The Economic Impact of Video Franchising and Broadband Investment in Michigan: 2006

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Executive Summary

Michigan passed major reform legislation in 2005, but did not address statewide franchising. This paper addresses the final leg of the deregulation journey. The major findings and recommendations of this paper are:

• Michigan is an opportunity state.

The U.S., once a leader in global telecommunications, today ranks only 15th in the world in broadband deployment. Michigan ranks only 30th in the U.S. in number of broadband lines per 1,000 inhabitants. Michigan can assist itself by removing barriers to rapid broadband deployment and join with other states in helping the U.S. to recapture its role as a leader in the global information economy.

• Michigan is not fully participating in the national economic growth engine.

The maturity and decline of the manufacturing sector, coupled with high unemployment and depopulation in the 1990's, suggests Michigan is not fully participating in the national economic growth engine. New economic benefits demand supporting infrastructure that is not yet fully in place.

• Impact of competition can be immediate

In Texas, the adoption of statewide franchising resulted in an immediate 25% reduction in cable rates in affected markets, and a recent study by the FCC suggests direct competition would result in a 27% reduction in rates. For Michigan, we can expect the introduction of competition to save existing Michigan cable subscribers between \$156 million and \$468 million annually.

• Statewide vide o franchising is the key.

Twenty years of data collected by federal agencies and independent scholars point to the significant, positive effects direct competition on (1) Michigan consumers and (2) the Michigan economy. This includes the potential for 34,400 new jobs and an increase in the Gross State Product of more than \$13.5 billion.

• The danger of the status quo

Michigan indeed is at a crossroads. The costs of inaction and maintenance of the status quo are quite injurious to consumer welfare. Opportunity costs suggest doing nothing or to delay reform is to ignore these substantial enhancements in consumer welfare and economic benefits to the state.

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The Introduction to Statewide Franchising

By

Robert E. Yadon, Ph.D.

Introduction

Michigan was one of the first fourteen states to adopt telecom reform legislation in 2005. Since that time, however, Texas, Indiana, Virginia and Kansas have all gone the next step and passed statewide video franchising laws, with an additional ten states considering new franchising legislation. The question remains whether Michigan will complete the reform agenda this year? While Michigan's willingness to examine statewide franchising is positive, the devil is always in the details, and the verdict on this legislation awaits final action of the legislature in the weeks ahead.

What is the potential to stall or sidetrack this agenda as some would recommend? Michigan is clearly at a crossroads, and there is always a risk it might take the wrong path. Passage of an improperly crafted bill is as dangerous to Michigan's economy as not passing reform legislation at all. The unfortunate, negative consequence to Michigan is it may have wasted this year to craft a final reform bill, only to pass legislation that severely hampers its chances of meeting its goals. Michigan needs final passage of a fair franchise reform package that will propel its economy forward. New competition will serve the needs of both metropolitan and rural areas of the state, and encourage investment to underserved areas. What issues are on the table?

Special Entitlements

In 1984 with the breakup of the Ma Bell monopoly, consumer groups feared prices would immediately soar to the detriment of those on fixed income, and the elderly would be forced to live without basic phone service. It didn't happen. In fact, FCC figures indicate that over the next fifteen years, while telephone prices remained roughly the same, telephone penetration in Michigan actually increased from 93.3 percent in 1984, to 93.9 percent in 1999.² Today, that monopoly for residential service is totally gone as most in Michigan have a multitude of choices for telephony service (incumbent wire line telephone firms, competitive wire line companies, cable modem, cellular, and internet-VoIP),³ and according to the FCC, the telco incumbent's control of the residential marketplace has dwindled to below 50 percent. In fact, according to the latest FCC figures, wire line telephone penetration in Michigan has now dropped to 91.5% in

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¹ Governor Jennifer M. Granholm signed into law PA 235, which amends PA 179 of 1991 entitled "Michigan Telecommunications Act" The effective date is November 22, 2005.

² See "Telephone Penetration by State" (Table 16.2) in FCC, Industry Analysis and Technology Division, Wireline Competition Bureau, *Telephone Subscribership in the United States* (March 2005).

³ Loomis, David G. & Swann, Christopher M., "Intermodal competition in local telecommunications markets." Information Economics and Policy 17 (2005) 97-113.

2005. In this new competitive environment, there are only a few elements of the telephone industry that remain regulated, and those need to be phased out in this new competitive landscape.

Here we are, 22 years later, and we still have consumer groups speculating the sky is falling and under deregulation the rate of basic telephone service will skyrocket. They were wrong before, and they're wrong now. First, if the wire line telephone business is fully deregulated and allowed to compete on a level playing field with other firms already in the market, it's highly unlikely that the ILEC's would drive additional customers away with unbridled rate increases. That scenario doesn't hold water from a business case or economic sense. On the contrary, Michigan's new regulatory landscape can join Indiana to become the poster child for surrounding Great Lakes states. Under the microscope, ILEC's in Michigan can ill afford any unwarranted or unnecessary rate increase when also hoping to champion a national telecom reform agenda.

Second, in a competitive, deregulated environment, economics suggests price should be allowed to respond to market pressures and approach the actual cost of providing service. This does not include a statutory mandate to provide entitlements to individuals based on age alone. For example, AARP does a creditable job of negotiating with individual businesses for reductions in rates for hotels, car rentals, etc., for its members, but these adjustments are voluntary and not a matter of state or federal policy. True, this does not eliminate the need for Michigan to meet social obligations like Universal Service, federal and state assistance programs (Lifeline; Linkup) and continue the support necessary to guarantee affordable telephone service to low income households at or below the poverty level. Yet, Michigan has a proud history of helping those who are truly in need.⁴ These assistance programs were largely responsible for increasing telephone penetration in Michigan over the past twenty years. With these federal and state safeguards already in place, the most vulnerable of Michigan's citizens, those on low and fixed income, will continue to afford telephone service based on documented need, not some lobby-manufactured voodoo that we should all be compelled to pay for special entitlements based on age alone.

