consumer Protection and Competition Act of 1992, Pub. L. No. 102-385, § 2(a)(1), 106 Stat. 1460 (1992) ("1992 Cable Act").

[5] Id. § 2(a)(2).

[6] Id. § 3(a) (to be codified at 47 U.S.C. § 543(b)(1)).

[7] See Report and Order and Further Notice of Proposed Rulemaking, MM Docket 92-266, ¶¶ 185-88, 205-07 (released May 3, 1993) ("Order").

presumed reasonable. Individual operators can still use cost-of-service principles to justify rates in excess of the benchmark.[8] It is therefore critical for the Commission to avoid setting the benchmark too high. An inflated benchmark will effectively validate rates above the competitive level and will therefore permit monopoly operators to continue exercising market power contrary to the Congressional purpose.

To derive an appropriate competitive benchmark, the Commission conducted a cable industry survey designed to ascertain the average rate differential between monopoly and competitive systems.[9] The issue at this stage of the proceeding is how best to construct the competitive benchmark in light of the survey results and the Commission's statutory mandate.

The survey showed that the rates of systems subject to multichannel video competition were approximately 28% lower than those of monopoly systems.[10] The rates of low penetration systems, by contrast, are every bit as excessive as those of the monopoly systems.[11] Indeed, the average rates of low penetration systems are so significantly higher than those of systems facing multichannel video competition that including them in the calculation of a competitive rate

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[8] Order ¶ 187.

[9] Order ¶ 207 and App. E.

[10] Order App. E ¶ 30.

[11] Id.

level dramatically skews the result, reducing the competitive rate differential from 28% to only 10%.[12]

As the Commission's findings strongly suggest -- and as the accompanying Affidavit of Thomas Hazlett corroborates -- the rates of low penetration systems must be excluded in order to construct a meaningful competitive benchmark. Professor Hazlett's analysis of the survey data shows that the rates of low penetration systems are not only far higher than those of competitive systems, but also 10% higher even than those of monopoly systems.[13] Including in the calculation of a competitive rate level the exorbitant rates of systems in this highest-priced subgroup thus "defeats the purpose of a competitive subsample altogether" and "serves only to dilute the actual price differential between competitive and monopoly cable markets."[14]

Strong empirical evidence substantiates the Commission's view that the low penetration of cable systems is attributable to "factors other than the presence of competing video distribution services."[15] Professor Hazlett conducted a systematic survey of each system in the Commission's low penetration sample. His findings show that "the factors contributing to low penetration . . . are primarily high priced service, incomplete cable plant, and low community

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[12] Order ¶ 560.

[13] Hazlett Affidavit ¶ 10 and Table 2.

[14] Id. ¶ 14.

[15] Order ¶ 561.

demand for cable."[16] Among the principal characteristics of low penetration systems giving rise to low demand for service are "below average income levels, relatively older populations, non-English speaking populations, . . . seasonal fluctuations of population, and reports of poor cable service."[17] Professor Hazlett found "no evidence that competition in the multi-channel video market is a factor."[18]

In these circumstances, where low penetration is attributable to factors unrelated to the presence of competition, incorporating the rates of low penetration systems would grossly distort the competitive benchmark and frustrate the Commission's regulatory objective. The whole purpose of a benchmark is to approximate the rates that would be charged in a truly competitive environment. It is an understatement to say that "excluding the rates of low penetration systems would better reflect competitive rates."[19] Both the Commission's record and Professor Hazlett's supporting evidence demonstrate that the benchmark rate will reasonably reflect competitive levels <u>only</u> if the Commission excludes from its calculation the rates of systems that face no multichannel video competition and whose prices exceed even those of monopoly systems.

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[16] Hazlett Affidavit ¶ 15.

[17] <u>Id.</u> ¶ 26.

[18] <u>Id.</u> ¶ 15.

[19] Order ¶ 563.

