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CABLE MERGERS, MONOPOLY POWER AND PRICE INCREASES

by
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CABLE RERUNS THE PRICE INCREASE

This month the cable industry is socking American consumers with the some of the largest rate increases in recent years.[1] Basic rates are slated to increase over 7 percent on many cable systems, when the general rate of inflation is hovering around 1 percent (see Exhibit 1).

Ignoring the market presence of Direct Broadcast Satellite TV, whose competitive potential was recently weakened by the Federal Communications Commission's denial of the DirecTV/Echostar merger,[2] the cable TV industry is doing exactly what should be expected from a monopolist whose hand has just been strengthened.[3]

Cable operators are blaming the rate increases on a number of things in an effort to hide the underlying cause – the greed of the nation's most persistent monopolists in the midst of a costly and anti-consumer merger wave. In keeping with justifications used for previous price hikes, they are blaming programming costs and capital investments needed to

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[1] Berkowitz, Harry, "Basically, a Cable Hike: Biggest rise hits 'family' package," *Newsday* (New York, NY), December 3, 2002; Hume, Elizabeth, "Cable rates about to jump," Sacramento *Bee*, November 30, 2002; Hensel Jr., Bill. "Cable Rates Going Up Yet Again," *Houston Chronicle*, November 28, 2002; Clarke, Susan Strother. "Cost of Watching Cable TV Will Rise," *Orlando Sentinel*, November 27, 2002; Cox, Jonathan. "Cable bills set to rise in 2003," *The [Raleigh, N.C.] News and Observer*, November 19, 2002.

[2] Ironically, both consumer groups and conservative commentators recognized that the merger was necessary to increase the possibility that satellite could some day be a meaningful competitor to cable (See *the Wall Street Journal* editorials "Powell's Second Chance (October 31, 2002)" and "Standing Up to Justice (November 15, 2002)," as well as opinion-editorials by former U.S. Sen. Malcolm Wallop (R-Wyo.), the head of the Frontiers of Freedom Institute ("Rural Americans? Want Broadband? Don't Ask the FCC," *Wall Street Journal*, October 14, 2002) and Randolph J. May, the head of the head of the Progress and Freedom Foundation ("Anti-merger mania: Regulators should let EchoStar, DirecTV join forces," *Washington Times*, December 2, 2002).

[3] The failure of satellite to discipline cable and the decades long pattern of abuser of monopoly power y cable operators is documented in Mark Cooper, *Cable Mergers and Monopolies: Market Power in Digital Media and Communications Networks* (Washington, D.C.: Economic Policy Institute, 2002).

EXHIBIT 1:
EXAMPLES OF RECENT CABLE RATE HIKES

Cablevision in Long Island, N.Y., raised standard cable TV rates by 9.9 percent on January 1.

AT&T Broadband in Boston raised standard cable TV rates by 7.8 percent on January 1.

Comcast in Sacramento, Calif., will raise standard cable rates by 6.2 percent and rates for premium packages by up to 21 percent in mid-January.

Comcast in Nashville, Tenn., raised rates for standard cable service by 7 percent in October 2002.

Time Warner Cable in Orlando, Fla., raised rates for standard cable service by 7.2 percent on January 1.

Comcast in Washington, D.C., raised standard cable rates by 9 percent as of January 1 (including an “upgrade fee”).

Time Warner Cable in Binghamton, N.Y., raised standard cable rates by 8 percent on Jan. 1.

Time Warner Cable raised rates by an average of 7 percent for customers in Raleigh, Durham, Chapel Hill, and Charlotte, N.C. on Jan.1.

Time Warner Cable in Houston, Tex., raised standard cable rates by 5 percent on January 1.

Cox Communications in Baton Rouge, La., raised standard cable rates 7 percent in November 2002.

make new services available. Those claims simply do not withstand scrutiny. The FCC's recent *Ninth Annual Report On Competition in Video Markets* provides all the ammunition needed to shoot these claims down.[4]

Unfortunately, the FCC appears to have little interest in reigning in cable operators, since Michael Powell, who chairs the agency, insists that rising prices are not a consumer problem.[5] Indeed, the FCC's own report that describes the industry's true financial health was buried with a New Year's Eve release.

PROGRAMMING COSTS: REVENUES ARE INCREASING MUCH FASTER THAN COSTS

The cable industry will claim that programming costs are driving prices up. While programming costs have certainly risen, a close look at the numbers shows that rising program costs account for only a small part of the rising rates.

If costs were really the cause of rising prices, then the cable industries' operating margins – the difference between its revenues and costs -- would not be rising. The facts are just the opposite. Operating margins have been increasing dramatically since 1997 (see Exhibit 2). The operating margin for the industry as a whole will reach $18.8 billion per year in 2002, $7 billion more than it was in 1997.

Operating revenues per subscriber have increased dramatically over that period, from $208 per year to $273 (see Exhibit 3). That is, after taking out all the operating costs, including programming costs, cable operators have increased their take per subscriber by over 30 percent.

The increase in operating revenue is just under $5.50 per month. Basic rate increases over this period have been about $8.50 per month. In other words, almost two thirds of the basic rate increases have been taken below the (operating cost) line. To put this another way, each $1 per month price increase raises industry revenues by about $800 million per year. Basic rate increases are driving the increased operating cash flow of the industry.

The ability of cable operators to raise rates and increase revenues, even with rising programming costs, stems from the market power they have at the point of sale. They would not be able to raise prices and pass program price increases through if they did not have monopoly power.

