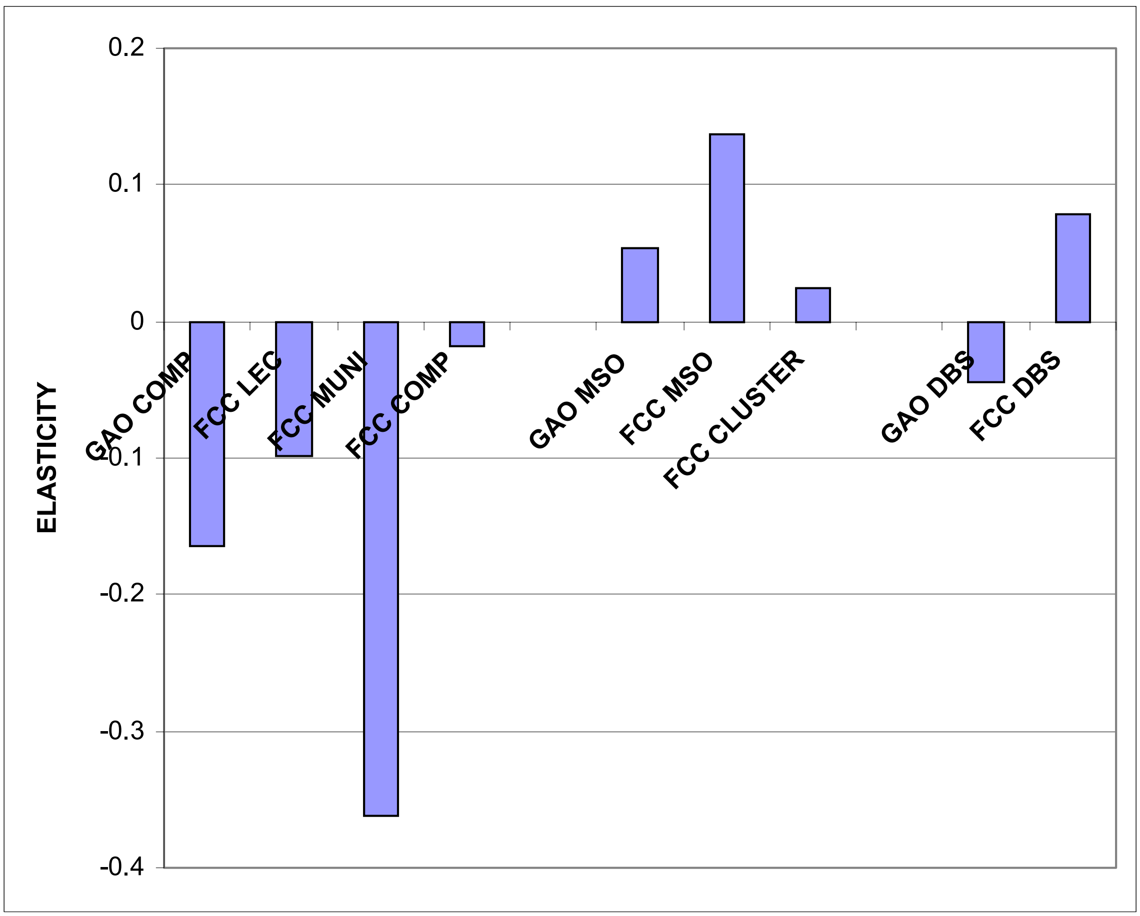
The critical first question that must be answered is simple – is there evidence that market power is being exercised on the supply side? The GAO provides an affirmative answer. The GAO report affirms each of the supply-side problems of the multichannel video market that has afflicted the American public since the industry was prematurely deregulated in 1984 and further deregulated in 1996. Exhibit 1 shows the price elasticities for dummy variables measuring various markets structural characteristics that affect the extent of competition included in the regression analyses conducted by the GAO and the FCC.

EXHIBIT 1:
IMPACT OF MARKET STRUCTURE CHARACTERISTICS ON MONTHLY RATES
(Regression Coefficients, dummy variables)



Sources: Federal Communications Commission, *Report on Cable Prices,* April 4, 2002, Attachment D-1; General Accounting Office, *Issues Related to Competition and Subscriber Rates in the Cable Television Industry,* October 2003, Appendix IV, Table 3.

GAO's Video Horizontal Market Structure Analysis

Head-to-head, wireline competition is the only market structure feature that disciplines monopolistic pricing. In its most recent report the GAO finds that head-to-head competition between cable operators lowers prices by 15 percent for basic and expanded basic service. Its earlier report had found a 17 percent difference. Well-specified econometric models have consistently found this to be the case. FCC analyses, which identified three types of head-to-head competitors (public, local exchange carriers, and other overbuilders), also find large price effects from head-to-head competition.