3. The Act's Exemption of Low Penetration Systems From Rate Regulation Does Not Imply That Their Rates Should Be Included in the Competitive Benchmark

The focus of the Commission's inquiry in the Further

standard by which cable rates should be regulated.[23] Although the sponsor of that bill believed that low penetration systems would have "little incentive or ability to charge monopoly prices,"[24] testimony in committee hearings refuted the supposed relationship between low penetration and the absence of market power, and Congress eventually rejected that hypothesis.

The cable industry itself exposed the flaw. The President of the National Cable Television Association acknowledged in Senate hearings that he did "not want to get into defending the logic" of the low penetration exemption "because I do not understand the logic of it."[25] He explained:

> If you have more than 50 percent penetration it may be simply as a result of providing good service, offering a good programming lineup and doing good marketing. There is nothing to say that above or below 50 percent, or for that matter any number arbitrarily chosen, is indicative of anything with respect to market power or competition.[26]

Congress ultimately agreed. It expressly repudiated the original rationale for the exemption, finding without

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[23] S. 833, 101st Cong., 1st Sess. § 3 (1989); see 135 Cong. Rec. 7006-09 (1989) (statement of Sen. Metzenbaum).

[24] 135 Cong. Rec. 7008 (1989) (statement of Sen. Metzenbaum).

[25] Cable TV Consumer Protection Act of 1991: Hearing on S. 12 Before the Subcomm. on Communications of the Sen. Comm. on Commerce, Science, and Transportation, 102d Cong., 1st Sess. 193 (1991) (testimony of James P. Mooney).

[26] Id. at 193-94.

market power vis-a-vis . . . consumers."[30] Incorporating the rates of systems that face no multichannel video competition would contaminate the benchmark, introducing a non-competitive distortion that would perpetuate rather than eradicate the rate abuses attributable to undue market power.

4. The Plain Language of the Act Gives the Commission Ample Discretion to Exclude the Rates of Low Penetration Systems

The statute directs the Commission to "take into account" (among other factors) the rates of systems subject to "effective competition."[31] That provision plainly gives the Commission discretion to exclude from the benchmark the rates of systems that exercise market power. Any other interpretation would disable the Commission from fulfilling its responsibility to rid cable rates of the influence of market power.

The key statutory phrase is "take into account." The Act instructs the Commission to consider each of the specified factors. No part of the provision implies that the agency must check its critical faculties at the door. On the contrary, "take into account" is language of discretion and judgment. The phrase plainly denotes a balancing and evaluative process calculated to achieve the overriding Congressional goal of ensuring that cable rates are reasonable. An uncritical acceptance or mechanical

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[30] 1992 Cable Act § 2(b)(5).

[31] 47 U.S.C. § 543(b)(2)(C)(i).

application of any factor would be unfaithful to the express statutory command.

Judicial interpretations of similar language in other statutes confirm the plain meaning of this provision. The D.C. Circuit has held repeatedly that, when an agency is required to "take into account" certain factors, it need merely "reach an 'express and considered conclusion' about the bearing of [each factor], but need not give 'any specific weight' to [a particular] factor."[32] So long as the agency "inform[s] itself" about the matters that Congress specified, it can dismiss any enumerated factor if it does "not consider it significant."[33] Obviously, if a factor may be disregarded entirely, it may also be modified or qualified in light of the agency's expert judgment and in furtherance of the statute's governing policies.

Those principles apply with full force to this proceeding. Given the results of its industry survey, the Commission properly and responsibly "takes into account" the rates of systems subject to "effective competition" when it determines that the rates of one subgroup of those systems must be excluded in order to calculate a meaningful competitive rate level consistent with the statutory objective. Certainly nothing in the text of the statute

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[32] Small Refiner Lead Phase-Down Task Force v. EPA, 705 F.2d 506, 516 (D.C. Cir. 1983) (quoting Weyerhaeuser Co. v. Costle, 590 F.2d 1011, 1045 (D.C. Cir. 1978)).

[33] BASF Wyandotte Corp. v. Costle, 598 F.2d 637, 662, 663 (1st Cir. 1979), cert. denied, 444 U.S. 1096 (1980).

requires the Commission to blind itself to the facts. Congress deliberately chose not to legislate a specific formula for rate reasonableness that would have deprived the Commission of discretion. It chose instead to rely on the FCC to devise a mechanism for keeping cable rates at a competitive level free of the distortions of market power. The statute's use of the phrase "take into account" reflects that decision.