Finally, the threat of future telephone rate increases as a result of SB 1157 and HB 5895 are speculative at best. Prior to divestiture, there was no competition in wire-line services for residential customers. Cable was technically limited to the provision of video entertainment, there were no cellular telephone companies, the Internet was restricted to military and research university applications, and VoIP wasn't even an acronym. Will there be rate adjustments in the future? Maybe, but the reason rests more with the rebalancing going on within the competitive communications industry, and the inefficiencies of price cap regulation that has historically kept true telephone prices below cost. In reality, a 2004 GAO report demonstrated that the presence of wire-based cable competitors resulted in lower prices for telephone and high speed Internet services in

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⁴ Michigan has a long history of assisting low-income residents via the Link-Up America and Lifeline Telephone Assistance Programs. Qualification guidelines established by the Michigan PSC are based on 150% of the federal poverty guideline's maximum income per household.

most of the markets studied. Specifically, in five of the six city pairs studied, prices for local telephone service were between 4% to 28% lower that in similar markets without competition. And in four of the six city pairs studied, prices for high-speed Internet service was between 2% and 38% lower where competition was present. Here's the clue. *Competition leads to lower prices, not higher!* It's time to let marketplace forces dictate "price" and not rely on outdated, unnecessary state and federal regulations.

Ridiculous Suggestion of Redlining

One of the more absurd suggestions by opponents is that the telephone industry will engage in a willful program of redlining of broadband services in Michigan. Again, if history proves correct, exactly the opposite will happen. Dating back to the era of Theodore Vail, the telephone industry evolved under the motto, "One Policy, One System, Universal Service" for all. In short, it's part of a corporate culture that has resulted in over 95% telephone penetration of U.S. households today. If there is factual evidence to the contrary, it hasn't been produced.

Let's set the record straight, redlining is illegal and immoral, and requires no additional enforcement in a statewide franchise agreement. Should the potential for abuse be monitored? Certainly, but by federal law telephone companies are prohibited from subjecting any particular person, class of persons, or locality to any undue or unreasonable prejudice or disadvantage. This is sometimes confused with "equal access" requirements at the state or local level that force a provider to build in areas where the number of available customers (density) may not support construction, maintenance, or ongoing service in that area. For example, cable systems have been forced to provide "equal access" within specific franchise areas under the reasoning they did so with the economic protection of a 100% market monopoly. Cable systems are not, however, required to meet that same benchmark beyond their franchise area, nor should they unless all video providers would have to meet this unrealistic test.

When looking at cable television in Michigan, the total penetration rate for cable systems can be compared to rates in surrounding states. Of the five states listed in Table 1 below, Michigan ranks third in cable penetration and population. While Michigan is on par for cable penetration with surrounding states, the same cannot be said for broadband penetration. Table 2 below shows that Michigan ranks 30th in the United States in broadband penetration, and next to last when measured against peer states.

This lack of investment in broadband infrastructure is not simply a problem for Michigan, but it is a national problem as well. Once the leader in global telecom, the

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⁵ See U.S. General Accounting Office, Telecommunications: Wire-Based Competition Benefited Consumers in Select Market, GAO-04-241 (Washington, D.C.; Feb. 2, 2004).

Table 1 2005 Cable Penetration Estimates							
	Population TV Households Cable TV HH Penetration						
Michigan	10,207,421	3,912,480	2,602,900	67%			
Illinois	12,699,336	4,671,870	3,160,120	68%			
Ohio	11,477,557	4,561,000	4,205,280	70%			
Wisconsin	6,554,343	2,189,310	1,288,080	59%			
Indiana	6,249,617	2,418,800	1,460,430	60%			
Source: Population Division, U.S. Census Bureau; National Cable & Telecommunications Association.							

Table 2 Michigan's Comparison with Peer States, Broadband Internet Lines per 1,000 population 2004				
Rank/State	Population High-Speed Lines Lines per Person (000)			
#22 Illinois	12,712,016	1,534,653	120.7245963	
#23 Wisconsin	5503533	649,630	118.0387217	
#24 Ohio	11450143	1,347,040	117.6439456	
#30 Michigan	10104206	1,097,230	108.5914123	
#34 Indiana	6,226,537	641,607	103.0439553	
Source: www.fcc	.gov			

U.S. dropped in broadband penetration from 4th in 2001 to 16th in early 2004 according to the International Telecommunication Union (ITU).⁶ With 11.4 broadband subscribers per 100 inhabitants, this placed the U.S. firmly behind nations like South Korea (24.9), Netherlands (19.6), Denmark (19.3) and our neighbor to the north, Canada (17.6). Norway, Israel and Finland pushed past the U.S. for the first time, and France's aggressive rollout of broadband threatened to move the U.S. even lower (see Appendix A). As of December 31, 2004, the US was 15th overall in broadband penetration per 100 inhabitants, up one spot from 16th place in June 2004.⁷

The reason for this decline can be traced to antiquated and inefficient telecom policies at the national and state levels that delay broadband deployment in the United States according to Lara Srivastava, a telecom policy analyst for the ITU. Srivastava said, "Those countries that have done well, have done well because of active government policies for the development of broadband. In the U.S., they don't have active policies like Korea or Singapore, or Japan."

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⁶ "ITU Strategy and Policy Unit Newslog – ITU's New Broadband Statistics for 1 January 2005." Available at www.itu.int.

⁷ ITU, "The Internet of Things 2005," 7th Ed, (November 2005)

⁸ Drew Clark, "U.S. Drops Again in Global Internet Race," National Journal's Technology Daily (April 25, 2005).

Is there good news on the horizon? Table 3 below shows that the major communications firms like Verizon and AT&T have already begun the process of testing and deploying broadband technologies that will help return the United States to a leadership position in the global broadband community. Given this landscape, the goal for Michigan should be put out the "welcome mat" and move to the front of the line for investment dollars from these firms.