Unfortunately, only about 2 percent of American households enjoy the benefit of head-to-head, wireline competition. The result is an abuse of market power that costs the American public about $4.5 billion per year in cable rates alone.[1] This is a rather large iceberg submerged in the industry analyses.

Bigger monopolies are worse when it comes to consumer prices. In the GAO analysis, if a cable system is part of a large national operator, its prices are 5.4 percent higher than if it is not. The GAO called this horizontal concentration. Well-specified econometric models have been finding this to be the case for several years. The FCC has found even larger effects of being part of a multiple system operator (MSO). When the FCC models add in a specific variable for regional clustering, a dramatic trend in the industry, they find that clustering has an added effect of further raising price. Being served by one of the mega-multiple system operators who have been expanding their grip on the industry through mergers and clustering drives prices higher by more than 5 percent and perhaps as much as 8 percent. Thus, there could be as much as an additional $1.5 billion in consumer savings that could be wrung out of the cable market if it were deconcentrated.

The important implication here is that the theory under which the large cable operators were allowed to become larger is not supported by the empirical evidence.[2] That theory involved

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[1] I assume that 98 percent of cable subscribers lack head-to-head competition (Federal Communications Commission, *In the Matter of the Annual Assessment of the Status of Competition in the Market for Delivery of Video Programming: Ninth Annual Report,* MB Docket No. 02-145, December 31, 2002, para. 115) and 90 percent of those take expanded basic service (Eisenach, Jeffrey A. and Douglas A. Truehart, *Rising Cable Rates: Are Programming Costs the Villain?*, supported by ESPN, Inc., October 23, 2003 (hereafter ESPN), p. 2). Therefore, 62 million cable households are the victims of abuse of market power. Their bills could be reduced by $8 per month as a result of genuine head-to-head competition and deconcentration of the industry.

[2] Thus, Comcast (Katz, Michael, *An Economic Analysis of the Claims made by Dr. Mark Cooper in "Cable Mergers, Monopoly Power and Price Increases,"* Commissioned by Comcast Corporation, July 28, 2003) has failed to notice the consistent empirical evidence that finds size and clustering increase prices, contradicting their claim that (pp. 18-19) "there is no reason to think that consolidation of cable ownership at the national level will affect actual competition among cable system operators. Although Dr. Cooper makes a passing reference to a 'tight national oligopoly,' the notion of an oligopoly, tight or otherwise, has no economic meaning if the firms do not compete with each other." There is very good reason to reach this conclusion, the empirical reality of the cable industry. Cable industry experts find that mergers of some monopolists matter (John B. Hayes, Jith Jayaratne, and Michael L. Katz, *An Empirical Analysis of the Footprint Effects of Mergers Between Large ILECS,* April 1, 1999, p. 1; citing "Declaration of Michael L. Katz and Steven C. Salop," submitted as an attachment to *Petition to Deny of Spring Communications Company L.P,* in *Ameritech Corp. and SBC Communications, Inc., for Consent to Transfer of Control*, CC Dkt. No. 98-141 (filed Oct. 15, 1998) and *Petition to Deny of Spring Communications Company L.P,* in *GTE Corporation and Bell Atlantic Corporation for Consent to Transfer of Control*, CC Docket. No. 98-184

the claim that the combination of larger, clustered systems would create efficiency-based cost savings that would be passed on to the public because one big monopolist is no worse that two, contiguous smaller ones. Under this theory, the fact that cable operators never compete with one another has been twisted into a perverted justification for allowing them to merge. Since they never compete, the argument goes, where is the harm? The econometric evidence suggests that there is considerable harm.[3]

Intermodal competition – between cable and satellite – does not effectively discipline cable's pricing power. In contrast to head-to-head competition, which lowers cable bills by $5 per month, competition from satellite lowers bills by a mere $.15, according to the GAO. In other words, head-to-head competition is almost 40 times as effective as intermodal competition when it comes to price. In fact, in the GAO report, even satellite's very modest pricing effect is not statistically significant by traditional standards. It failed at the 5 percent level of significance. The FCC's econometric analysis did not find even this small price effect. In fact, it finds a statistically significant effect in the opposite direction.

To the extent that satellite has any competitive effect, it drives cable operators to offer more channels, but this effect stems from the decision of satellite to offer local programming.[4] Where satellite offers local programming, cable operators offer about 5.4 percent more cable channels. The consumer advocate view of satellite as a niche product that cannot discipline cable pricing abuse for the vast majority of cable subscribers who take only basic and expanded basic is supported by these results.

