

The Case for Competition and Effective Rate Regulation

Testimony

of the

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On behalf of

NATIONAL ASSOCIATION OF COUNTIES

AND TELECOMMUNITY

Before the

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INTRODUCTION

Good Morning Mr. Chairman, Senator Hollings and Members of the Committee. My name is Marilyn Praisner. I am a member of the County Council of Montgomery County, Maryland. I am testifying today as the Chair of TeleCommUnity and the Chair of the National Association of Counties' Telecommunications & Technology Committee. TeleCommUnity is an alliance of individual local governments and their associations, which seeks to refocus attention in Washington on the principles of federalism and comity for local governments' interests in telecommunications. NACo is the national association of the nation's 3,066 counties and seeks to ensure county officials' voices are heard and understood in the White House and the halls of Congress.

I. ONLY REAL COMPETITION RESULTS IN LOWER RATES.

Mr. Chairman, in response to the GAO's cable rate report, you are quoted as stating:

"Consumers in the few markets with a choice of a second cable company pay 15 percent less for cable. The apparent implication for all other consumers is that they continue to be fleeced by their cable operators.¹"

We agree with your conclusion and thank you for the invitation to testify this morning.

In my testimony I seek to impart four thoughts:

- Local governments agree with you that only real competition creates downward pressure on rates –and real competition for cable exists only when a second wireline provider is present.
- Local rate regulation was thought to be a substitute rate restraint in the absence of competition, but FCC actions have frustrated rate regulation efforts by local franchising authorities. In addition, there are real limitations found in the Telecommunications Act which limits regulation to the basic programming tier. For example, were a local government to determine that an operator's basic rate was above that set by a competitive market, operators can limit choices on the regulated tier and move attractive programming to an unregulated tier. The result being that subscribers pay the higher rate selected by the operator.
- A la carte pricing could be a definite improvement over the current tier pricing system if it provides consumers direct control and choice over the channels they buy and the content that is coming into their homes while avoiding price manipulations by the cable operator.
- A la carte pricing is not, however, a solution to the real problem with cable--the lack of effective competition in the transmission platform. This monopoly transmission ownership gives the cable operator monopoly pricing power over the consumers and monopsony pricing power over the programmer.

¹ Frank Ahrens, **GAO Suggests Competition Good for Cable** Washington Post, October 25, 2003.

II. WITHOUT WIRELINE COMPETITION, CABLE RATES WILL CONTINUE TO RISE.

Two studies, one conducted by the GAO at the request of this Committee, and a second study done by the FCC, have independently documented that cable rates are lower in areas where a competing cable service is available from a second wireline provider. The GAO study found cable rates to be 17% lower, and the FCC found rates were 8% lower. The challenge arises in that according to the FCC, only 2% of the 33,246 cable communities have overbuild cable competition, and it appears that the cable industry intends to keep it that way.

The GAO found that the seven largest cable operators serve 83.8% of all cable subscribers and the top seven do not compete against each other in any market. These numbers take on even greater meaning when the size of incumbent MSO and competitors are compared. The total subscriber counts of the three largest overbuild/competitive cable operators combined serve only slightly more than half the number of subscribers of Mediacom, the seventh largest MSO. The competitive cable operators together serve less than four percent of the number of subscribers Comcast serves. Comcast is the nation's largest cable operator with over 21 million subscribers.

The National Association of Telecommunications Officers and Advisors, the association that represents local cable regulators, testified before the Senate Judiciary Subcommittee on Antitrust, Competition and Business and Consumer Rights on February 11, 2004. In that testimony, NATOA ratified the findings of the FCC and GAO, described in detail various problems that have prevented the success of cable overbuilds, and pointed to specific legislative changes that might open the door to more overbuilders. However, experience with overbuilding makes local government believe that competition will continue to be scarce.

- **Direct Broadcast Satellite (DBS) Service Does Not Constrain Cable Rates.** While the cable industry has touted the threat posed by DBS, both the GAO and FCC in their research failed to conclude that DBS competition has a limiting effect on cable rates. The National Cable Television Association (“NCTA”) claimed otherwise to the FCC, stating that cable's market power is restrained to the extent that there are competitive alternatives available to customers if a cable operator attempted to raise its prices. Local governments believe there are several factors that prevent DBS from being a true “competitive alternative” for major television market cable customers and thus from restraining cable prices:
 - **Non-Interchangeable Equipment.** It is easier for customers to switch between wireline competitors using cable modem and set-top boxes than it is for customers to switch between dish systems and cable boxes.
 - **No High-Speed Two-way Service.** DBS does not offer two-way high-speed data services comparable to DSL or cable modem. This means a DBS subscriber must still subscribe to a wireline service.
 - **Provision of Local PEG and Broadcast Channels.** In the GAO study, 47% of respondents cited the ability to receive local broadcast and cable channels

from the same provider as a major reason for selecting cable, and DBS providers confirm that provision of local broadcast channels increases subscription rates. Yet local broadcast channels are offered by DirecTV or Echostar in only 62 of 210 television markets and local channels are offered by both providers in only 41 markets. In addition, DBS does not carry local Public, Educational and Government Access (PEG) programming.