When looking at investment costs and the impact of broadband deployment, there is a perfect case study in neighboring Indiana. Over the past year, Verizon has been engaged in the remarkable task of deploying fiber to the premise (FTTP) for residents of Ft. Wayne/New Haven and Allen County, Indiana. Verizon FiOS Internet Service is provided by Verizon Online and uses fiber-optic cable, instead of copper wires, to directly link residential customers to the Verizon backbone. This deployment involved over 800 subcontractors, a \$75 million investment by Verizon, created 200 new jobs while offering high bandwidth Internet service to virtually every resident. Exceptions include multiple dwelling units (MDU's) where separate, negotiated contracts are required, and a small section of Allen County served by Sprint. This Indiana project is one example that redlining is a myth. While Verizon has announced no immediate plans to deploy FiOS-TV in the Ft. Wayne footprint, that decision will probably be expedited under Indiana's new statewide franchising laws.

Table 3
National Broadband Deployment: 2006

Company	Broadband Initiative	Also Doing
AT&T	Project Lightspeed 18 million homes by 2008, 3 million this year, 9 million in 2007	Homezone combines DSL, DISH satellite available 2Q 2006
BellSouth	Fiber to the curb	WiMAX broadband wireless, ADSL 2+
Verizon	FiOS reaching 3 million homes per year to 15 million to 20 million by 2009	DSL extensions Fixed wireless trials
Qwest	Qwest ChoiceTV over VDSL to limited communities in Arizona and Colorado, HFC network in Omaha	No specific plans announced

Source: Carol Wilson, "Big telco initiatives not the whole broadband story," <u>TelephonyOnLine</u> (Feb 6, 2006)

⁹ FiOS Internet service is offered to residential customers in various download increments, starting at 5 Mb/s up to 30 Mb/s.

¹⁰ In Ft. Wayne, future deployment of FiOS-TV would be in direct competition with Comcast. For a discussion on the impact of direct competition in Missouri see the section entitled, "The Impact of Lower Cable Rates on Missouri Consumers," in this report.

As a matter of corporate policy, Verizon has constantly held the practice of redlining to be both immoral and bad business. This hasn't stopped opponents from making unsupported claims to the contrary. In the case of rollouts in New York, a local newspaper serving the Westchester and Rockland communities took upon itself to research claims of redlining in its area. The paper ranked 75 communities in the Westchester area and 40 towns in Rockland County by median household income and examined each to see which Verizon has targeted. The results of the study indicate that communities targeted by Verizon for broadband service do not support charges that the firm was focusing only on the richest areas. In fact, the newspaper said, "Viewing the numbers a different way shows Verizon's choices are tilted slightly more toward wealthy communities, but not to the degree where it would be fair to say the company is ignoring low-income cities, towns and villages." 11

As the table above shows, each ILEC will determine the best technical solution to deploy. AT&T's Lightspeed strategy, for example, will likely use some high-capacity version of DSL technology to established communities while building fiber to the premise on new home construction. Regardless of the technology, fiber to the premises, fiber to the node, or broadband wireless, Michigan consumers could soon see a massive rollout of broadband technology by the major ILEC's that already provide phone service to over 80 percent of Michigan's telephone households.

While Verizon's deployment is currently a residential, internet-only rollout, expansion to include commercial customers is not far away. This comes as good news to Ft. Wayne firms like Raytheon and Star Financial Bank who are waiting in the wings. Common themes when talking with executives include broadband as an enabler for recruitment, allowing for small office/home office (SOHO) flexibility, high speed connections with vendors or sub-contractors, communication between remote offices or branches, and of course e-commerce opportunities for retail establishments and entrepreneurs.

What is the real impact of video franchise reform? In Indiana, it took less than 30 days after HB 1279 was signed by Governor Mitch Daniels for AT&T to announce a 250 million dollar, multi-phased initiative to bring high-speed DSL service to all AT&T central offices in Indiana within 12 months. This first build out phase involves 33 rural communities across the state, including rural towns as small as Stewart, Indiana

¹¹ Drury, Allen. "Verizon denies redlining allegations," <u>The Journal News</u> (November 29, 2005).

One option is to use ADSL2+ to deliver between 12 Mb/s and 24 Mb/s service over copper loops of up to 5000 feet. Also, VDSL2 can offer consumers up to 100 Mbps up and downstream. VDSL2 is a fiber to the hub technology that brings "fiber like" bandwidth to the household via copper telephone lines.

¹³ According to the Michigan PSC, the major ILEC's are SBC (AT&T), CenturyTel, Frontier Communications, and GTE Systems (including Alltel). SBC (AT&T) controls just over 80% of the access lines in Michigan as reported in TAM 2000 Directory.

(population: 268). ¹⁴ As for Texas, it took just over 60 days for AT&T to announce an \$800 million investment for that state. ¹⁵

Conclusion

Michigan indeed is at a crossroads; the legislative road was initiated with SB 1157 and HB 5895. The Michigan legislature can improve its chances for a successful journey by discounting the campaign of disinformation and crafting legislation that removes roadblocks to outside capital investment, competition and eventual economic growth. It's time to enable all in Michigan who desire and need to compete in the information economy with that opportunity. Michigan can attract new companies, generate more jobs and keep its best and brightest right there in Michigan.