Fidelity to its statutory mission therefore both permits and requires the Commission to eliminate low penetration systems from the competitive benchmark. Having learned from its survey that the rates of such systems greatly

Respectfully submitted,

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June 17, 1992

Before the
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Washington, D.C. 20554

In the Matter of	)	
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Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992 Rate Regulation	))))	MM Docket 92-266

AFFIDAVIT OF THOMAS W. HAZLETT

Thomas W. Hazlett deposes and says:

1. I am an Associate Professor at the University of California, Davis, where I teach economics and public policy. During the 1991-92 academic year I served as Chief Economist of the Federal Communications Commission. During the 1990-91 academic year I was a Visiting Scholar at the Columbia Institute for Tele-Information at the Columbia University Graduate School of Business.

2. I received my Ph.D. in economics from UCLA in 1984 and have taught a variety of courses in microeconomics, finance, and public policy at the graduate and undergraduate levels. I have researched and written numerous academic articles on competitive and regulatory issues in the cable and broadcast television industries. The Appendix to this Affidavit includes a list of my publications relevant to this affidavit.

3. The Commission has decided in its initial Order in this proceeding to establish benchmark prices for "competitive" cable systems. The benchmark is to be the level below which prices in

monopoly systems are presumed to be reasonable.[1] Cable systems charging higher rates are required to justify those rates by reference to the actual cost of providing service.

4. The 1992 Cable Act expressly exempts systems with a penetration of under 30 percent from rate regulation.[2] The Act does not, however, direct that the prices charged by those systems be considered by the Commission as benchmarks for "competitive" rates. The Act's stated purpose is to protect consumers from the exercise of market power by cable operators. The Commission has elected to set regulated rate "benchmarks" according to the difference-- in today's marketplace-- between prices charged by competitive versus monopoly systems.

5. The Commission has asked for comment on how best to estimate the prices charged by "competitive" systems.[3] My comments address the relevance of data from "Type A" -- low

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[1]In my view, the Commission's undertaking to regulate price using a benchmark approach will create enforcement difficulties. Cable operators can readily (for example) reduce the average price charged per channel by adding additional channels that offer programming of little value to consumers. For a further discussion of these issues, see Hazlett, *The Demand to Regulate Franchise Monopoly: Evidence from CATV Rate Deregulation in California*, ECONOMIC INQUIRY XXIX (April 1991); *Cable Reregulation: The Episodes You Didn't See on C-SPAN*, REGULATION (Spring 1993 Forthcoming).

[2]Cable Television Consumer Protection and Competition Act of 1992, at §623(l)(1)(A), Pub. L. 102-385, 106 Stat. 1460, 1470 (Oct. 5, 1992) (hereinafter 1992 Cable Act).

[3]Report and Order and Further NPRM at 348, ¶562, *In re* Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, Rate Regulation, MM Dkt. 92-266 (F.C.C. Apr. 1, 1993).

penetration -- systems in estimating competitive prices.[4] Attached to my comments is a summary of a survey which was conducted to identify the factors which contributed to the low penetration rates reported by Type A systems. The results of this study, in conjunction with the FCC's cable rate survey, show clearly that the low penetration rates found in these systems are attributable to factors other than the presence of competing multi-channel video service providers. As discussed further below, Type A systems are not competitive in any relevant economic sense.

A. Defining and Measuring Penetration

6. The Commission must recognize first that cable operators face a strong incentive to under-report their penetration rates, either by undercounting the number of homes that do subscribe or by overcounting the number of homes that don't. This is because the 1992 Act exempts low penetration systems from regulation.[5] In fact a number of local cable administrators stated that their own records revealed penetration rates above 30 percent or expressed misgivings about the reported rates. Such anecdotal responses are not, of course, sufficient to quantify how much (if any) misreporting has occurred, but the

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[4]Cable systems that face head-to-head competition are referred to as Type "B" systems in the FCC survey. Municipal overbuilds are labeled "C."

