CABLE TELEVISION:
THE PROBLEM OF LOCAL MONOPOLY

Richard A. Posner

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THE FORD FOUNDATION
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The question of state and local control of cable television is of basic importance to the future of this relatively new industry. Generally speaking, since only one supplier of cable service operates in any given local area, state and local governments are becoming increasingly concerned about whether cable television companies should be subject to the rules and practices developed for the control of public utilities and common carriers.

The purpose of this brief discussion paper is to present a number of provocative ideas about the advantages and disadvantages of alternative forms of local regulation. The paper is an outgrowth of research on the future of cable television done by The Rand Corporation under a grant by The Ford Foundation. A preceding study under the project is reported in Leland L. Johnson's *The Future of Cable Television: Some Problems of Federal Regulation*, RM-6199-FF, January 1970. In that Memorandum, a number of topics are treated of primary concern at the federal level.

The author, who is Professor of Law at the University of Chicago and consultant to The Rand Corporation, gratefully acknowledges the comments, on earlier drafts, by Harold Demsetz, Aaron Director, Leland L. Johnson, R. E. Park, and George J. Stigler.
SUMMARY

If monopoly were to become a serious problem in the cable television industry, it would have detrimental effects in that fees to cable subscribers would be excessively high, with surplus profits channeled into the hands of cable operators. However, the extent to which monopoly power exists or is likely to develop in the cable industry is unclear. Much depends on the adequacy of over-the-air service and other substitutes for cable service. The fact that cable operators are able to charge a monthly fee for their service is not by itself evidence that they are able to wield strong monopoly power. Nevertheless, because only one supplier of cable service operates in any one given area, as in the case of public utilities, concern is widely expressed about appropriate regulatory policy at the state and local level.

One of the most straightforward approaches to granting franchises would be for municipalities to auction them off to the bidder offering the largest lump-sum payment. Although this approach is attractive in siphoning excess profits from cable operators to the public treasury, it does not alleviate other problems of monopoly. Fees to subscribers would be no lower than those in the absence of public intervention.

As an alternative to the lump-sum bid, franchises could be available to the cable operators bidding the highest amounts per subscriber, or the largest percentages of gross revenues, to go to the treasury. However, this method is questionable because it could lead to even higher subscriber fees than would the lump-sum auction.

Another possibility would be to award franchises to those cable operators offering the most service in terms, for example, of channels made available free of charge for civic or educational purposes. This approach avoids the drawbacks of the auction approaches, but it can lead to undesirable hidden costs imposed on subscribers.

One variant of the franchise approach is a bargaining technique under which the municipality would, through a specially established
committee, serve as bargaining agent for consumers. The purpose would be to obtain the most attractive package of service from among the competing franchise applicants. This system would have the advantage of directly attacking the monopoly problem -- unlike the auction approaches -- but it too suffers a variety of weaknesses.

All in all, given the great uncertainty that exists with respect to the future characteristics of cable television, a period of experimentation seems merited. It would be well for state and local authorities to examine carefully the range of options open to them, to experiment with different ones, and to encourage empirical research into the magnitude of the local monopoly problem.
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I. MONOPOLY AND THE PUBLIC WELFARE

Cable television systems pick up broadcast signals by antenna or microwave relay and distribute them to subscribers in homes and other locations by means of coaxial cables. In some respect, a cable system's grid or network of cable is similar to that of the local water, electrical, gas, or telephone company. As with the supply of these other services, running more than one company's cable to any home would involve unnecessary duplication, for a single cable system can carry all the signals that a subscriber is likely to want and at substantially lower cost than two or more smaller cables.\(^1\) It is therefore unlikely that two or more cable companies could economically serve the same subscriber at once; the service is a technical or natural monopoly at the local level (how local we have yet to consider).

Cable systems generally operate under municipal franchise to avoid or mitigate the widely feared abuses of unregulated monopoly.\(^2\) Thus, in evaluating alternative forms of local control, it is well to begin with a brief summary of the objections to unregulated monopoly.

When a seller obtains complete control of the supply of a product having no good substitutes, he can increase his profits by selling a smaller quantity at a higher price. In the case of cable television, a contraction of sales would mean a reduction in the number of cable subscribers, and an increase in price would mean an increase in the monthly (or other) fees charged subscribers.\(^3\) At the monopoly price,

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\(^1\) Twenty-channel systems are now technically and economically feasible, and indeed a 42-channel system is under construction at the present time. Leland L. Johnson, The Future of Cable Television: Some Problems of Federal Regulation, RM-6199-FF, p. 10, January 1970.

\(^2\) The franchising authority may, as in New York City, divide the city into several separate franchise areas; but within each area only one cable company is franchised.

\(^3\) Alternatively, the monopolist could seek to increase his profits by holding the price constant, and reducing the quality of his service -- as by reducing the number of channels made available to subscribers, lowering technical standards, or failing to provide other services to subscribers and to the community for which cable systems are otherwise suitable. For simplicity of analysis in this Memorandum I shall assume that quality remains constant and focus on appropriate pricing policies.
those who continue to buy the product pay a higher price for each unit than they did before the sale of the product was monopolized. These consumer losses, however, are the monopolist's gain; so far as these sales are concerned, there has been a transfer of wealth but no fall in business volume. The fall in sales results from the fact that, as mentioned above, some consumers who bought at the lower, competitive price now choose not to do so when the monopoly price is charged. Since these consumers lack adequate substitutes for the monopolized product, total consumer satisfaction is diminished; the value of production -- output measured in dollars -- is reduced.

The reduction in output (here a reduction in the number of cable subscribers due to excessively high subscriber fees) is the main economic objection to monopoly. Economists in general do not attempt to appraise the welfare effects of mere transfers of wealth that leave the total value of production unchanged, although the redistribution of wealth from consumers to monopolists in the form of excess profits is probably the core of the popular objection to monopoly. Other objections to monopoly -- that it retards innovation, reduces managerial incentive, or impairs quality or service -- are, in the present state of economic knowledge, less well established than the concern about the smaller output,\(^1\) and even the concern about smaller output requires qualification in three respects:

(1) **Role of Price Discrimination.** The point that monopoly reduces output is strictly valid only if the monopolist is constrained to sell at a single price. Ordinarily, the assumption is justified, since if a seller sold at different prices to different purchasers those who bought at lower prices would resell to those charged the higher prices and the monopolist's attempt to discriminate would fail. For sellers of nontransferable services, however, such as cable television, arbitrage (as this reselling activity is called) is not much of a threat, and discrimination becomes a feasible strategy. A cable company would find it quite easy to discriminate. It could charge

different rates in low- and high-income areas; a basic subscription fee and then separate charges for additional channels and/or programs; hourly rates, and so on. Metering and the provision of different types or levels of service appear feasible at moderate cost.