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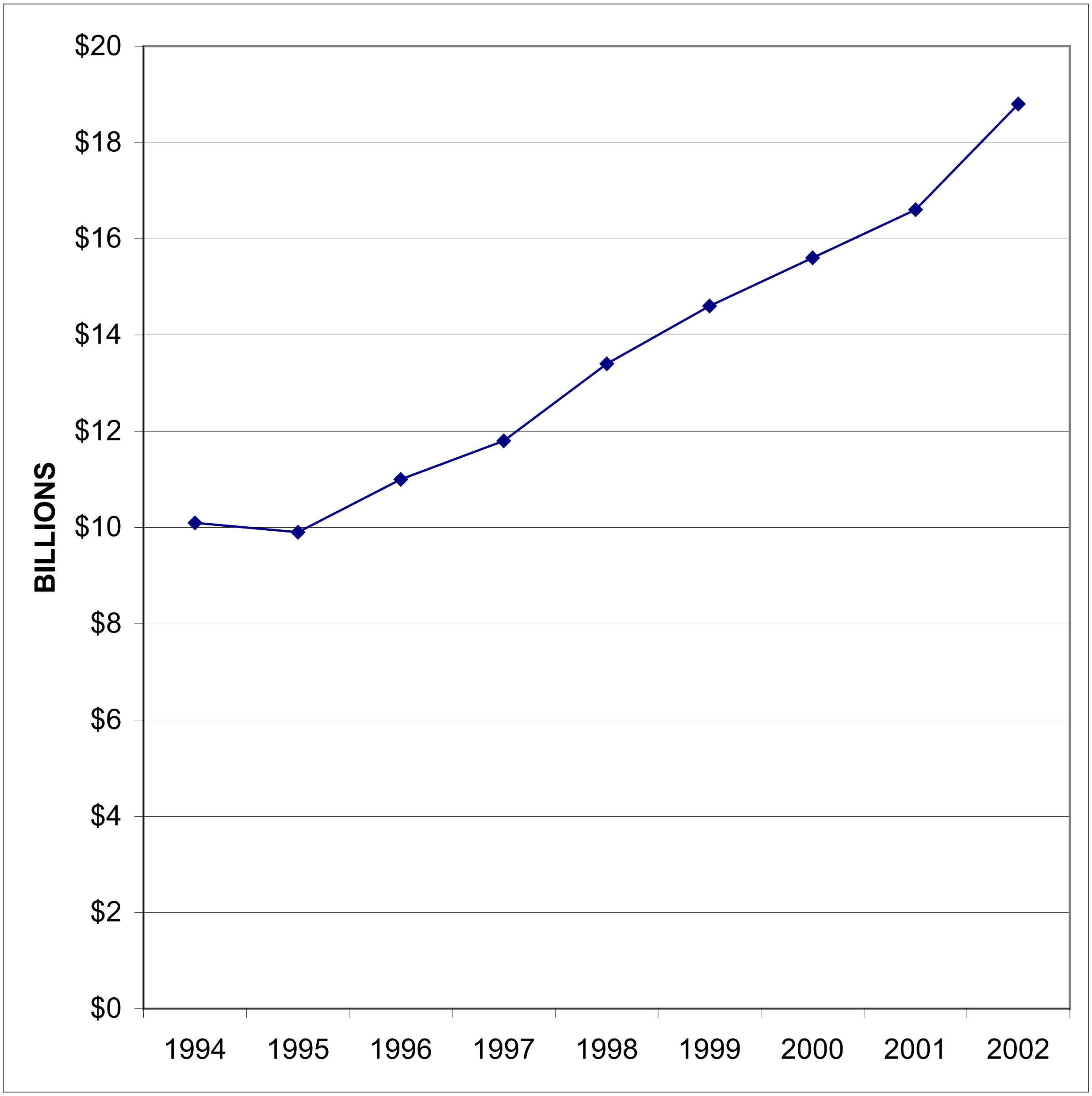
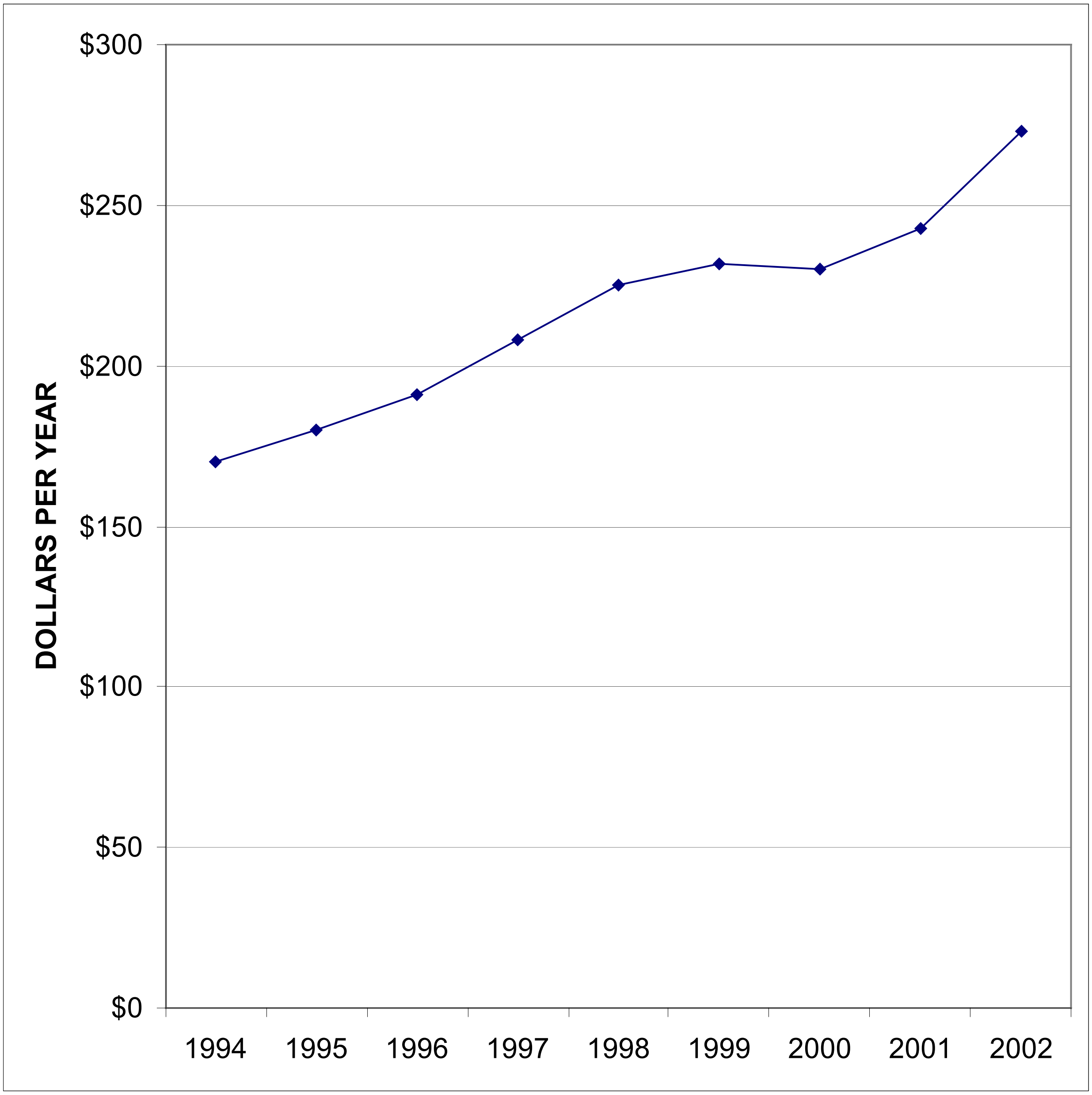
[4] This is the title of the press release. The formal document is Federal Communications Commission, *Ninth Annual Report*, In the Matter of Annual Assessment of the Status of Competition in the market for the Delivery of Video Programming, MB Docket No. 02-145, December 31, 2002.
[5] McClintock, Pamela, "Powell: No Cable Coin Crisis" *Variety*, April 30, 2001; Hearn, Ted. "Powell: Value Matters in Cable Rates," *Multichannel News*, March 13, 2002; Powell Press Conference, February 8, 2001; Dreazen, Yochi. "FCC Chairman Signals Change, Plans to Limit Intervention," *Wall Street Journal*, February 7, 2001.