III. CONSOLIDATED CABLE INCUMBENTS ARE USING AGGRESSIVE MARKETING TO ELIMINATE WIRELINE COMPETITORS.

It is apparent that cable operators understand that other wireline providers provide the greatest competition. Competitive broadband providers, including nascent cable system overbuilders, have complained of incumbent cable operators using aggressive marketing tactics to drive these small competitors out of the market entirely – including deeply discounted introductory rates, e.g., \$24.95 per month for 200 channels compared to \$77.90 per month in a neighboring community without wireline competition; cash bonuses, e.g., \$200 to switch to the incumbent’s cable service and another \$200 to switch to the incumbent’s Internet service; and forgiveness of old debt owed by subscribers to the incumbent. It is also unclear whether the neighboring community’s rates are being increased to offset the discounted price offered in the competitive neighborhood.

The NATOA testimony in February attached a detailed study of these practices which the Committee will find useful and informative.

All of these factors together mean:

- Cable prices go down when there is wireline competition;
- Cable prices do not go down when there is no wireline competition or when there is competition only from non-wireline providers.

We believe any effective legislative attempt to reduce cable rates should focus in part on encouraging wireline competition. Any legislative reform of programming requirements should examine how cable operators may be using vertical integration and monopsony power to control competitors’ access to programming to discourage competition. This issue should be addressed explicitly before considering cable operator requests for more control over programming.

IV. A LA CARTE OFFERINGS ARE AN IMPROVEMENT OVER CURRENT TIERS, BUT ALONE WILL NOT PROTECT CONSUMERS.

Cable rates will continue to rise significantly so long as cable incumbents exercise substantial monopoly and monopsony pricing power over cable consumers. Programming cost increases are not the primary culprit. The increases in cable rates since 1992 continue to run more than twice the rate of inflation. Programming costs explain only about 20-30% of this phenomenon.

In my jurisdiction, Montgomery County, Maryland, consumers have brought me a range of complaints about the dominant cable operator. We are seeing very high prices, with annual increases faster than the local rate of inflation. Cable rates have gone up each of the last three years by 3 to 4 times the rate of inflation. The "basic preferred" tier went up 9% and the "packages" went up 18%.

We are seeing the same price differentials attributable to cable overbuilds observed by GAO. For example, in the District of Columbia, where there is competition to Comcast rates are \$5.50/month lower for expanded basic (\$3.00 lower for cable modem with cable TV and \$3.00 lower for cable modem without cable TV). DC and Montgomery County are in the same metro area and prices and costs for programming and operations should be the same. Cox TV (in Fairfax County) is \$3.00/month lower for expanded basic and \$6.00 lower for cable modem services with and without cable TV.

We are seeing cable services being moved between and among tiers with little or no explanation or warning. Consumers routinely complain that they are not offered the lowest available prices or accurate descriptions of their purchasing options when they call the company. The company is bundling cable modem and video services together in a manner that confuses any comparison pricing with DSL. The company appears to be forcing consumers to pay for digital converters and digital tier services when the consumer is seeking to buy pay-per-view and pay channels, despite the anti-buy-through language of the federal law.

Most of the problem is caused by lack of effective competition. This allows cable operators to exercise their maximum pricing power to charge "whatever the market will bear" and to offer a quality of service only sufficient to maintain subscribership, not sufficient to make customers happy. Local government had hoped the 1992 Cable Act amendments would result in some pricing restraints. Other than the period of the FCC-imposed rate freeze in 1993-94, however, federal rate regulation has not changed the price trend line. In part, this is because the 1992 amendments are unnecessarily complex and obtuse. In part, this is because the FCC over the last twelve years has not aggressively sought to restrain cable prices within the power Congress granted.

For this reason, NACo and TeleCommUnity would support a la carte offerings as part of a general repair to the existing cable rate regulation system. A la carte could be a means to provide consumers greater control over what they purchase. It might reduce some cable operator monopsony pricing power over programmers, similar to the must-carry/retransmission developments for over-the-air broadcasters. We also agree that a la carte offerings could permit parents greater control over what programming comes into their home. This does not necessarily mean lower prices for all consumers. A la carte offerings will not fully insulate consumers from aggressive pricing by cable operators holding substantial monopoly pricing power.

It is also important to carefully consider whether and how to mingle a la carte channels with the existing tier system of rate regulation. In the past, cable operators used their control over à la carte tier pricing as a means to charge more, not less, per channel.²

In 1994, the initial cable rate regulation rules exempted single-channel à la carte offerings. Operators began offering à la carte channels on a single and à la carte tier package basis. The single channel price, however, was so high that it only made sense to purchase à la carte channels as a tier package. However, because each channel in the à la carte tier was technically available as a single à la carte channel, cable operators claimed that the à la carte tier package was not subject to rate regulation (as other programming tiers were). On an ad hoc basis, the FCC permitted this à la carte tier arrangement so long as six or fewer channels were packaged together. Ultimately, the FCC found no sufficient justification for the tier restructuring “other than to avoid rate regulation.” Despite this finding, however, the FCC neither prohibited this evasion, nor sanctioned the operators for trying to avoid compliance with rate regulation rules.