In the end, the efforts of Michigan's elected representatives will be judged on their willingness and vision to participate in an honest, bi-partisan effort to craft additional innovative and meaningful telecom reform legislation. Here's how the Indiana General Assembly was recently judged in an editorial by the Indianapolis Star:

". . .Telecom reform, which drew bipartisan support in the House and Senate, was a key objective facing lawmakers when they convened in January. Opponents, chiefly the cable TV industry, launched a high-profile advertising campaign in an attempt to scare Hoosiers about the supposed dangers of telecom deregulation. Thankfully, reason, not fear, won out.. . .Indiana, in the past, has been far too slow to adapt to changing markets. While Hoosiers hesitated, industries declined, jobs were lost and wages stagnated. This time, however, the General Assembly and the governor didn't listen to the fear mongering. An innovative reform package was approved. The state is poised to move forward. Leadership prevailed." 16

As with Indiana's reform bill, all legitimate issues and concerns in Michigan over statewide franchising, franchise fees, rights of way, access channels, etc., can be resolved. Under proposed legislation, Michigan's cities and towns would continue to manage public rights-of-way and receive franchise fees. All Michigan markets, not just the metropolitan areas, need a uniform opportunity to attract outside capital and participate in broadband deployment. As a recent national study correctly pointed out, the rationale for government preventing competition is contradicted by twenty years of data collected by federal agencies and independent scholars.¹⁷

The debate on statewide franchising is not limited to Texas, Indiana, Virginia, Kansas and Michigan alone. Over a dozen states are set to enter the fray, including Florida, Wisconsin and California. Today, Michigan can join with other states to

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¹⁴ "AT&T Indiana Announces Expansion of Broadband Service," InsideINdianaBusiness.com Report, April 6, 2006.

¹⁵ "SBC: Texas Policy Changes Bring \$800 Million in New Technology for State Consumers," SBC News Release, November 17, 2005.

¹⁶ "State plugs into telecom process," Indianapolis Star (March 15, 2006).

¹⁷ <u>Video Franchising</u>, Mercatus Center, George Mason University, February 13, 2006. Available at http://www.mercatus.org/regulatorystudies/.

complete reforms that will promote economic growth. History shows us that waiting on the federal government to act are clearly not expedient or prudent. It's time to fully deregulate the telecommunications industry and the ball is in Michigan's court. If Texas, Indiana, Virginia and Kansas are any indication, the reaction to statewide franchising from the major carriers in Michigan should be equally swift and expansive.

The Michigan Economic Landscape

By

Barry Litman, Ph.D.

Introduction

The state of Michigan has many points of compelling prominence that have always established it as a premier state in the Midwestern part of the United States. It has a diverse economy, dominated by heavy industry due to the central importance of the automobile and derivative industries. Besides automobiles, it has a very fine higher educational system, with three major universities—two of world class status—and a fine system of regional universities, private colleges, community colleges and trade schools. It has a very strong agricultural sector due to highly fertile farmlands that dominate the landscape between the major and smaller cities in the state. It is a leader in the production of a varied group of agricultural products.

Michigan has a world respected group of medical complexes in Detroit, Ann Arbor, and now in Grand Rapids and many fine regional hospitals located in satellite cities throughout the state. Michigan is a tourist Mecca, blessed by many natural attractions, especially the Great Lakes that surround it on all sides and the pristine beauty of the Upper Peninsula which harkens back to the earlier days when the state was being settled. The four season climate not only is attractive to summer tourists wishing to use the "water wonderland," but also to winter skiers who are interested in the vast complex of mountain facilities located in the northern part of the Lower Peninsula. The proximity to Canada via the Windsor tunnel and bridge and the cross over in Sarnia make travel to a foreign country quite easy and without significant hassle. The major league sports teams located in Detroit and the cultural attractions in the major cities and smaller communities indicate that Michigan is not myopically focused only on automobiles but rather seeks many other entertainment venues. Over the last decade, new initiatives in Detroit and outstare have created an attractive complex of gambling facilities that are the bait to lure conventions and tourists from throughout the country.

However, from a purely economic standpoint, one cannot lose sight of the critical importance of automobiles to the large cities throughout the state. Detroit, Pontiac, Dearborn, Flint, Saginaw, Lansing and others grew their local economies around the large automobile plants. Since the health of the automobile industry was tied to the general health of the national economy, Michigan's financial fortunes follow a roller coaster ride throughout the various business cycles. The blessings that such a large industrial infrastructure confers during the good times are overshadowed by the curse during the downswings.

The auto industry is also tied to fluctuations in the prices of oil that are heavily controlled and influenced by the OPEC oil cartel. Widespread price increases in oil that are currently present and have occurred with regularity over the last several years, have created hesitancy in the minds of consumers toward buying new cars, trucks and SUVs or downsizing their purchase into more fuel efficient or used cars. This diminished demand has resulted in frequent plant layoffs, closings, and buy-out options for highly trained blue and white collar employees. It also has a trickle down effect on independent parts suppliers like Delphi who are dependent on a strong and healthy auto industry. While rebates and extended warranties can cause temporary excitement in the markets, they cannot cure the fundamental, structural problems that accompany loss of domestic market share, and transferring of facilities off-shore into cheaper labor markets with lower fringe benefits. There is an even worse aspect to each economic recovery; there is a clear trend in loss of high paying manufacturing jobs and replacement with low paying service jobs. Thus, once Michigan's unemployment rate finds its own equilibrium, it will mask the shift in jobs to a newer and less attractive mix.

The economic plight of Michigan is common to all the large Midwestern industrial states, but the solution of trying to rebalance the state economy is never easy or quick. Hence, a threatening cloud of economic woe hovers over the state of Michigan. Whether that cloud yields a storm or a rainbow depends on critical decisions that start instantaneously. The plight of the Michigan economy is most clearly stated in the March 2006 report from the Michigan Department of Treasury, excerpted below in a series of tables. Compared to national or regional statistics, Michigan is lagging behind the current economic recovery. Its most recent unemployment rate of 6.8% is two points above the national average of 4.7%. The health of Michigan is tied to the current tax and regulatory climate of the state, plus the health of the auto industry which has not participated significantly in the economic recovery. With all the rebates, lower sticker prices, enhanced warranties of the last few years, auto industry sales are stagnant. General Motors is on the verge of bankruptcy as indicated by its devalued bond rating, low stock prices, lower market share and retrenchment. Until the state of Michigan weans itself off the auto industry, it will continue to have this unpredictable and unstable growth pattern.