EXHIBIT 2: CABLE INDUSTRY OPERATING REVENUE (TOTAL REVENUE MINUS OPERATING COST)



Source: Federal Communications Commission, *Ninth Annual Report*, In the Matter of Annual Assessment of the Status of Competition in the market for the Delivery of Video Programming, MB Docket No. 02-145, December 31, 2002, Table 4; Federal Communications Commission, *Fifth Annual Report*, In the Matter of Annual Assessment of the Status of Competition in the market for the Delivery of Video Programming, MB Docket No. 98-102, December 23, 2002, Table B-6.

EXHIBIT 3: OPERATING REVENUE PER SUBSCRIBER



Source: Federal Communications Commission, *Ninth Annual Report*, In the Matter of Annual Assessment of the Status of Competition in the market for the Delivery of Video Programming, MB Docket No. 02-145, December 31, 2002, Table 4; Federal Communications Commission, *Fifth Annual Report*, In the Matter of Annual Assessment of the Status of Competition in the market for the Delivery of Video Programming, MB Docket No. 98-102, December 23, 2002, Table B-6.

One can also question the vigor with which cable operators resist program cost increases. Approximately 40 percent of the top channels (measured by subscription or prime time ratings),[6] which command the highest prices,[7] are owned in whole or in part by cable operators or companies that have large ownership stakes in cable companies. Cable operators have ownership interest in about one-third of all national cable programming networks and half of all regional programming networks.[8] In other words, for a substantial part of the industry, rising programming prices are just a transfer from one subdivision of the cable company to another, which comes out of the consumer's pocket. They would not be so willing to raise prices if they did not have such a large ownership interest in programming.

CAPITAL EXPENDITURES: REVENUES FROM ADVANCED SERVICES COVER THE COSTS OF SYSTEM UPGRADES

Another claim by cable operators is that they need the increased profit margins to pay for the system upgrades that are being put in place. Again, by looking at revenues we find that this argument does not stand up.

The digital upgrades are intended to make a new range of services available. By selling these services, the upgrades pay for themselves (see Exhibit 4). If we compare the build up of capital expenditures (a large part of which is claimed as a cost of system upgrades) we observe that revenues from services that are made possible by these upgrades have increased very rapidly. The cable operators do not need to and should not be raising basic cable rates to pay for this upgrade. They would not be able to raise basic rates to cross-subsidize advanced services if they did not have monopoly power.

MERGERS AND ACQUISITIONS CONSUME FAR MORE CAPITAL THAN SYSTEM UPGRADES

While the cable industry has certainly increased capital expenditures to upgrade its plants, it has actually sunk a lot more capital into another activity – mergers and acquisitions. It is the outrageous prices that have been paid to buy each other out and consolidate the industry that is helping to drive the rate increases (see Exhibit 5).