Under perfect discrimination the monopolist's output would be identical to that of a competitively organized market. The only difference would be in the transfer of wealth from consumers to the monopolist. However, perfect price discrimination is unattainable in the real world. And when discrimination is less than perfect, the effect on allocation is indeterminate; in some cases it may be worse than if the monopolist charged a single price.¹ Price discrimination may also entail substantial administrative costs. Nonetheless, the existence of seemingly very good opportunities for discrimination in the provision of cable service must reduce one's confidence that unregulated cable monopolies would force a reduction in output of the sort noted above.

(2) Adequacy of Substitutes. Thus far it has been assumed that the standard, over-the-air service provided by local television stations is not a perfect, or nearly perfect, substitute for cable television service. If it were a perfect substitute, cable companies would have no power to extract excess profits. Clearly, some consumers are willing to pay for the better reception (especially of color) and greater number of signals that cable television offers. But these indications of monopoly power are inconclusive. It is possible that the price that consumers are willing to pay for cable service just covers the costs of the service and that a higher price could not be maintained in view of the availability of over-the-air service at no cable charge to the viewer. In that event there would be no monopoly problem.

(3) Advance Solicitations for Service. Regardless of the supply characteristics of the service, no problem of monopoly need arise if purchasers have an adequate opportunity to solicit competing bids in

advance. The winning bidder will be the supplier who undertakes to provide the service at the lowest possible price, a price that will not include any monopoly toll.\footnote{See H. Densetz, "Why Regulate Utilities?", \textit{Journal of Law & Economics}, Vol. 11, p. 55 (1968).} To be sure, as the cable television business now operates, subscribers are rarely, if ever, given a choice between cable companies. Only one cable company solicits their patronage. The immediate cause of this, however, lies not in the economics of cable television but in the fact that a cable company must obtain a municipal franchise in order to be permitted to serve any part of the community. Whether it is because municipalities assume that the cable television business is a natural monopoly, or desire to limit the inconvenience to the public of having several companies ripping up public rights-of-way to lay cable, or want a share of monopoly profits in the form of tax revenues, municipalities do not grant more than one cable franchise for any given area within their jurisdiction. Such a policy, as we shall see, is not inevitable. And as we shall also see, were the conventional franchise approaches abandoned, the problem of monopoly might become less of a problem.

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Even if the conditions of the cable television industry are favorable to excessively high subscriber fees and reduced output, the magnitude of this distortion remains a critical question. Regulation to correct trivial departures from competitive conditions cannot be justified; the costs would exceed the benefits. There is an important area here for empirical study, and until then any policy proposals to regulate cable television based on the assumption that it is a naturally monopolistic industry will have shaky foundations.\footnote{One study discloses that cable television revenues are very high in relation to operating expenses; but the absence of figures for depreciation and capital costs precludes a conclusion that profits are abnormal. See M. Seiden, \textit{An Economic Analysis of Community Antenna Television Systems and the Television Broadcasting Industry}, reprinted in \textit{Progress Report from FCC -- 1965}, Hearings before the Subcommittee on Communications of Senate Committee on Commerce, 89th Cong., 1st Sess., ser. no. 89-18, pp. 51, 74 (1965).}
II. THE RESPONSE OF GOVERNMENT

The problem -- if it is a problem -- of local cable monopolies has been attacked by a number of state and local governments. Two weapons have been employed: rate regulation and franchise regulation. A few states have enacted statutes subjecting cable systems to comprehensive regulation over rates and other aspects of service by the state public utility commissions.\(^1\) In some other states, state public utility commissions have asserted regulatory authority over cable television using existing statutes, with varying success.\(^2\) The FCC has not yet asserted authority to regulate cable television under the common carrier provisions of the Communications Act, and it now seems clear that, in the absence of such assertion, the states are not prevented by federal law from regulating cable television rates and service.\(^3\) However, the principal efforts to deal with the monopoly problem thus far have been made by local authorities in the exercise of their power to require that any company proposing to use public rights-of-way obtain a franchise.\(^4\)


\(^2\) See, for example, Television Transmission, Inc. vs. Public Utility Commission, 47 California 2nd 82, 301 p. 2d 862 (1965); Opinion of Attorney General, State of Indiana, December 31, 1965, Utilities Law Reporter, State Volume 1965 et seq., 20276; Opinion of Attorney General, State of Ohio, Utilities Law Reporter, State Volume 1969 et seq., 21206. Some of the state courts that declined to permit state regulatory jurisdiction to be asserted over cable television did so on the ground that the Federal Communications Act preempts any state or local regulation of companies subject to federal regulation under the Act. See Note, "The Wire Mire: The FCC and CATV," Harvard Law Review, Vol. 79, pp. 366, 369-370 (1965). A recent Supreme Court decision, however, that upheld (albeit without opinion) the State of Nevada's right to regulate cable television rates against a claim of preemption has, for the present at least, eliminated that ground. TV Pix, Inc. vs. Taylor, No. 214, October Term 1969, decided February 2, 1970. However, if the FCC decided to regulate cable television rates, as it probably could under the very broad common carrier provisions of the Communications Act, then any inconsistent state or local regulations would fall.

\(^3\) 47 U.S.C. 201 et seq. (1964).

\(^4\) For the legal basis of municipal regulation of cable television see, for example, City of New York vs. Comtel, Inc., Utilities Law
The terms of cable franchises vary widely from place to place.\textsuperscript{1} Some franchises are exclusive — the franchising authority binds itself not to franchise any additional companies in the service area of the franchisee during the term of the franchise — and some are nonexclusive. The duration of franchises typically run from 10 to 35 years. The franchisee is generally required to pay the franchising authority a substantial fee, which may (1) take the form of a fixed initial or annual fee (or both), (2) be computed as a percentage (usually between 1 and 6 percent) of the franchisee's annual gross revenues, or (3) be scaled to the number of subscribers served. Sometimes a combination of these methods is used. In addition, franchisees are sometimes required to provide, without charge, several channels for use by schools, police, and other municipal departments. In some instances, the franchisee is forbidden to increase the monthly subscriber charge stated in his franchise; and provision is sometimes made for renegotiation of the rate only after a stated number of years.

Frequently, there is more than one applicant for a cable franchise; at this writing, 17 companies are vying for franchises in New York City.\textsuperscript{2} Formal bidding is not employed to select the winning applicant, nor are the criteria for selection clear. Political considerations, plus subjective evaluations of competing applicants, are thought to play major roles in the selection process.