Unemployment is naturally highest in the largest manufacturing cities like Detroit, Flint, and Saginaw while other cities with a more diversified base are not as badly affected. For example, Grand Rapids, Ann Arbor and even Lansing have lower unemployment rates since they are located near major universities, world class hospital complexes, and state government. The economic picture in Michigan is not all bleak. As the tables show, there have been increases in industrial production, capacity utilization, retail sales and durable good manufacturing and sales. But these sector statistics have not been strong enough to propel the Michigan economy toward the same economic recovery that is happening nationally, where gross domestic product is exploding at the rate of 4.7%.

This is clearly a defining moment in Michigan's history! Action is needed to diversify the economic base while simultaneously attracting capital of all kinds. Whether this turns out to be a zero sum or positive sum game remains to be seen. There is an ancient Chinese proverb that says, "A journey of a thousand miles begins with a single step." One way to answer this challenge is for Michigan to take that first step in telecommunication reform by changing the locus of franchise authority from the local city, county or township into the hands of a state regulatory commission.

The shift toward statewide franchising would most certainly more evenly balance the expertise between the negotiating parties. In streamlining the process through bypassing local negotiations, there will be greater standardization of terms, no whipsawing and less uncertainty in commencing construction. The citizens of Michigan deserve as rapid a deployment of broadband services as possible. They deserve to be included in the inevitable and inexorable march toward fulfillment of the information super highway. TO DELAY IS TO DENY the achievement of this goal and certainly is contrary to the dictates of the First Amendment which creates and promotes an open marketplace of discourse and ideas. As Judge Learned Hand observed in the influential Associated Press case in 1943: the consumer has the right to "the dissemination of news from as many different sources and with as many different facets and colors as possible ... is closely akin to, if not the same, as the interest protected by the First Amendment." It is the role of government to ensure that this marketplace of ideas is open and free and to intervene when roadblocks stand in the way of democratic freedoms.

The fact that the lobbying pressure is so intense for this regulatory reform reflects the heartfelt intensity of consumers for greater FREEDOM OF CHOICE in their array of telecommunications services. They wish to break free of the quasi cable utility that has set unreasonably high prices, earned excessive profits, and decided their programming. While these citizens are neither the "poor nor huddled mass" of Emma Lazarus; nonetheless, "they are yearning to be free." And their pleas of freedom are being heard throughout the corridors of government. When all the rhetoric is said and done, this is truly a consumer movement without parallel!

Broadband telecommunications is one of the new technologies that offer states in transition, like Michigan, a chance to move into a high technology area that has been demonstrated to directly add mid level jobs and indirectly through its pulling power as well. Once outside capital is acquired, new sales, marketing, and customer service personnel will be needed to handle the new products. However, more than the direct employment effect in the telecommunications industry is the catalyst that such broadband development will create across many different industries. When broadband internet is made available widely to private residences and businesses, it can change the way in which business is conducted. In its role as an intermediate product, it can increase worker productivity and enhance other measures of efficiency. The high correlation between economic development and telecommunications infrastructure is quite clear and important. Whether telecommunication investment causes the economic development or economic development spawns telecommunications is not as critical as the fact that they reinforce each other.

When broadband multi-channel programming is offered, it can both inform and entertain. The strategic product groups of news, information and lifestyle programming creates new sources of intellectual capital that can further be explored through on-line search engines and interactive product websites. Often, advertisers can mention and direct consumers to information-laden websites that answer questions and even permit easy electronic commerce purchases. When high speed, high capacity internet is added to the telecommunications equation, it creates a multiplier effect that returns added bonuses for each investment dollar. The effect is very dramatic in rural areas, where farmers make quick adjustments and reposition themselves in product space.

In the same way that states are hurrying to create a fertile environment for incubating firms involved with recombinant molecular biology (e.g., new DNA products), so should they create telecommunications and information technology corridors to accelerate economic development. There is little question that the telco's will need to seek outside economic investment. The question is how the state best can facilitate that process so that it is ahead of the game rather than at the end of the line, when remaining capital funds may not be so plentiful. This underscores the urgency in seeking immediate regulatory reform so that the investment process can be launched quickly and the multiplier and accelerator effects occur sooner than later. No one should be naïve to think that telecommunications reform can be the magic bullet that cures all of Michigan's economic woes; however, it is an important step that will dovetail with other initiatives like energy cells, and recombinant molecular biology to restore Michigan as a premier progressive state, ready to move aggressively into the high technology arena of the new millennium.

Reform: The Window of Opportunity

By

Robert E. Yadon, Ph.D.

As Michigan rolls further into 2006 it finds itself with a new window of economic opportunity with the recent introduction of SB 1157 and HB 5895, which seek to further reform Michigan's telecommunications laws. With these bills in their embryonic stage there is a greater and more important goal than just policy change, it is the creation of a stronger more vibrant Michigan economy. The inclusion of statewide franchising will help stimulate growth in private capital investment, the creation of new jobs, and increases in tax revenues through innovation and the rapid deployment of new broadband infrastructure.

Studies have shown that by taking a proactive approach in telecom reform, the Michigan legislature has the necessary vehicle to drive Michigan's economy and establish itself as one of the technological leaders in the nation. Final reform legislation is vital to the economic health of Michigan, and without stimulus companies are unlikely to invest in new broadband infrastructures, thereby leaving Michigan lagging behind the proverbial bell-curve.

Earlier reform legislation not only established Michigan as a technological leader and competitor in the nation, it also provided footing to make it competitive in the global market. Yet today, Michigan finds itself only 90% of the way there. The world is flat, and Michigan's competition is no longer only with neighboring states (e.g., Illinois, Ohio, Indiana, and Wisconsin). Competition with other countries such as China, India, and Canada is vital to future economic success. The competition is not just about technological superiority, it is about investment and jobs. Michigan is a state facing a crisis point if its economy lags, job loss increases in the manufacturing sector, and the so called "brain drain" continues as state college graduates seek employment elsewhere.