Between 1998, when the first mega merger between cable operators was announced, and 2001, when the last big merger was announced, cable companies spent over a quarter of a trillion dollars buying each other out. In those four years, they spent almost six times as much on mergers and acquisitions as they did on capital expenditures to upgrade their systems. At the same time, the average price paid per subscriber more than doubled (see Exhibit 6).

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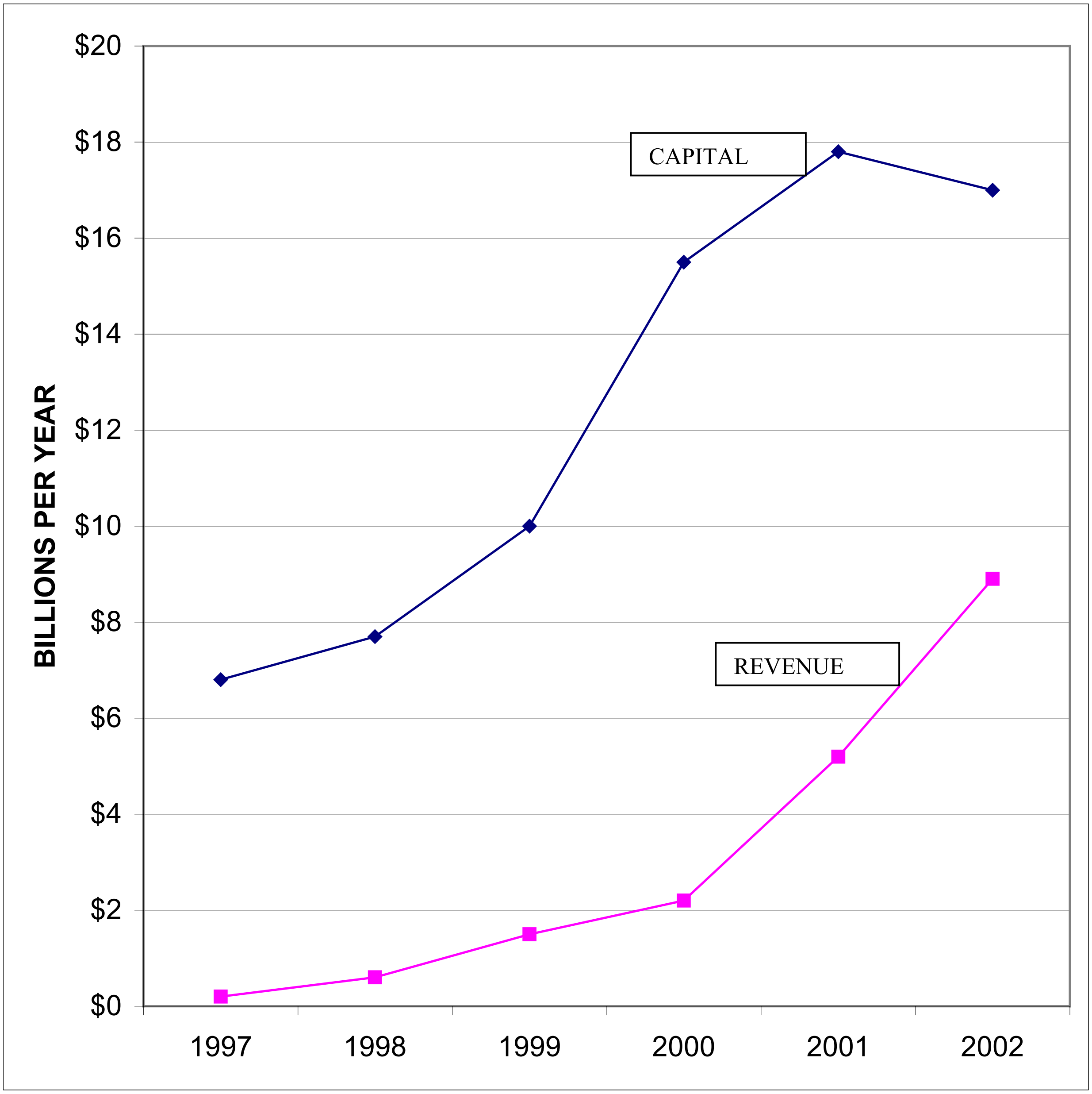
[6] *Ninth Annual Report*, Appendix C.

[7] Hazlett, Thomas W. and George Bittlingmayer. *The Political Economy of Cable "Open Access."* Joint Center, Working Paper 01-06, May.