Insofar as local franchising authorities attempt to fix subscriber rates, regulation by franchise blends into conventional public utility or common carrier rate regulation. Nonetheless, the franchise approach

\textsuperscript{1}The description of franchise terms that follows is based on a survey of municipalities conducted by M. Seiden, op. cit., pp. 83-85. Although Seiden's study carries only to 1965, a perusal of recent issues of the television trade journal, Broadcasting, which contains a weekly summary of developments in cable franchising, indicates that the franchising process continues to operate today in essentially the manner described in Seiden's survey.

has distinctive features meriting separate consideration. But before discussing them let us consider another and logically prior approach -- no regulation at all.
III. THE CONSEQUENCES OF NONREGULATION

FREE MARKET CONTRACTS

Suppose there were no franchise or other public regulation of the transactions between cable television companies and subscribers. In this event, if only one company solicited subscribers in an area, the subscribers might be induced to pay a fee in excess of the cost of serving them. However, in the absence of regulation, more than one company might solicit in each area. Since many companies are capable of building and operating cable television systems, one would expect several companies to solicit subscribers in each commercially attractive area. Whichever company offered the best contract to the subscribers would be the one that served the area. In principle, competition among the soliciting companies would squeeze any monopoly profit out of the subscriber charge, so long as the companies were prevented from colluding. The result would be like that under a "full-requirements contract," where the purchaser agrees to buy all his requirements of a particular good from one supplier, at a specified price and for a specified period of time. During the life of the contract, there is only one seller; he has a legal monopoly. But the buyer is protected by the initial competition among potential sellers seeking to be awarded the exclusive contract.¹ At the same time, use of free market contracts would raise several problems to which we now turn.

Geographical Separation of Subscribers

If, during the period of initial competition, several companies succeeded in signing up some of the residents of an area, each company's subscribers might be widely scattered. In that event, the

¹One interpretation of the exclusive contracts involved in the famous Reading antitrust case is that they were designed to secure independent coal operators from monopolistic pricing by the railroad cartel. United States vs. Reading Co., 226 U.S. 324 (1912). On the importance of competition for, as well as in, the market, see also United States vs. El Paso Natural Gas Co., 376 U.S. 651 (1964).
building of a separate cable network by each company would involve unnecessary duplication of facilities. If so, however, one would expect the companies to exchange subscribers so that each would be serving a compact group.¹ The subscriber who found himself in the service area of a company other than the one to whose service he had subscribed would be protected. He would have an enforceable contract with the first company. If the second company wanted to provide a different level of service from that specified in the subscriber's contract with the first, it would have to obtain the subscriber's consent.²

The Role of Enforceable Commitments

Perhaps such companies would not offer contracts, that is, enforceable commitments, at first. Competition, however, would soon force them to offer such contracts. Were it common practice for cable companies to charge higher rates than they had indicated in soliciting subscribers, future subscribers would be unwilling to indicate their intention of subscribing unless they had a firm contract from the cable company to serve them at the promised rates. Unfortunately, this solution also involves difficulty — for contracts are costly and they expire.

The Problem of Contract Expiration

To take the second of these points first, when the cable subscriber's contract with the cable company expired, he would be at

¹No windfalls should result from the cable companies' getting together and swapping subscribers in order to eliminate wasteful duplication. In contracting with subscribers, each company will presumably anticipate the process of eliminating such duplications and price its service accordingly.

²At first, many households might sign up with the first cable company to solicit them, without considering alternative suppliers. But this is a general problem of consumer marketing, and one that competing sellers normally manage to overcome. The word would soon spread that one should not subscribe to cable television service without comparing the contracts offered by competing companies.
the company's mercy for there would be no other cable company in the area to which he could turn. To be sure, the monopoly position in which the cable company found itself upon expiration of the contracts with its subscribers would last only until a competitive company could move into the area and offer them a better contract. However, there would be a lag between the time the first company raised its price and a new company (a) found out, (b) signed up enough subscribers to justify building its own system, and (c) either built such a system or bought the existing system of the first company. Plainly, the length of the lag is an important consideration in evaluating the monopoly power of cable companies in the absence of any regulation.

What determines the length of the lag? The size of the area in which only one company can economically provide cable television service is probably the most important factor. If that area is an entire city, it may take a long time for a new entrant to win over the existing cable system's subscribers and build a cable network to serve them. If on the other hand the area is only a small neighborhood, entry could be rapid; cable companies in adjacent areas would have only to extend their lines a few blocks.

One might argue that entry would not be likely to occur until the plant of the existing cable company is no longer usable and needs to be replaced. The costs of running an already constructed cable system are only a small proportion of the total costs of the system (most of the costs being incurred in the initial construction). Therefore it might appear that the existing cable company in an area would have a decisive cost advantage over any new firm which would have to construct (or extend) its system in order to serve the same area.

But such reasoning again ignores the possibility of contractual arrangements. Before entering a new area, a cable company can be expected to seek contracts from subscribers now served by the firm (or firms) already in the area. Such a contract might provide that the subscriber, in exchange for a lower rate, would agree to take service from the new firm for a specified period. During this period, the firm would be protected by these subscriber contracts from
retaliatory price cutting by the existing firms. Of course, rather than lose this business, the existing firms might offer subscribers a lower rate in order to forestall new entry; but such a process of threat and response should eventually compress rates to a competitive level.

Although rapidity of entry would obviously improve the subscriber's bargaining position, cable subscribers might not necessarily be subjected to monopoly prices in those cases in which entry is slow. The feasibility of contractual arrangements is again critical. As an example, suppose that it would take two years for a new company to enter the market of a company that has three-year cable service contracts with its subscribers. At the end of the first year of the contract, subscribers should be able to obtain either an extension of the contract or a new contract with a rival cable company for service commencing upon the expiration of the original term. The important point here is that the subscriber in this hypothesized situation clearly has the upper hand. And notice that there is no need to assume that the subscribers can or will bargain collectively with the company that serves them. It is only necessary that there be potential entrants to whom the individual subscribers can turn for a better deal.

The Cost of Contracting

Now let us return to the point that contracts involve expense. As every shopper knows, most transactions involving individual consumers are not handled by means of formal contracts embodying continuing obligations. This may be accidental, but it may also reflect the costs of substituting formal, long-term contractual arrangements for informal or short-term arrangements. A contractual solution to the problem of local cable monopoly could turn out to be quite costly. Whether or not it would is an empirical question. As mentioned earlier, the first step in answering it is to determine the minimum geographical market area of a cable system, since the smaller it is the more credible will be the threat of new entry.
COSTS IMPOSED ON THE COMMUNITY

Aside from the mechanics of contracting, the question arises about the extent to which competition among cable companies might impose significant costs on the community -- "external" costs, which the companies would not take into account. If several companies ripped up the same street to lay parallel cables when a single cable entailing less disruption would suffice, an unnecessary amount of inconvenience would be imposed on the passersby. These costs could be reduced by a municipal digging fee that reflected not only the damage to the street but the inconvenience to its users.