Although Michigan was not the first state to propose telecom reform, history tells us that opponents to a complete reform package will attempt to win the day and delay the efficient entry of competing services. If successful, Michigan may find itself as one of the last states to enable technological advances. For example, any amendment to strip out statewide franchising would be shortsighted at best. The danger here is that Michigan may be cast into a pool of states that have taken a "passive" approach to reform. The window of opportunity for outside investment is small and if not acted upon will shut out Michigan and its citizens. As commercial business seeks to invest capital in states that have regulations that are more favorable in which to compete, Michigan and its citizens may be forced to look through this window as other states reap the rewards of telecom reform. If Michigan does not take action to provide a fair and competitive market this capital will be invested in other states, and Michigan will find that the economic window

of opportunity is shut, and if opened again the necessary outside investment capital may not be available..

Overall Impact of Deregulation on the Nation

To understand the effects of complete telecom reform on Michigan's economy one must look to studies and other states that have taken an aggressive approach to reform. Why is reform necessary and what potential does reform offer, not only to individual states, but also the nation? And what does this mean for Michigan in terms of economic growth and technological innovation?

The telecommunications sector is critical to the nation's economic health. It is the 21st century's means by which people communicate and business is conducted. Telecommunications directly affects jobs, productivity, and the nation's ability to compete in the global economy. However, currently there are staggering statistics facing the telecom industry, which indicate that deregulation is not only necessary but also paramount.

In 2004, the U.S. Chamber of Commerce commissioned a study that analyzed the economic impact of telecom reform on the nation. The study found that heavy regulation of the telecommunications industry is moving the nation away from its technological superiority. The current status of regulations is beginning to seriously hinder the growth and development of not only the telecom industry, but also the nation. Specifically, the study found that current telecom regulations have cost the nation more than 380,000 jobs and a loss in capital investment of tens of billions of dollars.¹⁸

In addition, the U.S. Chamber study authored by John Rutledge and others, found that the regulatory environment contributed directly to decreased employment, output, and productivity. The study found that there was a 21% decrease in jobs in the telecom sector and a 39% reduction in equipment manufacturing. The reduction in jobs and equipment manufacturing can be directly attributed to telecom companies' depleting revenues. Depleting revenues and an adverse regulatory environment have caused innovation to remain stagnant. The study blames heavy regulations for the depressed state of the telecommunications industry because it hinders and/or delays investment.

The study also stated that telecom reform would lead to capital spending, increased jobs, investment, and output in the nation. There are some estimates that if changes recommended by the study are made it could lead to \$58 billion in capital investment on network assets and add \$167 billion to the GDP over the next five years. However, if the regulatory landscape of today continues to exist it is very unlikely that the U.S. will see this investment.

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¹⁸ Hazlett, T., Bazelon, C., Rutledge, J., Hewitt. (September 2004) Sending the Right Signals Promoting Competition Through Telecommunications Reform: A Report to the U.S. Chamber of Commerce. p. 33. ¹⁹ Ibid, p.34.

²⁰ Ibid, p.86.

By increasing capital spending in this sector the U.S. will begin experiencing more innovation in its communications networks while creating jobs in the information technology sector. Using the Standard Bureau of Economic Analysis, figures show that each additional \$1 of capital spending will lead to \$2.86 of output in the telecom sector and each additional \$1 million investment in telecom will lead to the creation of 18.2 jobs. The study concluded if there were an increase in the GDP by \$167 billion, there would be an increase in employment of 212,000 jobs over the next five years. ²¹

As American telecom companies fail to invest capital in innovation of new infrastructures, and other countries such as China and India begin improving their communications technology, the U.S. will not only find itself lagging in the competitive race of technological superiority it will also find more of its jobs overseas as companies outsource to other nations. The United States once the undisputed world leader in telecommunications can do no better than 15th in the world with respect to that telecommunications technology known as broadband development. This pattern will be reflected at the state by below to states that offer employment opportunities that are based on the state's ability to efficiently and effectively use technology in a manner that will allow it to compete in the global market.

So, what does this mean to Michigan? If the issue of statewide franchising is not addressed, Michigan will have failed to take advantage of the opportunity to create jobs through these capital investments. Therefore, it is critical that Michigan begin to provide an attractive regulatory landscape that promotes innovation and investment through fair competition.

Effects of Broadband Infrastructure on State Economies

After analyzing the U.S. Chamber study it is important to understand the impact of broadband infrastructure on a state's economy. Currently, Michigan ranks 8th in the U.S. for population, 17th in terms of per capita income, but only 30th in the nation in broadband infrastructure per 1,000 population. ²²

This last ranking is partially indicative of the amount of capital being invested into the state for technological innovation. If Michigan continues local, market-by-market video franchising then Michigan may continue to fall further behind the bell-curve in broadband infrastructure deployment since current regulatory policies discourage outside investment and the state may begin experiencing greater job loss and the inability to compete with other states. This isn't simply an issue for Michigan alone, but it impacts the national economy. According to Dale Jorgenson, a noted economist from Harvard, the decline in the prices of information technology has enhanced the value of IT

²¹ Ibid

²² Federal Communications Commission. (2005, July). "High-Speed Services for Internet Access: Status as of December 31, 2004." Table 7: High-Speed Lines by Technology. Retrieved from http://www.fcc.gov/wcb/iatd/comp.html

investment as a source of economic growth. ²³ One way to secure the rapid investment in Michigan is to mandate statewide franchising. In another text released last year, Jorgenson examines the U.S. economy growth since 1995, and finds that the surge is rooted in the development and deployment of information technology. ²⁴

Broadband holds great promise for the state's economic health. The deployment of broadband does not benefit just the companies providing the service, but it benefits the state as a whole, from business to consumer, regardless of geographic location. As companies seek to invest capital in rolling out new broadband infrastructure it is critical that Michigan realize the economic advantages that broadband gives a state.