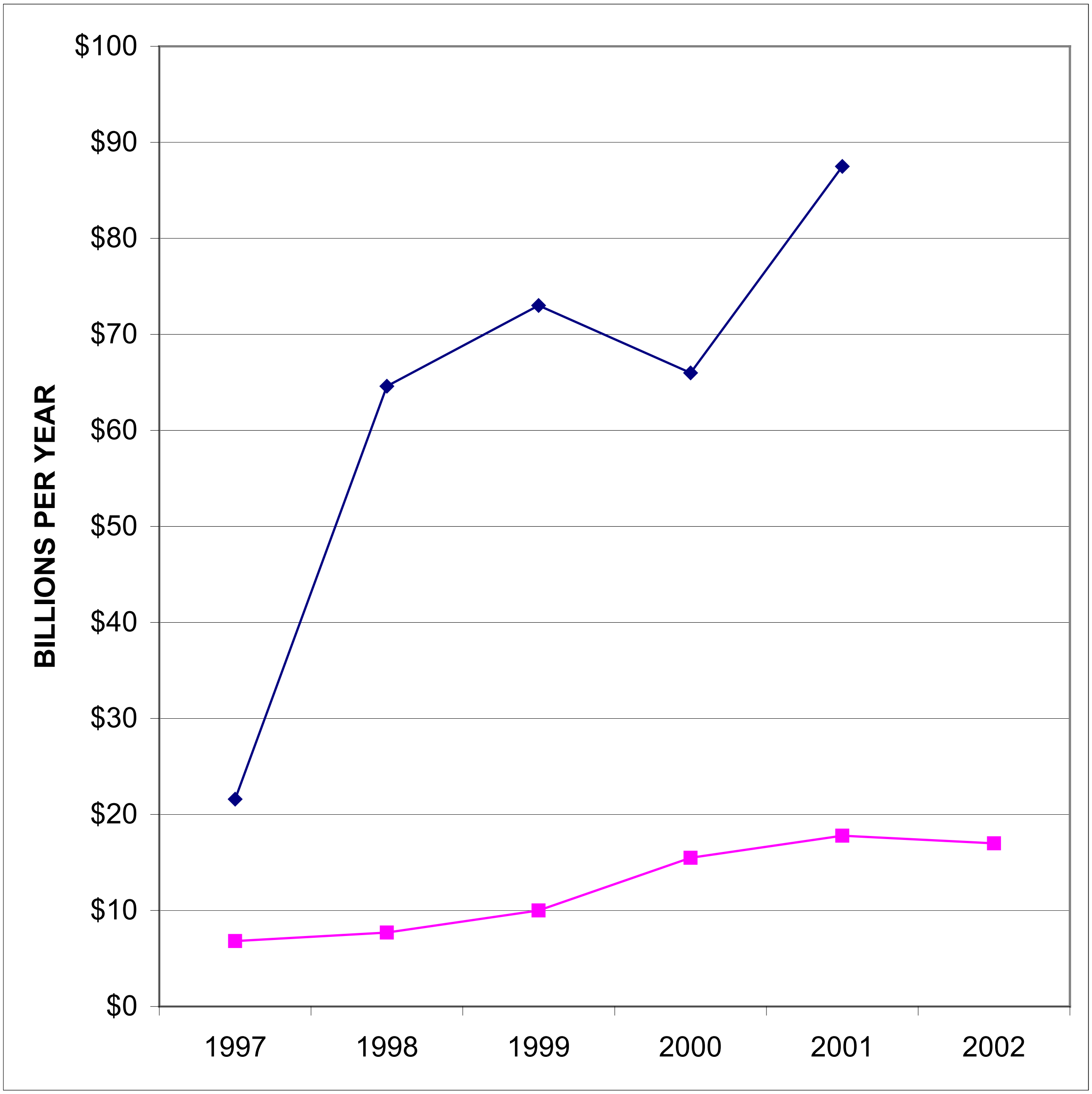
[8] *Ninth Annual Report*, Appendix, C.

EXHIBIT 4: CAPITAL EXPENDITURE AND ADVANCED SERVICE REVENUES



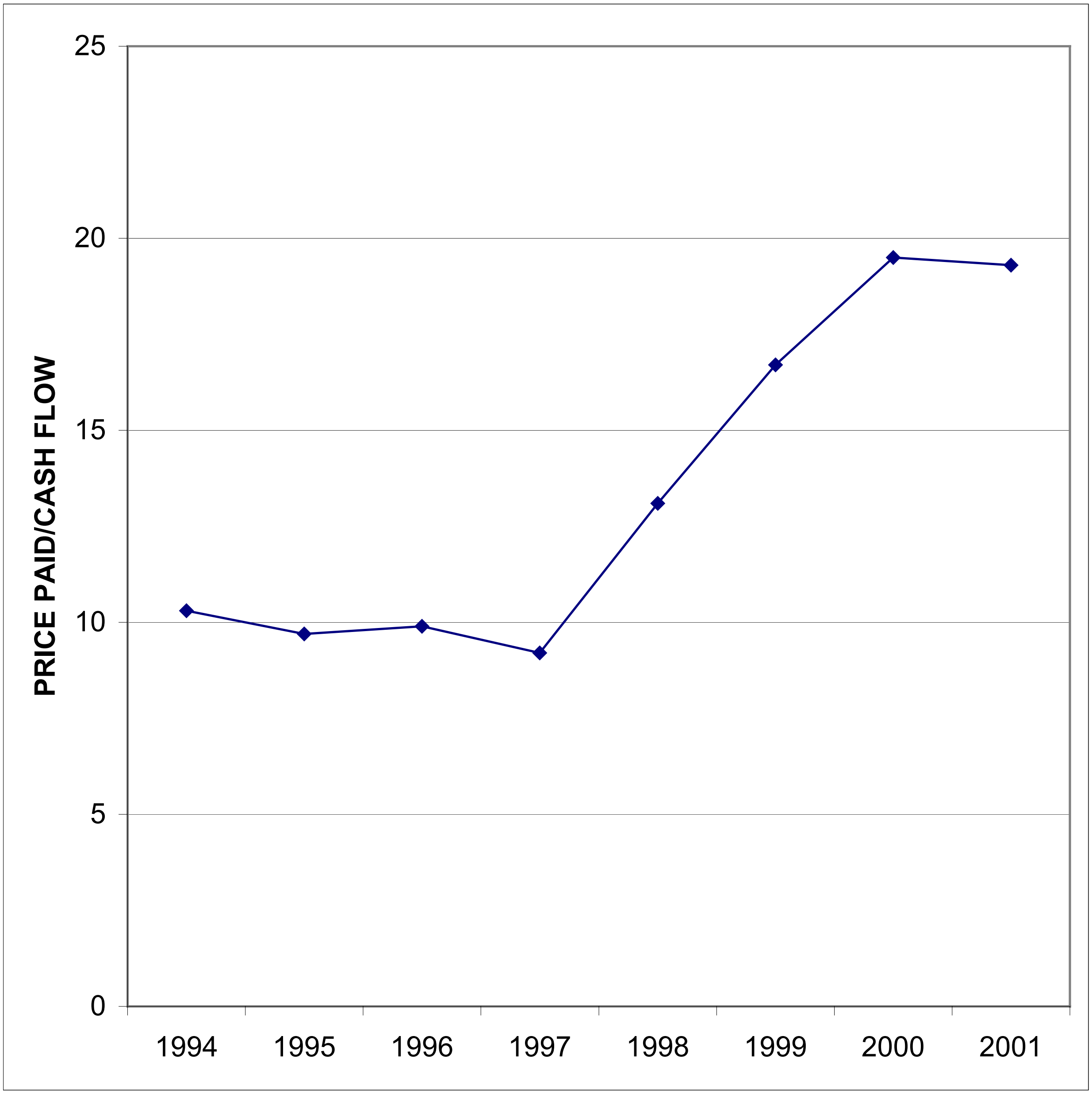
Source: Federal Communications Commission, *Ninth Annual Report*, In the Matter of Annual Assessment of the Status of Competition in the market for the Delivery of Video Programming, MB Docket No. 02-145, December 31, 2002, Table 4.