However, it is unlikely that public inconvenience would in fact be a serious problem in the present context. As mentioned earlier, duplication is unlikely. Before construction, the cable companies would rearrange their routes so as to minimize duplication; and as for any new entrant, he should be able to purchase the existing cable company's system once he has signed up enough subscribers to make commercial service by the existing firm unprofitable to that firm. In any event, the amount of disruption that the installation of a cable television network (or networks) entails should not be great, since to a great extent cable systems are able to use existing ducts and poles.

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To summarize, the concern with the consequences of technical or natural monopoly in local cable television service, although frequently overstated, contains a core of plausibility. If a single cable firm can service consumers in an area at lower cost than two or more firms could, there will be a lag (although not necessarily a long one) between the setting of a monopoly price by the existing firm and the provision of a competitive alternative to the consumer; and during that period the existing firm will obtain a monopoly return. Consumers may be able to protect themselves against monopoly pricing by entering into suitable contractual arrangements with the first supplier, although this would depend on the cost of such
arrangements, about which we know little. The nature of the service may be such that long-term contracting would be a substantially costlier method of defining the relations between the parties than would other arrangements; and an additional cost that a buyer incurs to avoid being subjected to a monopoly toll is itself a form of such toll.

At the same time, nonregulation may provide an attractive alternative to regulation of cable television service, at least on an experimental basis. It is not clear that cable has enough attributes of a natural monopoly to create a serious danger of restricted output. But even if it has, we have just seen that the bad effects of monopoly might be averted by the combined effect of the threat of new entry and the contracting process. This result is of course not certain; but alternative approaches, as we shall see, also have weaknesses.
IV. THE FRANCHISE METHOD OF REGULATION

The legal authority of municipalities to refuse the use of public rights-of-way can be used to affect a cable company's ability to exploit its monopolistic position. Two basic approaches are possible. One, the "concession approach," which has already been used widely, involves extracting concessions from the company -- in effect, to condone its monopoly but insist that the fruits be shared with the franchising authority. The second, the "bargaining approach," involves the use of the franchising authority's bargaining leverage to prevent the charging of monopoly prices. We shall treat these in turn.

THE CONCESSION APPROACH

Lump-Sum Auctions

The concession approach can take several forms. One possibility, which has been rarely if ever employed, is simply to auction off the franchise to the bidder who offers to pay the largest lump-sum for it. In bidding under such a system, an applicant for the franchise would first estimate the monopoly profits (if any) that the franchise would yield were no fee imposed. He would then estimate the capitalized present value of those anticipated profits. That amount is the maximum amount that he would bid for the franchise. The bidder who expects the franchise to yield the largest monopoly profits would be the high bidder and would receive the franchise.

The advantages of this method are that (a) it captures the monopoly profits for the public (in the form of the lump-sum payment to the franchising authority) and (b) it is easy and cheap to administer. The disadvantage is that it does nothing to alleviate the monopoly problem and it may actually aggravate the problem. Fees to subscribers would be no lower than if no attempt to regulate the cable monopoly had been made. Less obviously, there is a danger

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1To overcome any liquidity problem, the sum could be made payable in annual installments rather than all at once.
that the franchising authority will be tempted to offer applicants not merely the right to wire homes in its jurisdiction but the exclusive right to do so, thereby superimposing a legal monopoly upon the franchisee's natural monopoly. By thus making the franchise more valuable, the franchising authority can extract a larger sum from the franchisee -- but at the cost of increasing the franchisee's monopoly power beyond what natural economic conditions dictate, and hence of worsening the misallocative effects of the monopoly.

It is sometimes argued that if economic conditions dictate the provision of a service on a monopoly basis, a grant of exclusivity adds nothing to the franchisee's power over price. But this takes too static a view. Changes in technology may, over time, erode a natural monopoly. For example, developments in communications might some day enable the telephone companies to offer cable television service in competition with cable companies, or to displace the latter altogether. Such developments would be hindered by the grant of long-term exclusive franchises to cable companies for the franchises would enlarge the cable companies' effective monopoly. What is more, since cable companies might not have monopoly power in the absence of government regulation, an exclusive franchise could create monopoly where none would otherwise exist.

Even if the franchising authority resists the temptation to award an exclusive franchise, the problem of governmental support or enhancement of monopoly cannot be easily dismissed. Once a firm has obtained the valuable right to exploit a local monopoly of cable service, it will argue strenuously to the franchising authority against the grant of a franchise to anyone else. Especially if the franchisee has not completed payment of the lump-sum, such an argument is bound to carry weight. It is noteworthy that even where public revenues are not at stake, regulatory authorities are frequently inhospitable to new entrants.¹

¹See Posner, op. cit., p. 612, and sources cited. Some reasons for regulatory hostility to entry are discussed later in the paper. For an example of the kind of protracted (and costly) proceeding that
Auctions Geared to Size of Cable System

An alternative approach would involve awarding the franchise to the firm that offers to pay the franchising authority the highest fee per subscriber or the largest percentage of gross revenues. This method is questionable since it could lead to even higher subscriber fees and lower output levels than the lump-sum auction method. If the fee is based on the number of subscribers, the franchisee will treat it as an additional cost per subscriber and the profit-maximizing strategy in these circumstances is to raise rates to subscribers. If the payment to the franchising authority is a percentage of gross revenue, the cable operator will treat it as reducing the demand for his product, and again one can demonstrate that so long as the cable operator seeks to maximize profits he will raise rates to subscribers. (A firm might also regard a municipal fee or tax on a per-subscriber basis as reducing its revenue, rather than as increasing its cost; but as just explained, it will raise subscriber rates in either case.) Thus, we end up with subscriber rates even higher than that of either

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1 This is best illustrated with use of economic theory. In the following diagram the demand curve is denoted by DD, \( P \) is the price and \( Q \) the output of a profit-maximizing monopolist having marginal cost \( MC \). The effect of the fee is to raise his marginal cost to \( MC' \). Since the profit-maximizing price and output of a monopolist is determined by the intersection of his marginal-revenue curve (MR) with his marginal cost curve, it is readily apparent from the diagram that an increase in the firm's marginal costs will lead to an increase in price and a diminution in output.

![Diagram showing the effect of a subscriber fee on price and output](image-url)
an unregulated monopolist or a monopolist franchised under the lump-
sum auction method outlined previously.

This method of awarding franchises may, indeed, be unworkable. Even when a bidder offers a fee per subscriber or a percentage of gross revenues so high that it would require him to operate at a price level where output was extremely small, he would still obtain monopoly profits. There is therefore room for a still higher bid involving a still smaller output. The tendency is for price to approach the highest point on the demand curve and for output to approach zero. The franchising authority may attempt to prevent such a result by fixing a ceiling on the rates that the franchisee may charge, but this involves a shift to another form of control, rate regulation, which has (as we shall see) severe problems of its own.