Broadband deployment and access to high-speed Internet offers consumers and business enormous economic benefits and new opportunities for citizens. If there were more broadband deployment then states would begin seeing instant economic gains and benefits to consumers and to business productivity. Sectors such as healthcare, education, and retail sales could be completely transformed while also providing benefits to the economic situation of the states. By creating a regulatory environment that encourages investment and innovations in the telecommunications sector, consumer demand for these services will increase. As consumer demand increases so will the amount of capital spending in faster more reliable broadband deployment thus creating jobs and a competitive environment to offer better services at lower costs.²⁵

Table 1 Jobs and Output Due to Broadband Deployment					
Direct Jobs Spillover Jobs Total Jobs Increase in State (000) (000) (000) GSP (bill.)					
11.3	23.1	34.4	\$ 13.64		
23.4	27.2	50.6	\$ 22.50		
15.2	28.2	43.4	\$ 16.49		
8.6	10.9	19.5	\$ 6.67		
7.6	13.6	21.2	\$ 7.73		
	Direct Jobs (000) 11.3 23.4 15.2 8.6 7.6	Direct Jobs (000) Spillover Jobs (000) 11.3 23.1 23.4 27.2 15.2 28.2 8.6 10.9 7.6 13.6	Direct Jobs (000) Spillover Jobs (000) Total Jobs (000) 11.3 23.1 34.4 23.4 27.2 50.6 15.2 28.2 43.4 8.6 10.9 19.5		

Source: Brough, W. (December 2003). State Economies Can Benefit from Broadband Deployment. CSE Freedom Works Foundation. p.20.

Two separate studies analyzed the economic impact of full broadband deployment if there were no regulatory policies that hindered the development of new infrastructure. These two studies concluded that full broadband deployment would create about 1.2

²⁴ Jorgenson, Dale, W., et. al. (October 2005). <u>Productivity, Volume 3, Information Technology and the American Growth Resurgence</u>. MIT Press. See http://post.economics.harvard.edu/faculty/jorgenson/

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²³ Jorgenson, Dale W. (July 2002). <u>Econometrics, Volume 3, Economic Growth in the Information Age.</u> MIT Press. See http://post.economics.harvard.edu/faculty/jorgenson/

²⁵ Brough, W. (December 2003). State Economies Can Benefit from Broadband Deployment. CSE Freedom Works Foundation. p.11.

million jobs throughout the country. ²⁶ If there were full broadband deployment the studies indicate that California would generate 170,000 new jobs and New York would gain 90,000 new jobs. As Table 1 indicates, Michigan would generate approximately 34,400 new jobs as a result of direct investment in new infrastructure. In the table above, "Direct Jobs" indicates those jobs directly related to broadband deployment. The term "Spillover Jobs" are those jobs that are a result of the broadband infrastructure being in place.

Broadband deployment can also be directly related to a state's Gross State Product (GSP), expressed in billions of dollars. By pursuing widespread broadband deployment the ability to strengthen the health of the national and state economies increases. Through broadband deployment researchers have found that many jobs can be replaced from the technology bust of 2001. These increases in employment from broadband roll out can directly improve a state's output and increase and strengthen its economic conditions. As state output increase so will tax revenues from the employment opportunities that broadband deployment offers. Also, states will see increased tax revenues and increased capital spending as companies become more profitable through this technological innovation. ²⁷

Other studies have found similar findings. In a 2005 study, *Measuring Broadband's Economic Impact*, broadband was shown to directly affect economic activity by allowing business to develop and create jobs in communities with broadband access. This study by MIT and Carnegie Mellon researchers found that between 1999 and 2002 communities that had access to high speed Internet experienced more rapid growth in employment and number of businesses establishments in the IT sector. Also, broadband had a direct affect on the rental housing rates by increasing the property value during the same time period compared to homes that did not have broadband access. The study's overall conclusion is that "communities with broadband access did significantly better than those without." The study concludes that broadband has a direct and important impact on the economic well being of the states and the nation. It is the most vital portion of the nation's central communications system²⁸.

Based on the studies analyzed, Michigan has much to gain from full deregulation and even more to lose by maintaining the status quo. These studies have provided Michigan lawmakers with clear analysis of what deregulation means in terms of economic growth, technological innovation, jobs, and tax revenues. The bottom line is that every month that Michigan fails to change its policy is costing the Michigan

²⁶ Pociask, S., (February 2005). "Building a Nationwide Broadband Network: Speeding Job Growth." TeleNomic Research, available at http://www.newmilleniumresearch.org/archive/, and Crandall, R., Jackson, C., & Singer, H., (September, 2003), "The Effect of Ubiquitous Broadband Adoption on Investment, Jobs and the US Economy." Criterion Economics, L.L.C., available at http://www.Newmilleniumresearch.org/archive/.

²⁷ Ibid, p.14.

²⁸Lehr, W., Osorio, C., Gilbert, S., & Sirbu. M., (December 2005). Measuring Broadband's Economic Impact, available at http://www.broadbandproperties.com/2005issues/dec05issues/Measuring Broadband Eco Impact, Lehr, Gilett, Sirbu.pdf.

economy and citizens millions of dollars. The final reform bill should allow Michigan a window to begin a new wave of economic growth and also begin developing a strong technology industry that supports new business and jobs.

Midwest States That Have Taken On Reform

It is important for Michigan's policymakers to recognize what other states and studies have found. In 2005, 14 states passed some measure of telecom reform and Michigan was one of them. In order for the Michigan General Assembly to make a decision regarding further deregulation it is essential that it understand the benefits that reform will offer. As Michigan examines statewide franchising it should take a lesson from states such as Texas, Indiana, Virginia and Kansas who have already taken a proactive-approach in taking advantage of this window of economic opportunity. In 2005, Texas became the first state to pass statewide franchising (SB 5). In 2006, Indiana passed the most comprehensive telecom reform legislation in the United States (HE 1279) including statewide franchising, and Wisconsin, like Michigan, is again in the process of attempting to improve their reform legislation with the addition of statewide franchising (SB 1157). They all have accomplished this by deregulating state telecom laws, and something can be learned from their experiences.²⁹

On September 7, 2005, Texas Gov. Rick Perry (R) signed Senate Bill 5 into law. Within 45 days of the law's enactment, 64 new companies had received state video franchises to operate in municipalities, and some incumbent cable companies had slashed their rates up to 25% to stay competitive.