EXHIBIT 5: EXPENDITURES ON MERGERS AND ACQUISITIONS COMPARED TO CAPITAL EXPENDITURES



Source: Federal Communications Commission, *Ninth Annual Report*, In the Matter of Annual Assessment of the Status of Competition in the market for the Delivery of Video Programming, MB Docket No. 02-145, December 31, 2002, Table 4.

EXHIBIT 6: CASH FLOW MULTIPLE PAID PER SUBSCRIBER



Source: Federal Communications Commission, *Ninth Annual Report*, In the Matter of Annual Assessment of the Status of Competition in the market for the Delivery of Video Programming, MB Docket No. 02-145, December 31, 2002, Table 5; Federal Communications Commission, *Fifth Annual Report*, In the Matter of Annual Assessment of the Status of Competition in the market for the Delivery of Video Programming, MB Docket No. 98-102, December 23, 2002, Table B-8.

When a cable operator pays such an outrageous price, the previous owner is reaping the financial rewards of his monopoly power. The acquiring company can only pay such a high price by assuming that his monopoly power will allow him to continue to increase prices. Monopoly power is being bought and sold and borrowed against. The new cable operator, who has paid for market power, may insist that the debt he has incurred to obtain it is a real cost on his books. That may be correct in the literal sense (he owes someone that money) but that does not make it right, or the abuse of market power legal.

OTHER EVIDENCE ON MONOPOLY POWER

If all cable companies faced meaningful competition – as those serving about five per cent of consumers do, through head-to-head competition with other cable companies -- the cable industry could not pay inflated prices (and incur excess debt) through the merger/acquisition process, and could not pass along these excess costs to their customers. The General Accounting Office recently found that, in communities where there are two cable companies (and two satellite providers) cable prices are on average 17 per cent lower for comparable services than in communities with two satellite providers and just one cable company.[9]

These recent findings are only the latest in a long series of analyses that demonstrate cable's monopoly power. In addition to repeated findings that head-to-head competition lowers prices,[10] the FCC's analyses of clustering[11] and demand elasticities [12] indicate the problem of market power. Numerous studies of the monopoly rents captured by cable operators in the sales prices of their systems point to the same problem (See Exhibit 7).[13]

The behavior of cable prices is only one area in which the cable monopoly is having a severe anticompetitive impact. The same, lame theory of cross-technology competition that

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[9] See "Issues in Providing Cable and Satellite Television Services," U.S. General Accounting Office, Oct. 2002, at 9.