Auctions Based on Service Concessions

Another alternative would be to award the franchise to the firm that offers the most service. This might be the firm that promised to dedicate the greatest number of channels, free of charge, to the use of the franchising authority, or to provide the greatest amount of original programming. The effects on output of this approach are more complicated but could still be significant. If the response of applicants under such a scheme is to offer more channels or more programs, the consequences depend on the additional investment and operating cost entailed in the larger system. If additional channels can be provided at no additional cost, then requiring the franchisee to build the larger system will not affect the price to the subscriber or the number of subscribers served. But to the extent that additional channels do entail an additional cost to the cable operator, the adverse effects of local cable monopoly would arise as before.\(^1\)

\[^1\text{It appears that additional costs are involved. See Ohls, \textquote{Marginal Cost Pricing and Investment Theory and CATV} (forthcoming in the \textit{Journal of Law & Economics}).} \]
It is notable that the franchise applicant, under pressure to offer service concessions, may not respond simply by proposing a larger system. To illustrate, suppose that he estimates that subscriber demand would warrant an eight-channel system. He might, as just suggested, decide to offer to build a 12-channel system and dedicate four of the channels to the franchising authority; but alternatively, he might decide to offer to build only a nine-channel system, with four again dedicated to the use of the franchising authority. Since the subscriber demand for five channels would be less than the demand for eight, the franchise applicant would expect less revenue from the smaller system. However, if the smaller system were significantly less costly than the larger, it might represent, on balance, the more attractive bid from the applicant's standpoint. The smaller system would, however, result in lower benefits to subscribers than would be larger systems that would have been built in the absence of regulation.

**Fixed Concessions**

We have thus far considered several possibilities for awarding the franchise to the high bidder. But the usual practice is different. Franchising authorities specify a fixed percentage of gross revenues or other specific concessions to be paid by the franchisee, rather than letting the size of the concession be determined by competitive bidding. This procedure limits the undesirable effects of encouraging franchise applicants to outbid each other, but it does not eliminate them. Any franchise exaction that increases the per-subscriber cost to the cable operator will be passed on (at least in part) to the subscriber in the form of higher rates, so long as the operator seeks to maximize his own profit. Moreover, the fixed-concession method deprives the franchise system of one of its most attractive features — ease of administration. When the franchise is awarded to the high bidder, the process of choosing among applicants involves a minimum of administrative machinery and official discretion. Once the auction method is abandoned, an apparatus for awarding franchises to those applicants whose plans of operation are judged to be most
in accord with some nonprice, nonquantitative criterion such as the "public interest" becomes inevitable.¹ The costs of such an apparatus aside, schemes under which valuable franchises are awarded according to ill-defined criteria carry the threat of breeding corruption.

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The concession approach, as one might denote the various franchise schemes thus far considered, is the prevailing mode of cable television regulation today.² It has been endorsed by some distinguished authorities such as the New York Mayor's Advisory Committee on CATV and Telecommunications.³ The proponents seem to overlook the undesirable effects of the concession approach (in the form of higher rates to subscribers) and the temptation of local governments to become partners of cable systems in the extraction of monopoly profits.

At the same time, these need not be decisive objections to a scheme of taxation -- which is, functionally, what the concession approach is. No taxes are wholly free of effects on the allocation of resources; nor is the avoidance of monopoly necessarily a dominant social goal. The concession approach might therefore be deemed socially preferable to alternative revenue measures (although if this judgment is to be made, it should at least be made with an awareness of the effects on rates to subscribers). Communities that do adopt the concession approach would be well advised simply to auction off cable

¹The inadequacies of nonquantitative criteria in the award of valuable franchises are well documented in the literature on broadcast regulation by the FCC; they are one of the reasons behind proposals that broadcast licenses be auctioned off to the highest bidder. See, for example, R. Coase, "The Federal Communications Commission," Journal of Law & Economics, Vol. II, pp. 1-40 (1959).


television franchises to the highest lump-sum bidder. The lump-sum method has several advantages over alternative concession approaches:

(a) it maximizes the franchising authority's revenues;
(b) it creates no incentive on the part of the franchisee to charge even higher prices and produce even less than if he were left alone; and
(c) it is cheap and convenient to administer.

Moreover, franchising authorities might reduce the undesirable effects of franchise systems in protesting existing franchisees by granting no exclusive franchises, and holding new auctions at frequent intervals.

THE BARGAINING APPROACH

The franchising power can be used in a different way, designed not to compel the local cable monopolist to divide monopoly profits with the franchising authority (either in money or in service) but rather to compel the cable operator to charge subscribers the competitive rate. Under this approach, a local agency would act as the purchasing agent for the residents in its jurisdiction for cable television service. It would conduct an auction, with the franchise awarded to the firm that offered the best overall deal to subscribers rather than to the firm that offered the largest concessions to the franchising authority. Each bidder would submit a plan of service and a schedule of rates, and the bidder submitting the best service-rate package would win. So long as there was more than one bidder and collusion among the bidders was prevented -- conditions that ought not be insuperably difficult to secure -- the process of bidding subscriber rates down and quality of service up would work in the public interest. The undesirable effects on subscriber fees of the franchisee's monopoly would be eliminated and indeed he would have no monopoly in any meaningful sense. This approach, too, raises problems which we now need to consider.
Comparisons Between Alternative Packages of Service

Since bidders may offer quite different types or levels of cable service, having different costs, it may be difficult to decide which bid is best from the subscriber's standpoint. Consumers face and overcome this problem daily in choosing among products that differ in quality as well as price. However, in the present context it is not the consumers (the cable subscribers) who determine the preferred price-quality mix, but an official body that must attempt to infer the consumers' preference, and, failing that, to substitute its own.

This problem could be alleviated to some extent by beginning the bargaining process with an "open season" in which all franchise applicants were free to solicit the area's residents for a set period of time. This would not be a poll -- the applicants would seek to obtain actual commitments from potential subscribers. At the end of the solicitation period the commitments received by the various applicants would be compared and the franchise awarded to the applicant whose guaranteed receipts, on the basis of subscriber commitments, were largest. In this fashion the vote of each subscriber would be weighted by his willingness to pay, and the winning applicant would be the one who, in free competition with the other applicants, was preferred by subscribers in the aggregate. To keep the solicitation process honest, each applicant would be required to contract in advance that, in the event he won, he would provide the level of service and at the rate represented in his solicitation drive.