[5]1992 Cable Act §623 (a)(2).

Commission must bear in mind that at least in some cases low penetration figures may reflect no more than a cable operator's determination to escape FCC regulation.

7. The Commission must likewise recognize that the Act's definition of "penetration" cannot be reconciled with the search for truly competitive service areas. "Penetration" is normally defined in franchise agreements, as well as in industry parlance, as number of subscribers divided by homes passed by cable. The

density, so that high priced alternatives (like satellite dishes) make more economic sense than cable for many residents in the area.

9. Fully 20 of the 79 Type A systems that the Commission has identified are not, in fact, "low penetration" in the usual meaning of that term. In fact, those 20 systems have penetration rates ranging from 30.2% to 91.3% of homes actually passed. See Table 1. Even when effective competition is defined as existing wherever cable penetration falls below 30 percent, there is still no plausible rationale to presume that the cable prices in these 20 systems are "competitive." Rather, the real question is why such a disproportionate number of homes in the service area have no cable service available to them at all.

B. High Price as a Cause of Low Penetration

10. As shown in Table 2, the average price per channel for first and second tier service[7] charged by Type A systems is 10 percent higher than it is for monopoly systems and a full 62 to 74 percent higher than it is for overbuilt (Types B and C) systems.

11. These differences would be inexplicable if low penetration really reflected competition. Types B and C systems

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[7]Because cable operators define "basic" service differently, the combination of Tier 1 and Tier 2 services, often referred to as "expanded basic," yields a more representative sample of common cable service than Tier 1 alone.

are indisputably competitive. If Type A systems were competitive too, they should be charging much the same prices, and both should be charging well below the monopoly systems. But in fact, prices charged by the Type A systems are even higher than in the monopoly systems.

12. There is thus strong evidence to conclude that low penetrations in the Type A systems do not reflect competition, but its precise opposite -- penetration is relatively low because prices are relatively high, even higher than those charged by indisputably monopolistic systems. These high prices may actually cause the low penetration. If these systems in fact faced effective competition, one would expect that more elastic firm-demand would depress both price and penetration. That is not what one finds in the FCC survey data.

13. Type B systems charge about 32 percent and Type C systems charge 37 percent less than monopoly systems.[8] See Table 2. Averaging in the Type A systems narrows this gap to a mere 10 percent.

14. It would be completely inappropriate for the Commission to include in a benchmark calculation of "competitive" systems prices that exceed even the average prices charged by monopolistic systems. Including this high-priced subgroup defeats the purpose of a competitive subsample altogether because it serves only to dilute the actual price differential between

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[8]In using its regression method the FCC found price discounts of 27 percent for Type B systems and 30 percent for Type C systems.

competitive and monopoly cable markets. In fact, if the prices charged by the Type A systems were even higher, or if Type A systems were more numerous, the result could be a "competitive benchmark" rate above the monopoly rate. This would clearly be nonsensical.

C. Other Non-Competitive Factors that Lower Penetration

15. Empirical evidence strongly supports the view that factors other than the presence of competition account for the low penetration in Type A systems. These factors were identified through a telephone survey of system operators and franchising authorities in communities served by Type A systems. The interviewees were asked directly for factors accounting for the low cable penetration in their service areas. Their explanations were then examined against census data as summarized in the attached Appendix.[9] The results of this systematic survey strongly support the view that the factors contributing to low

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[9]Demographic data are from the National Planning Data Corporation (based on the 1990 Census) and are available for 75 of the 79 systems in the Commission's sample. Four systems failed to supply sufficient information on the FCC survey to determine the appropriate geographic unit involved. Also excluded from the aggregate analysis are three additional systems from Puerto Rico since the Census Bureau does not use Puerto Rican data in its calculation of national figures. The elimination of these three additional systems reduces the number of systems in the study to 72. Elimination of the four systems for which insufficient information was given is random and would not affect the validity of the sample. Elimination of the three Puerto Rican systems would, if anything, tend to decrease the aggregate results for such variables as income and population density.

penetration in these systems are primarily high priced service, incomplete cable plant, and low community demand for cable. For this group generally there is no evidence that competition in the multi-channel video market is a factor. In fact, in the FCC's survey only four of the 79 low penetration systems cited the existence of multi-channel competitors in their areas. The demographic factors that do contribute to low penetration, in addition to high price and unbuilt cable plant, are surveyed below.