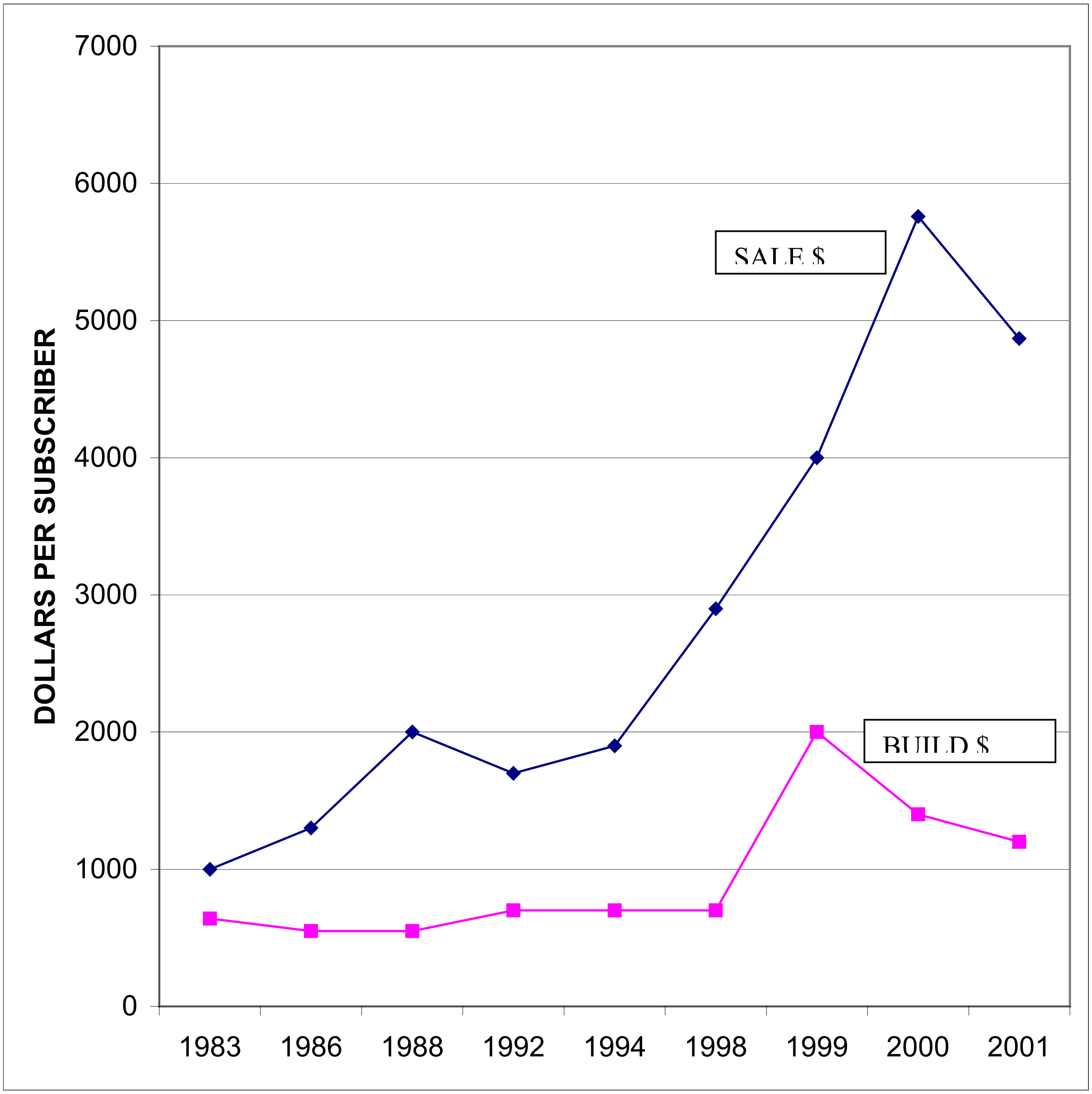
[10] Federal Communications Commission, *Report on Cable Industry Prices*, In the Matter of Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992, Statistical Report on Average Rates for Basic Service, Cable Programming Service, and Equipment Report on Cable Industry Prices, MM Docket No. 92-266, April 1, 2002, p. 29; Federal Communications Commission, *Report on Cable Industry Prices*, In the Matter of Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992, Statistical Report on Average Rates for Basic Service, Cable Programming Service, and Equipment Report on Cable Industry Prices, MM Docket No. 92-266, p. 33, February 8, 2002; Federal Communications Commission, *Report on Cable Industry Prices*, In the Matter of Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992, Statistical Report on Average Rates for Basic Service, Cable Programming Service, and Equipment Report on Cable Industry Prices, MM Docket No. 92-266, June 15, 2000, p. 26.

[11] Report on Cable Industry Prices, 2001, p. 31.

[12] Report on Cable Industry Prices, 2001, p. 33; Report on Cable Industry Prices, 2002, p. 29..

[13] Formally, the ratio is called Tobins q and it is represented as the ratio of the sales price to the reproduction cost of the assets. This measure has been used for the past decade in the cable industry. In particular, it was used by telephone companies in arguing that they should be allowed to enter the cable TV business, see Shooshan and Jackson, Measuring Cable Market Power: Recent Developments, December 1988; S. J. Grossman, On the Misuse of Tobin's Q To Measure Monopoly Power, February 26, 1990.Hazlett and Bittlingmeyer,

EXHIBIT 7: SALES PRICE v. COST TO BUILD (TOBIN'S q)



Sources: See next page.

SOURCES:
Sales Prices
1983-1998: Kagan Associates Inc., *Cable TV Master Database*, various issues.
1999- 2001: Federal Communications Commission, *Ninth Annual Report*, In the Matter of Annual Assessment of the Status of Competition in the market for the Delivery of Video Programming, MB Docket No. 02-145, December 31, 2002, Table 5.

Reproduction costs
1983: H. L. Vogel, *Entertainment Industry Economics* (Cambridge University Press, Cambridge, 1986).
1986: Shooshan and Jackson, *Opening the Broadband Gateway: The Need for Telephone Company Entry Into the Video Services Marketplace*, October 1987.
1988: Shooshan and Jackson, *Measuring Cable Industry Market Power*, March 2, 1990; Leland L. Johnson and David P. Reed, *Residential Broadband Services By Telephone Companies*? (Santa Monica, Rand, 1990).
1992: David P. Reed, *Residential Fiber Optic Networks* (Artech House, Boston, 1992), Tables 5.3 and B.8.
1994: Johnson, Leland, and David P. Reed, *Residential Broadband Services By Telephone Companies*? (Santa Monica, Rand, 1990); Bell Atlantic, *In the Matter of the Application of The Chesapeake and Potomac Telephone Company of Maryland and Virginia for Authority Pursuant to Section 214 of the Communications Act of 1934, as amended, to Construct, Operate, Own and Maintain Facilities and Equipment to Provide a Commercial Video Dialtone Service within a Geographic Territory Defined by the Maryland and Virginia Portions of the Washington Local Access Transport Area, December 1994, Exhibit 3; U.S. West, In the Matter of the Application of U.S. West, Inc., for Authority Pursuant to Section 214 of the Communications Act of 1934, as amended, to Construct, Operate, Own and Maintain Facilities and Equipment to Provide a Commercial Video Dialtone Service in Portions of Colorado Springs*.
1999: Morgan Stanley Dean Witter, *Digital Decade,* April 6, 1999.
2000: Thomas Hazlett and George Bittlingmayer, *The Political Economy of Cable "Open Access"* (Joint Center, Working Paper 01-06, May 2001)
2001: Dear Stearns, *Cable TV and Broadband* (April 2000); ABN-AMO, *Return On Bandwidth* (June 2001). Upgrade costs are about $600. Basic network costs are about $600.