In some instances this method would distort consumer preference. Suppose that 30 percent of the consumers "vote" for system A, 30 percent for system B, and 40 percent for system C, and that A and B are quite similar, but C is quite different: C will be franchised, though franchising either A or B would probably please more consumers. Problems of this sort are resolved automatically in a market by recontracting. One can devise methods of approximating the market result -- by having a run-off solicitation campaign or by permitting subscribers to sign up with more than one system -- but this may be too awkward and cumbersome to be feasible.
An alternative method would be to have the desired level and quality of service determined by an administrative group especially selected for the purpose. In comparing disparate bids, the decisions of the group might reflect the preferences of the community with greater accuracy than would the decisions of an existing local government body. Perhaps this is not a very precise and discriminating method of registering consumer preference, but it does avoid the distortion problem noted above. Incidentally, the separation of the cable franchising responsibility from other local government functions may have independent merit, and it could be implemented consistently with reliance on the solicitation process to determine the winning bid.

Determining the Duration of the Franchise

Another problem with the bargaining method involves the duration of the franchise. If it is long, the parties may not have foreseen all of the circumstances that might require modification of its terms. Although this is a problem common to all contracts, the peculiarity here is that one of the contracting parties is not a true party in interest but a public body charged with overseeing the interests of the other parties (the subscribers). As we shall see later in discussing rate regulation, one cannot assume that such a body will represent the consumer interest faithfully. When the cable company asks for a modification of the contract by virtue of an unforeseen change in circumstances, the public body may react in the ineffectual or perverse manner.

It is therefore desirable to keep the term of the franchise sufficiently short so that no modification of its terms need be entertained. However, the fact that the cable company's plant is bound to outlast a short-term franchise raises questions: Will not a company that still has a usable plant be able to outbid any new applicant that would have to build a plant from scratch? Will not the bargaining method be ineffective, therefore, after the first round? Not necessarily. In bidding for the franchise on the basis of new equipment costs, new applicants need not be at a significant disadvantage in relation to the incumbent
franchisee. For example, once a new applicant is franchised he could negotiate to purchase the existing system of the existing franchisee, who otherwise would face loss of the unamortized portion of his investment if his successor builds his own plant.

Insofar as the economic life of cable plant is considered a problem when the franchise term is short, it can be solved in either of two ways: (1) by a provision in the franchise requiring the franchisee, at his successor's option, to sell his plant (including improvements) to the latter at its original cost, as depreciated; or (2) by specifying in the franchise itself the "option price" at which the franchisee would be willing to sell his plant at some future date. The holder of the first franchise would be eligible to receive another franchise, but, under either system, he would have no advantage over other applicants by virtue of owning a still usable cable network. Competing applicants would not have to be prepared to duplicate his network. Nor would they labor under any uncertainty as to the price that they would have to pay to buy it.

In fixing the option price, under the second solution above, it is important to bear in mind that the new franchise should not be granted simply to the applicant who offers to pay the highest price for the existing franchisee's plant. That would lead to the capitalization of future monopoly profits, and the whole purpose of the bargaining method would be subverted. The plant should be transferred to the firm that offers subscribers the most attractive package of rates and services for the next franchise period.

The option price would be difficult to fix in any case where the ultimate development, and hence cost, of the cable system was uncertain at the time the franchise was granted, or where replacement or improvement of plant during the franchise period was contemplated. One danger is that the firm that submitted the winning bid might be counting on an inflated option price (the burden of which would fall on subscribers in subsequent franchise periods) to give it a monopoly return. This problem might be solved by structuring the bidding process so that each applicant would be required to submit a set of rates covering a range of
different types and level of service, and a corresponding set of option prices for the purchase of its plant at the end of the franchise period. (The reason for specifying several option prices is that different types or levels of service may require plants with different costs.) A provisional winning bid would be determined in the solicitation contest already described. The winner's service-rate package would then be compared with the submission of the other applicant respecting similar types and level of service. If the relevant option price specified in the provisional winner's bid were lower than the other applicant's, the award of the franchise to the provisional winner would be confirmed. If, however, his option price were higher than his rival's, another step would be necessary: computation of the present value of the excess rates that subscribers in future franchise periods would be required to pay in order to amortize the provisional winner's higher option price. If the present value of that future burden exceeded the present value of the rate savings that subscribers would obtain from the lower rate specified in the winning bidder's package, the franchise would be awarded to the other applicant. Of course, there would be subjective judgments to be made in using this process. The selection of a discount rate and the estimation of the number of subscribers that the cable system would have in its mature state might be difficult. However, the alternative of paying the outgoing franchisee his depreciated costs would not be straightforward either.

Even if we left determination of the transfer price to negotiation between the old and new franchisee, the short-term franchise would probably have an adverse effect on planning for long-range growth in demand. A firm which cannot be in business for more than three, or five, or seven years will not build for the more distant future. It might build a plant designed to wear out after five years, thereby minimizing its costs and rates but possibly imposing much higher costs in the long run than if a sturdier plant were built. This problem would not arise if renewal were virtually automatic, as is the case with broadcasting licenses; but the essence of the approach here is that renewal not be automatic or routine.
Other Considerations

Finally two other problems of the bargaining approach should be noted:

(1) It provides no revenue to the municipality, although it does increase the economic welfare of its inhabitants as cable subscribers.

(2) It comes into play only when a franchise is to be awarded, and would appear to have no application, therefore, to existing franchises. However, the relatively few cable systems currently in operation probably constitute only a small fraction of the number of systems that will be operating when the industry reaches its mature state; and existing franchises will some day expire. Moreover, local authorities could use the eminent-domain power to cancel existing franchises and institute the bargaining method.

Despite the problems that it involves, the bargaining approach, properly structured, has sufficient promise to warrant its experimental adoption in some communities. At least, it is a method of coping directly with monopoly pricing, which the concession approach is not.

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By way of summary, it may be helpful to present some of the steps that would be involved in implementing one variant of the bargaining approach. This is not intended as a complete blueprint for action, but only a general outline that would have to be adapted to reflect local situations. For purposes of discussion, we shall assume that the community in which the approach is tried has no existing cable television service.

(1) The first step would be for the mayor or council to appoint a Cable Television Board, consisting of representative private citizens of the community, assisted by a small professional staff.

(2) The Board would invite applications for cable television franchises from members of the industry. To assure wide distribution
of the invitation, it could be channeled through the industry's trade association, the National Cable Television Association in Washington, D.C. The invitation would, of course, specify the various conditions of the franchising process. The terms offered in an application could at the Board's discretion be disclosed to the other applicants, who would then be free to revise their offerings.