16. Many Type A systems simply operate in unusually poor areas where demand for cable is likely to be very low. For example, Rhonda Andrews of Houston's Rate & Regulatory Affairs Office is charged with overseeing the system operated by the Meca Corporation on the Southeast and Northeast sides of Houston. She described these systems as operating in "low income areas [which] have had a lot of problems with collections." The City Clerk in suburban Kinloch, Missouri, echoed these observations, saying that the only reason she could give for low penetration was the fact that many residents probably could not afford service. Mayor Billy Graeter speculated that the low penetration rate of the system in Fayetteville, Texas, is due at least in part to the fact that the community is composed of "mostly older people" who simply "can't afford it."

17. Demographic data bear out these impressionistic reports. The median household income for the nation as a whole was $30,056 in 1992. By comparison, the unweighted average of

the median household incomes for the 72 Type A systems was $27,338[10]; 13 of these systems had median incomes below $20,000.[11] See Table 3.

18. Another reason frequently offered for low penetration rates by those interviewed was that the population in the service area was elderly. Mike Zibrowski, the Controller of Hamtramck, Michigan, described Omnicom's potential subscribers as mainly older residents who "really don't have any use for cable." Similarly, the City Administrator for Johnson County, Texas, which is served by Willow Park Cable, stated that although it was a "wealthy community," many of the residents were "retired folks" who had concluded that the service "is not worth the money."

19. It is well known among cable industry marketing personnel that the best cable markets feature families with children; older consumers tend to be more modest users of cable services, possibly because they did not grow up in the Television Age and simply have a lesser preference for the service. The average age of residents in the Type A areas is well above the national average. The median age of heads of household in the United States for 1992 was 44.9 years. Over three quarters of the Commission's Type A systems have a higher median age than that. The median age for all the Type A systems together (an

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[10]Half of these systems have median household incomes below $26,101.

[11]The income figures of the three franchise areas in Puerto Rico would reduce the median household income of the sample by approximately $700.

unweighted average of the median ages) is 49 years. In 32 of the Type A systems, the median age is over 50 years. Two systems have median ages above 65 years. See Table 4.

20. Some interview respondents cited seasonal fluctuations as the reason for low cable subscribership. Glenn Gimbutt, City Attorney for Apache Junction, Arizona, speculated that one of the reasons for Triax Midwest's low penetration rate was the seasonal nature of the town's population, which triples for six months of the year: "If you count only permanent homes, the penetration rate is above 30 percent. But if you count the mobile homes and park model recreational vehicles, the rate is below 30 percent." John LaPoint, the Town Supervisor in Putnam, New York, cited a

to lower demand for cable subscriptions. Due to data difficulties, information on service quality was excluded from the FCC survey. Yet, in the attached telephone survey, local officials in Type A communities repeatedly cite customer dissatisfaction as an explanation of low subscribership.

23. The telephone survey pointed out that several communities experienced low penetration due to language differences. Where a high percentage of a community's residents do not speak English, demand for (English language) cable programming services is logically below that experienced in other communities.

24. Finally, new systems which have not yet been fully marketed may be expected to have low penetration. Typically, newly built cable systems register significant penetration gains over a three- to five-year period, after which system maturity occurs and subscriber gains tend to level off. Hence, recent cable builds may report low penetration simply because they are in the earliest stages of a cable system life cycle.

Conclusion

25. The Commission has specifically asked for comment on whether the inclusion of high priced Type A systems in the "competitive benchmark" sample makes sense. All the evidence indicates that the Type A Systems in the FCC's database do <u>not</u> face competition sufficient to suppress prices below monopoly