has failed to discipline pricing abuse in the multichannel video market is being used to allow cable operators to abuse their market power in the high speed Internet market.[14] Cable operators dominate the residential high speed Internet service, with a 65 percent market share of all residential customers and a 79 percent share in advanced services.[15] The FCC has exempted cable modem service from the obligation to provide nondiscriminatory access to independent Internet Service

Already, we see that cable prices have been rising [16] and the commercial terms that cable operators have offered are anticompetitive in every aspect. They

- Withhold strategic inputs from potential competitors (i.e. blocking access to required equipment)
- Create an artificial scarcity of capacity (bandwidth)
- Control the technology and functionality to protect the core monopoly product and dictate the pace and type of innovation (i.e. configuring networks to prevent activities at the network owner's discretion)
- Control the customer relationship (i.e. offer a restricted set of services to ISPs thereby interfering with the customer relationship)
- Squeeze the competitors by driving wholesale rates close to retail prices.

POLICY IMPLICATIONS: THINGS WILL GET A LOT WORSE UNLESS CONGRESS ACTS

The FCC's solution to the problem – "don't worry, be happy" about market power – has not shielded the public from abuse. Its claim that satellite provides sufficient competition to discipline cable pricing is obviously false. It decision to keep the satellite industry weak by preventing mergers has served to reinforce the market power of the cable industry. In short, the FCC has given a green light to the cable industry to go full speed ahead in exploiting its market power. It did its best to hide the abuse it has invited and caused by burying the release of its competition report on deadest news day of the year. The FCC may hide its head in the sand, but consumers still have to pay the ever-increasing cable bill.

The complete failure of all three types of competition envisioned by the Telecommunications Act of 1996 to discipline cable pricing abuse – cross technology

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[14] Cooper, *Cable Mergers*, Chapters 5 and 6; Cooper, Mark, *The Importance Of ISPs In The Growth Of The Commercial Internet Why Reliance On Facility-Based Competition Will Not Preserve Vibrant Competition And Dynamic Innovation On The High-Speed Internet* (Texas Office of Peoples Council, Consumer Federation of America, July 1, 2002).

[15] Industry Analysis and Technology Division, Wireline Competition Bureau, *High Speed Services for Internet Access: Status as of June 30, 2002* (Washington, D.C.: Federal Communications Commission, December 2002), Tables 1-4.

[16] Ploskina, Brian and Dana Coffield, "Regional Bells Ringing Up Higher DSL Rates," *Interactive Week,* February 18, 2001; Braunstein, Yale, *Market Power and Price Increases in the DSL Market* (July 2001); Todd Spangler, *Crossing the Broadband Divide*, PCMAGAZINE*,* February 12, 2002; Office of Market Monitoring and Strategic Analysis, Florida Public Service Commission, *Broadband Services in the United States: An Analysis of Availability and Demand* (Washington, D.C.: Federal-State Joint Conference on Advanced Services, October 2002).

competition from satellite, head-to-head competition from overbuilders, or the entry of the Bell telephone companies into the video markets - has exposed consumers to rate increases that are three times the rate of inflation. Congress was wrong to deregulate cable before the industry faced effective competition, and the FCC and Justice Department have made matters much worse by allowing the industry to concentrate and cluster itself into regional monopolies and a tight national oligopoly, that reinforces the industry's monopoly power at the point of sale.[17] Several key members of Congress have spoken about the cable monopoly problem.[18] Only Congress can fix the problem. The time has come to turn tough talk into tough action.

Congress must now empower the states to treat cable monopolies the same way they treat telephone monopolies. By restoring state power to prevent price gouging and discriminatory behavior, Congress can correct its mistake of allowing cable monopolies to abuse consumers and thwart the growth of video competition. In addition Congress must compel the FCC to eliminate impediments to cable competition – ranging from licensing new satellite or wireless entrants, to expanding access to multi-unit dwellings, to developing stricter ownership limits and nondiscrimination rules – to open the door for more consumer choice of media providers.

In the rulemakings that deal with advanced telecommunications service, the FCC must abandon the direction it has been taking. These and other similar deregulatory proceedings underway at the FCC are likely to severely limit competition in the emerging DSL market, and further shift market power to dominant wires companies, each of which has, and will, exploit market power in specific product and geographic markets while avoiding head-to-head competition. Consumers will bear the impact of this anticompetitive shift in fewer choices, rising prices and reduced customer service.

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[17] *Ninth Annual Report*, p. 52, concedes that "the market for the delivery of video programming to households continues to be highly concentrated." While it recounts both sides of debate over clustering (p. 56), it fails to note that its own analysis has consistently showed that clustering raises prices ().

[18] Stern, Christopher. "Comcast Cable Rates to Climb 6% in D.C. Area," *Washington Post*, December 5, 2002; "House Judiciary, Telecom Panels Weigh EchoStar-DirecTV merger," *Satellite Week*, December 10, 2001.