(3) After all applications were in, the Board would compare the terms offered in each. If the service offerings of the applicants were substantially the same, the franchise would automatically be awarded to the applicant offering the lowest rates to subscribers; or if the rates were the same, to the applicant offering the greatest service. If substantially different price-service mixtures were offered, the Board would group them into several classes and engage a professional survey organization to assist it in determining which the community preferred. The applicants would then be invited to submit bids on the level of service as selected and the franchise would be awarded to the lowest bidder.

(4) The period of the franchise would be three years. Shortly before the expiration of the franchise period, new applications would be solicited for the succeeding franchise. The existing franchisee would be eligible to compete on the same terms as other applicants; he would have neither preference nor handicap. The original franchise would provide, however, that he must transfer his facilities to the next franchisee (if different from himself) at their depreciated original cost.

(5) The process would be repeated at the close of each succeeding franchise period.
V. REGULATION OF SUBSCRIBER RATES

There has been, as yet, little direct experience with attempts to regulate subscriber fees or rates for cable television service. But there has been a good deal of experience with rate regulation in other industries, many of which, like local gas, water, electrical, and telephone service, resemble cable television in their supply and demand characteristics. This experience offers some guidance to the likely costs and benefits of extending the principles of public utility (or, what is the same thing, common carrier) regulation to cable television.

EFFECTIVENESS OF REGULATION

In principle, placing a ceiling on the rates that a monopolist may charge is a straightforward and efficacious corrective. But there is reason for concern that in practice it may not be so, and that in fact it may impose substantial, if largely invisible, efficiency costs on the community.¹ Thus far, empirical studies have not discovered any appreciable impact of regulation on the rates of the companies regulated.² This is probably due in part to (a) the paucity of resources, especially at the state level, devoted to rate regulation, and (b) the difficulty of determining a regulated firm's costs -- a necessary step if its rates are to be set at a level that will limit or prevent monopoly pricing while permitting the firm to recover its legitimate expenses.

¹The discussion that follows draws heavily on Posner, op. cit., p. 4, n. 1.
Some costs can be determined easily enough if the underlying data are known, but such data are held by the regulated firms and not always easy to extract in a trustworthy or usable form. Other costs are difficult to determine even if the underlying data are easily available. These include depreciation allowances and, especially, the cost of equity capital. The latter depends on the rate of return that investors demand for providing capital to firms of the regulated company's risk class and on the value of the company's capital assets against which to apply the rate; both quantities as yet elude confident measure. Problems are also encountered in separating costs between regulated and nonregulated services provided by the company. Slight errors in the successive steps required to determine the company's relevant costs may cumulate in a fashion to deprive regulation of any significant effect on the regulated firm's rate and profits. An additional factor is that rates are reviewed periodically rather than continuously, and changing conditions of cost or demand may produce windfall profits or losses in the intervals between rate reviews.

None of these problems can be written off as academic or trivial for cable television service. Indeed, some seem especially acute in this context. With the industry in so embryonic a state of development -- with demand and technology still so fluid -- the determination of proper depreciation periods and of risk (and hence of the required rate of return to equity financing) is likely to be unusually difficult. And periodic rate reviews may be too infrequent to permit the adjustment of rates to rapidly changing costs and demands. Moreover, since many cable companies have systems in different jurisdictions, and since some are subsidiaries or affiliates of noncable enterprises, cost separation problems seem unavoidable. Although present cable systems are relatively small and simple compared to many other regulated firms, the picture may change dramatically as the industry matures. And if the difficulties in the way of effective regulation are less pronounced with respect to cable television than to some other industries, the resources devoted to its regulation are likely to be less ample as well. Legislatures often thrust additional duties
on regulatory agencies faster than they appropriate additional funds. They assume that the agencies can probably do more with their existing resources than they are doing. If this is the prevailing attitude, the resources devoted to rate regulation of cable television operators are likely to be scanty.

OTHER PROBLEMS OF REGULATION

It is commonplace to measure the costs of regulation by the budgets of the regulatory agencies, but this greatly understates the true costs. It ignores not only the legal and other expenses that are imposed upon regulated firms, which doubtless exceed by several times the expenses of the agencies,¹ but also the considerable indirect costs of regulation arising from the adaptive responses that firms can be expected to make to a regulatory environment. To illustrate, a regulated firm might decide to diversify its operations to a greater extent than is efficient, hoping by skillful accounting to allocate the monopoly profits of the regulated business to one of its unregulated activities. Although this particular danger would be eliminated by forbidding regulated firms to diversify, this would be at the cost of blocking diversifications that may promote competition or efficiency. Or a regulated firm might devote extravagant sums to lobbying or propagandizing. This seems a particularly acute danger in a business engaged, as cable companies increasingly are, in originating news and other television programs.

Rate regulation may also discourage internal operating efficiency and distort the rate and direction of inventive activity. In a competitive industry, the pressure of competition should eliminate slack and foster optimum innovation. A monopolist is not completely free from competitive pressures — he must reckon with potential entrants and the competition of substitute goods or services. Moreover, monopolists still have substantial incentives to minimize costs and to innovate: these are methods of increasing profit, and a monopolist

must wring the last dollar of possible profit from his position not only as a good business practice but to prevent a takeover by those who can use his assets more productively. However, to the extent that regulators succeed in placing the regulated firm on a cost-plus basis -- the formal goal of the regulatory process -- the profit discipline is eliminated. Although a basic source of innovation will in any event lie in the manufacturing rather than in the service level of the communications industry, important service and marketing innovations are likely to come, if at all, from the cable television companies themselves.

A facile reply to the preceding criticisms of regulation is that it is the duty of regulatory agencies to prevent the regulated firm from incurring imprudent expenses. But in practice the control that regulatory agencies, especially at the state level, exercise over aspects of regulated firms' behavior other than price is severely limited. Also, since the agency's effectiveness in policing the regulated firm's costs is bound to vary among the different cost items, the firm's pattern of expenditures is likely to be biased in favor of those cost categories that are loosely policed; and this may have serious untoward results on operating efficiency. For example, if the agency effectively polices all costs except the cost of capital, the firm would be encouraged to step up its rate of capital investment, for by doing so its total dollar profits would rise. No matter if the output of the additional plant must be sold below cost, for the firm could recoup the loss from the unjustified plant expansion by raising its rates for other services.  

In this case, the result would be excessive substitution of plant and equipment for other inputs.

Additional social costs of regulation arise from two of the incidental restraints that public utility regulation imposes: over the structure of rates, and over competitive entry. Regulatory agencies have customarily required regulated firms to provide service at more or less uniform rates, despite differences in costs. As a result,
some customers receive service at a rate below the cost of serving
them, while others must pay exorbitant rates so that the company can
recoup its losses in sales to the favored customers. This practice
of cross-subsidization is inconsistent with an optimum allocation of
resources. It underallocates resources to the disfavored markets and
overallocates them to the favored ones.