Exhibit 2 explores the implications of the most recent econometric findings on horizontal market power. Using the traditional measure of market power and the standard measure of the pricing abuse that results – the Lerner index – they explore the relationship between the number and size of firms in cable markets and the mark-up of price over cost. The econometric estimate of a 20 percent mark-up is consistent with, even a conservative estimate of ,the pricing power suggested by the market structural conditions (demand elasticity and market shares) implicit in both the GAO and the FCC analyses. The iceberg is quite large.

(filed Nov. 23, 1998)) and that size and alternative distribution opportunities affect bargaining (see Rogerson, William P. " A Further Economic Analysis of the News Corp. Takeover of DirecTV, *In the Matter of General Motors Corporation, Hughes Electronics Corporation, and the News Corporation Limited Application to Transfer Control of FCC Authorizations and Licenses Held by Hughes Electronics Corporation to the News Corporation Limited,* MB Docket NO. 03-124, August 4, 2003.

[3] It turns out that large operators and clustered systems have more muscle to thwart competition and impose price increases. They can distribute programming terrestrially and extract exclusivity deals from independent programmers, thereby denying programming to competing distribution media (overbuilders and satellite). They have more leverage over local governments to obstruct the entry of overbuilders. The fact that they never compete can be attributed to weak-kneed competition policy, not strong economic efficiency. If they knew they could not grow through mergers, and they really cared about size so much, they might compete by overbuilding one another (Cooper, Mark, *Cable Mergers and Monopolies: Market Power in Digital Communications Networks* (Economic Policy Institute, 2002)).

[4] Comcast, which has a clear interest in weakening any competitor for cable, ignores this fact when it criticizes consumer advocates for calling for approval of the Echostar/DirecTV merger with conditions (p. 19). A primary purpose of the merger was to strengthen the ability to deliver local into local by affording satellite sufficient transponder capacity.

EXHIBIT 2:
Comparison Of Empirical Estimate Of Mark-Up Using Alternative Measures Of Concentration And Dummy Variables

SOURCE	CONCENTRATION MEASURES		
	Non-competitive	Competitive	$\triangle$ L
FCC (E_d = 2.2)	n = 2	n = 3	
	22.7	15.2	- 7.5
	HHI = 6800	HHI = 3912	
	45.1	17.8	-27.3
DIRECT ESTIMATE			
Head-To-Head			- 9.1
Concentration			-25.6
Total			-34.1
GAO (E_d = 1.54)	n = 2	n = 3	
	32.5	21.2	-11.2
	HHI = 7312	HHI = 3418	
	47.4	22.2	-27.3
DIRECT ESTIMATE			
Head-To-Head			-15.1
Concentration			- 5.4
Total			-20.5

Sources: Federal Communications Commission, *Report on Cable Prices,* April 4, 2002, Attachment D-1; General Accounting Office, *Issues Related to Competition and Subscriber Rates in the Cable Television Industry,* October 2003, Appendix IV, Table 3. Viscusi, W. Kip, John M. Vernon and Joseph E. Harrington, Jr., *Economics of Regulation and Antitrust* (Cambridge: MIT Press, 2001), pp. 102-108, 147-149, 258-259. Lerner Index:

$$L = \frac{1}{n} * \frac{1}{E_d} \quad \text{(Cournot Oligopoly)}$$

$$L = S_i \frac{(P_m - MC)}{P_m} = \frac{HHI}{10000} * \frac{1}{E_d} \quad \text{(Nash Equilibrium)}$$

GAO'S VIDEO VERTICAL MARKET STRUCTURE ANALYSIS

Vertical relationships are exploited by cable operators. GAO finds that cable operators are majority owners of one-fifth of the top 90 national networks. The GAO does not find price discrimination but it does find discrimination in carriage. That is, cable operators do not pay themselves more for their own shows, but they are much more likely to air them. The effect is quite large. Cable operators are 64 percent more likely to carry the programming in which they have an ownership stake. Cable operators who have a stake in programming also carry fewer channels overall. This result is consistent with prior academic studies.[5]

The picture that emerges in terms of vertical integration is the one we have painted for several years. While no cable operator had pricing power in the programming market until recently, they do have a substantial stake.[6] A one-fifth share of the most popular programs is a very substantial stake in the programming market and it blunts their incentive to resist price increases. Cable operators own minority stakes in other networks. With their market power at the point-of-sale, cable operators know that they can pass the costs through to consumers and they can assure that their own programs are carried much more frequently than those of others, thereby gaining a disproportionate share of the overall increase in programming costs.

Rights of carriage matter a great deal in the cable industry. The decision of Congress to give broadcasters must carry/retransmission rights has enabled the broadcasters to gain a significant advantage for their programming, in terms of carriage. Programs owned by broadcasters are 41 percent more likely to be carried by cable operators. Clearly, independent programmers are at a severe disadvantage, as has been demonstrated time and again. Although the GAO report concludes that 38% of the cable networks are majority owned by non-cable, non-broadcast firms, a much smaller percentage, less than 20 percent, do not have a least some minority ownership of broadcasters or cable operators.