We believe the FCC’s response provides an explicit warning to the Committee if it seeks to expand a la carte offerings without fundamentally reconsidering the existing rate regulation structure. The FCC's ruling has provided an implicit incentive for cable operators to aggressively interpret the existing rate rules to their benefit.

À La Carte Pricing Could Result in Channel Substitution, Not Lower Rates.

Local government is not in a position today to recommend a particular form of a la carte roll-out. Our experience with cable rate regulation demonstrates the law of unintended consequences when the cable industry is able to game the system to its benefit. For now, we recommend the Committee study several different approaches. We remain committed to the goal that a package of basic PEG, broadcast and cable services should be available to all residents at a reasonable, fixed and predictable price. In addition, the rollout of digital technology offers the opportunity for true a la carte offering of all other services not part of a basic package. However, the problem is complex on a mixed analog/digital system. In this mixed world, operator-owned programming interests may affect decisions as to which channels will be offered as part of a non-basic package or as à la carte channels.

This is especially true with the growing convergence of cable companies and entertainment companies. Congress should be concerned about channel substitution which does not necessarily save the consumer money. For example, assume in New York City that Cablevision agrees to carry YES Network, drop ESPN from its expanded-tier programming, and make ESPN available as a separate à la carte channel. If there are no substantial savings in programming costs between YES and ESPN, or if programming cost savings are not passed onto subscribers, then the subscriber who did not want sports

² In its study, the GAO agrees with much of what NACo and TeleCommUnity feel about a la carte offerings. The GAO concluded: "If cable subscribers were allowed to choose networks on an a la carte basis, the economics of the cable network industry could be altered, and, if this were to occur, it is possible that cable rates could actually increase for some consumers."

programming would see no price reduction, and the subscriber who wanted ESPN will have to pay the same price to receive ESPN-less programming or a larger price to receive the same programming with ESPN.

V. CABLE OPERATORS HAVE NOT PRESENTED VERIFIABLE PROGRAMMING COST DATA.

Despite cable operators' claims that prices have risen as a result of programming cost increases, they have never provided local government with verifiable programming cost and revenue data to evaluate the impact of programming costs on cable rates.

Notwithstanding the fact that a Justice Department investigation and an informal SEC inquiry related to the accuracy of operator-reported data are currently pending, Congress should require the cable industry to provide specific information about all channel programming costs, programming launch fee revenue, and corporate allocation of volume discounts.

- **Actual Programming Costs.** Cable operators submit only their basic tier channel programming costs to local governments as part of the rate regulation process and do not routinely submit any programming costs to the FCC. Thus, cable operators do not disclose to any regulatory body what they are paying for most of their programming.
- **Accounting Treatment of Launch Fee Revenue.** Cable operators receive substantial "launch fees" from programmers – i.e., fees for adding new channels to cable systems, for advertising new channels on existing channels, in program guides, on or with subscriber bills, and for other channel launch-related services – but do not uniformly treat them as programming revenues which offset total programming costs.
- **Allocation of Volume Discounts.** Cable operators often delay, or refuse to comply, with local government requests to disclose terms of their programming contracts, thus making it difficult to determine how volume discounts are allocated. In at least one instance, franchise-level reported programming costs were greater than the operator's actual costs because the operator negotiated volume discounts for programming, but charged its local franchises as if no discount had been obtained, booking the difference as profit for the corporate parent.

According to the 2001 Annual Report COMCAST filed with the SEC:

“[O]n behalf of the company, Comcast secured long-term programming contracts . . . Comcast charged each of the Company's subsidiaries for programming on a basis which generally approximated the amount each subsidiary would be charged if it purchased such programming from the supplier . . . and did not benefit from the purchasing power of Comcast's consolidated operations.”

VI. THE FCC HAS COMPLICATED THE REGULATION OF CABLE RATES.

The Committee needs to consider its oversight and instructions to the FCC. In the view of local government, the FCC has not adopted cable rate regulations that ensure reasonable rates.³ There are numerous ways in which the FCC has failed to establish or interpret rate regulation rules in a manner that ensures reasonable rates for subscribers. FCC inaction and delays make local rate regulation less effective, encourage operators to use the FCC appeals process as a means for running out the clock, and ultimately deny subscribers the protection from unreasonable rates that Congress intended. We need to establish a more effective process for supporting local rate regulation.

VII. CONCLUSION

Local government has used its cable franchising authority to promote deployment of advanced services and has protected subscribers to the extent it has not been preempted by the FCC or Congress.

Increased wireline competition is needed to reduce subscriber rates.

Congress should:

- Require operators to disclose actual programming costs.
- Review the lessons to be learned from the 1994 à la carte tier pricing rules before implementing à la carte pricing in 2004.
- Instruct the FCC to implement rate regulation and à la carte rules in a manner that prohibits unreasonable rates, eliminates consumer abuses, and reflects the reality of today's non-competitive markets.

³ Local government has participated in all of the FCC's dockets reviewing and considering changes to its rate regulation rules. We are happy to share these detailed comments and critiques of the current rules with the Committee as you request.