Were entry into regulated markets free from government restriction,
cross-subsidization would not persist for long. The high-profit mar-
kets would attract "cream skimmers," whose actions would compel the
regulated firms to lower their rates in the high-profit markets and,
indirectly, to raise their rates in the subsidized markets. However,
regulatory agencies control entry as well as rates and tend to look
with disfavor on "cream skimmers," precisely because they destroy the
pattern of rates preferred by the agency in the first place.¹ Blockage
of cream skimmers is only one example of the ways in which regulatory
control over rates and entry has often served to perpetuate monopoly
positions.

It can only be hoped that these adverse consequences of rate
regulation will be avoided in the cable television industry. On the
positive side, one can argue that past deficiencies characterizing
the regulatory process are merely accidental and remediable, and
afford no basis for opposing the extension of the regulatory principle
to a new industry. However, the observed inadequacies of much govern-
ment activity, including public-utility regulation, appear rooted in
stubborn, more or less permanent characteristics of the governmental
process.² The heart of the problem is that a regulatory agency's

¹For a case study of this phenomenon see R. Coase, "The Postal
Monopoly in Great Britain: An Historical Survey," in Economic Essays
in Commemoration of the Dundee School of Economics, 1931-1955, p. 25,

²See A. Downs, Inside Bureaucracy, Little, Brown and Company, Boston
(1967); J. Hirshleifer, J. DeHaven and J. Milliman, Water Supply: Eco-
nomics, Technology, and Policy, University of Chicago Press, Chicago,
pp. 82-86 (1960); C. J. Hitch and R. N. McKeen, The Economics of Defense
in the Nuclear Age, pp. 105-106, Atheneum, New York (paperback ed. 1965);
"output" -- effective regulation, as one might call it -- is not sold in any market and is not susceptible to direct measurement, or indeed of observation. With no dollar figure assignable (other than arbitrarily) to the agency's output, it is often impossible to determine whether too few or too many resources are being allocated to the agency and whether the agency is using them efficiently or inefficiently.

To determine whether a regulatory agency is performing in a satisfactory manner, one would have to know the costs and benefits of its activity and in most cases these are difficult to obtain. For example, an important component of these costs, those attributable to the impairment or perversion of business incentives that regulation may cause, elude measurement. The degree of misallocation of resources that would obtain if the firms were unregulated, and the degree of misallocation that in fact occurs, are also critical but unknown. It will also be impossible in most cases to ascertain whether the same reduction in welfare losses could have been obtained by better regulatory management at lower costs and whether additional inputs to the regulatory process would produce an additional benefit greater than their additional cost. Finally, there is not even general agreement that economic efficiency should be the only goal of public utility regulation; and once we consider other factors, such as equity, objective criteria of performance are out of the question.

Lacking such criteria, the individuals who control or manage regulatory agencies are forced to substitute subjective conceptions of the "public interest." The danger is ever present that these conceptions will be consciously or unconsciously designed to promote the regulators' personal welfare rather than that of society. Being human, rate regulators are tempted in many cases to follow policies designed to further their personal interests, such as power and security. A lack of social control may persist because consumers are too diffuse and unwieldy a group to organize effectively to participate in the political or regulatory processes, and because people are consumers last, subordinating their generalized interest in low prices and good service to their highly specific interests in firms that they work
for, own, or supply. A regulator's secure job, good relations with the legislature, and attractive prospects for future private employment are more likely, therefore, to depend on conciliation of the regulated firms than on vigorous championing of consumer interests. This implies lax regulation of profits but tight regulation of entry of new firms -- a combination calculated to aggravate rather than alleviate the burdens of monopoly.

Of course, regulators cannot carry these tendencies too far without inviting a public outcry, or at least feeling pangs of conscience; but the lack of objective performance criteria gives them a wide latitude. And while there are exceptional men who resist the tug of self-interest, it would be imprudent to base policy on the assumption that their views will systematically prevail.

Moreover, the problem of which agency is to regulate is particularly acute here. Because of the number of rates to be regulated, it would seem unworkable to vest regulation in the Federal Communications Commission. Recently, when one federal agency was directed to regulate the rates of several thousand small companies -- the regulation of natural-gas producers by the Federal Power Commission -- the results were chaotic.¹ The FCC is busy enough as is. On the other hand, state public utility regulation is by all accounts so underequipped and underfinanced in most states as to be of questionable efficacy in regulating cable television, when we do not even know whether a serious monopoly problem is presented by it.²


²A final argument against the extension of public utility regulation to cable television, but one that does not seem well-founded, is that such regulation is traditionally reserved for "essential" services such as water and electricity. This position is defended by Shaefer, "Cable Television: Is State Regulation Needed?" Public Utility Fortnightly, Vol. 84, p. 23, July 3, 1969. However, if the efficiency of resource use could be improved by the regulation of cable rates, and the benefits exceeded its costs, society would gain from regulation. In these circumstances, there would be no practical objection -- and there is no longer any constitutional objection -- to extension of the public utility concept.
VI. CONCLUDING REMARKS

As we have seen, none of the alternative regulatory designs (including no regulation), are free from difficulty. A period of experimentation seems merited. In cooperation with the FCC and other agencies, state and local authorities should explore carefully the range of options open to them, experiment with different ones, and support empirical research into the magnitude of the local monopoly problem and the effects of various methods of coping with it. It would seem especially important to avoid a national solution, which, at this stage of cable development, could easily be premature.

One can exaggerate, to be sure, the importance of "preserving options" in this area. We have considered three methods for avoiding monopoly: no regulation by reliance on the contracting process, the bargaining method of franchise regulation, and direct rate regulation. Because these are functionally quite similar methods, if one of the three methods is effective, the others are likely to be; and if one is ineffective, so are the others likely to be. They depend for their effectiveness on the ability to specify in clear and explicit fashion the price and service undertakings of the cable company. If the circumstances of the industry make such specification unfeasible or costly, none of the methods will work. Still, there is value in experimenting with alternative approaches.

Specifically, it would be good if some jurisdictions experimented with at least one of the methods of preventing monopoly prices — no regulation, the bargaining approach to franchise regulation, or rate regulation — and others with lump-sum auctions (the most efficient method of capturing any monopoly profits for the public). If the auction approach yields no significant revenues for the franchising authority, we will know that there is no significant monopoly problem, and then the major question for policymakers will be whether franchise fees on cable operations are preferable to alternative ways of raising funds for the local treasury. If subscriber rate regulation proves ineffectual, and if substantial revenues to municipalities are
generated by lump-sum auctions, municipalities will have good reason
to opt for the latter method of regulation, which, to repeat, does have
the advantage of capturing the monopoly profits for the public benefit.