GAO'S ANALYSIS OF HIGH SPEED INTERNET AND ADVANCED SERVICES

The cable industry is extending its market power to high-speed Internet services. The GAO report also affirms the dramatic entry of cable operators into the provision of Internet services and underscores our observation that one must consider all costs and all revenues when evaluating industry performance.[7] Since the upgrade of the plant supports other streams of revenue, the GAO cautions:

> First, depreciation expenses (and therefore infrastructure investment) represent a joint (or common) expense for both video-based and Internet-based services.

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[5] See Cooper, 2002, pp. 44-47.

[6] The one cable operator that appears to have pricing power in the programming market is Comcast, which is exercising market power not as a program producer/owner, but as a buyer of programming (Fabrikant, Geraldine and bill Carter, "Cable's New Giant Flexes His Muscles," *New York times,* October 20, 2003). Having achieved a large enough market share, it now has monopsony power over sellers of programming. Comcast is squeezing programmers to lower their fees, at the same time it is announcing price increases for basic and expanded basic that equal or exceed historic levels. It is both reallocating rents from programmers to itself, which is consistent with the Cox argument, and increasing the rents collected from consumers, which is not consistent with the Cox argument.

[7] Cooper, 2002.

Because these expenses are associated with more than one service, it is unclear how much of this cost should be attributed to video-based services. Second, cable operators are enjoying increased revenues from these non-video sources.[8]

The same is true for operating expenses. A large part of the increased expense is associated with the selling and servicing of advanced video, Internet and telephone service "have been spread across the entire revenue base – i.e. they are reflected in the prices paid by basic cable subscribers."[9]

Looking at a short period, 1999 to 2002, the GAO finds that revenues from Internet services alone are already almost equal to the increased depreciation expense of the cable plant upgrade. The GAO estimates that capital costs (depreciation expenses) have increased by $80 per subscriber, while Internet-only revenues increased by $74.[10] The GAO did not break out the revenues from advanced video services that are also made possible by the upgrade. Since penetration of high speed Internet is in its early stages, and advanced video services have not yet fully penetrated, cable operators are set to reap huge profits as advanced digital video and Internet services penetrate the market. Thus, while the GAO econometric analysis paints a clear picture of the effects of multichannel video industry market structure on consumer prices and quality, it presents a partial picture and chooses a very short time frame, 1999 – 2002, which misses critical factors.[11]

First, the upgrade of the cable plant began well before 1999, as did the post-1996 Act rate increases. By 1999, the cable industry had already upgraded one-third of its plant. Rates for basic+ expanded service had already increased by 50 percent and net operating income (operating revenue minus operating costs) had increased by over 25 percent. In fact, just one year after the passage of the Telecommunications Act of 1996, the issue of cable rate increases had already arisen. The FCC's cable price report noted that "the Cable CPI increased at a 3.7% compound annual rate from January 1995 to December 1995, and at a 8.5% compound annual rate for the eleven months from January 1996 to November 1996."[12] The song and dance about the causes of the increases had already begun, when the Commission declared:

> we note from anecdotal evidence reported in both the trade press and the general news media that cable operators have attributed the recent increases in cable rates to higher programming costs, system upgrades which provide additional channels, and the pass through of the effects of general inflation on operators' costs.[13]

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[8] GAO, p. 27.

[9] ESPN, p. 9.

[10] Cox critics ESPN for comparing current revenues to total capital, a criticism that applies to Comcast even more forcefully, since ESPN at least reports annualized increases in debt costs, whereas Comcast provides no similar calculation. ESPN/s reporting of debt service misses the point, however, since part of the debt was incurred to fund acquisitions, not capital expenditures.

[11] Comcast and ESPN also focus on a short time frame.

[12] Federal Communications Commission, *Report on Cable Prices*, In the Matter of Implementation of Section 3 of the Cable Television Consumer Protection Act of 1992, Statistical Report on Average Rates for Basic Service, Cable Programming and Equipment, MM Docket No. 92-226, January 2, 1997, p. 7.

[13] Id., p. 7.

Second, the GAO report does not examine all of the revenues and costs consistently, since it never factors in advertising revenue. It appears to underestimate an important source of revenue, digital tier revenue, and an important cost stream, non-programming operating expenses. Moreover, the upgrade of the physical plant was largely complete by year-end 2002 (80 percent) and capital outlays dropped off dramatically in 2003. In other words, capital costs are set to decline sharply, while revenues from the services that are supported by those capital costs are increasing sharply. For these reasons, the GAO analysis is partial, at best, and may give a distorted picture of video service profitability.