Michigan's decision to reform its telecommunication statutes last year were based on economics. The Michigan act was designed "to allow and encourage competition to determine the availability, prices, terms and other conditions of providing telecommunications services." It also "encourages the introduction of new services, entry of new service providers, the development of new technologies, and increases investment in the telecommunications infrastructure in the state." New legislation in Michigan, namely SB 1157 and HB 5895, establishes procedures for issuance by the Michigan Secretary of State of state-wide authorization to provide cable or video service, and authorizes use of public rights-of-way for the placement of facilities for the provision of cable or video services. These Acts retain the same level of control over rights-of-way issues exercised by municipalities today.

The Indiana reform legislation, signed into law March 14, 2006, contained several provisions designed to give Hoosiers access to the best technology at a reasonable price. It contained two major tenants:

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 ²⁹ General Assembly of Michigan, House Bill 5237, "Michigan Telecommunication Act." 93rd Legislation.
 (2005), and SB 1157 (2006). General Assembly of Indiana, House Enrolled Act No. 1279, 114th General Assembly (2006).
 ³⁰ General Assembly of Michigan, House Bill 5237, "Michigan Telecommunication Act." 93rd Legislation.

³⁰ General Assembly of Michigan, House Bill 5237, "Michigan Telecommunication Act." 93rd Legislation (2005).

- Statewide Video Franchising Following the model used in Texas, Indiana's HB 1279 eliminated the burden of local video franchising. The result will be a fast statewide franchising process controlled by the Indiana Utility Regulatory Commission (IURC). This will result in more video competition and lower prices for consumers. Since September 2005, when Texas statewide franchising went into effect, 120 franchises have been granted to competing business companies. Under the Indiana bill, all municipalities will receive up to a 5 percent franchise fee from the video company based on their existing agreements. It also allows for municipal ownership, and preserves existing requirements for public, educational and governmental (PEG) access channels. Finally, HB 1279 prohibits video providers from denying access to any group of potential subscribers on the basis of income.
- Telephone deregulation HB 1279 encourages telephone companies to deploy broadband by gradually deregulating basic phone services if broadband is made available. Standard telecommunication services would be deregulated in a phased manner over the course of three years. Companies must be able to offer high speed Internet to 50 percent of households in any given exchange before they can raise rates in that exchange. Monthly basic rates may increase by \$1 per year until 2009, when those services are deregulated completely. The bill does contain protection for low-income Hoosiers. HB 1279 establishes the Indiana "Life Line" program that provides discounted telephone rates to Hoosiers below 150 percent of the federal poverty level. This is a supplement to the federal program, which aids consumers with a household income below 135 percent of the federal poverty level.

In order for all these states to accomplish their reform goals, they had to deregulate their telecom policies in order to attract investment from private business. It is correctly assumed that private business will be reluctant to invest in states where they are forced to sell their services at prices set by the government. This type of regulatory environment is counter-productive in encouraging investment because private business will go to other states in which they are going to receive the best return on investment. This creates a number of economic problems for states.

The first problem of a heavily regulated telecom environment is a lack of capital investment, which means a delay or hindrance in deployment of new emerging technologies and new broadband infrastructures. This can be compounded when saddled with an arcane and costly requirement of market-by-market franchising.

Second, the lack of comprehensive statewide broadband infrastructure will also mean that other private business will fail to come into states because there are not adequate high-speed Internet services that enable business to function at a competitive level. Broadband is the path that enables business to communicate in a real-time efficient manner in order to provide the best services to its customers.

The third consequence of not receiving private capital investment for the innovation to new broadband infrastructure is the missed opportunity to create jobs. For

instance, Midwestern states such as Illinois, Ohio, Michigan, Kentucky, and Indiana have been plagued by a declining manufacturing sector and must find a way to gain these jobs back. The answer is in the information service sector through the collateral deregulation of the industry in concert with broadband deployment. The research findings are clear. Michigan must also find a way to expedite the deployment of broadband services and provide a level playing field for all competitors offering voice, data or video services.

Conclusion

The positive impact of a broadband infrastructure on a state's economy should be a matter of common sense. But the direct impact on the citizens of Michigan when telecom competition enters the landscape may not be as well known. The U.S. General Accounting Office (GAO) issued a report in February 2004 that found that in five of the six city pairs studied, the presence of wire based competitors to cable resulted in lower video prices in the market; prices which ranged from 15% to 41% lower than in similar markets without competition. ³¹

What's the "value" of direct competition to the cable subscribers of Michigan? The next section attempts to quantify the "value" of competing video providers to the residents of Michigan in terms of annual benefits (direct cost savings), numbers of new subscribers, financial gains for the new subscribers, and total gains.

³¹ See U.S. General Accounting Office, Telecommunications: Wire-Based Competition Benefited Consumers in Select Market, GAO-04-241 (Washington, D.C.; Feb. 2, 2004).

The Impact of Broadband Competition on Michigan Consumers

By

Barry Litman, Ph.D.

"Oh, it is wondrous to have a giant's size; it is tyranny to use it like a giant" (Shakespeare, Merchant of Venice, circa 1500 A.D.)

Introduction

The issue of state wide franchising of multi-channel telecommunications systems and its attendant impact on competition is only the first important step of regulatory reform intended to restore consumer sovereignty in the marketplace of diversity and enhancing consumer welfare. A second corollary aspect of redefining, rebalancing and restoring consumer sovereignty (R3) may be the eventual unbundling of basic network services and offering them individually as a la carte offerings on the cable menu. The addressable technology to permit such unbundling is now available and it would permit individualized consumer choice and a more reasonable repertoire of programming than the program proliferation that is rapidly becoming available. Overall, the total monthly bill for multi-channel services will be lower than the current one. Certain customers with fixed program tastes within a few categories will find their total bill significantly reduced while others with more varied tastes across different categories will pay higher fees but nonetheless can still take advantage of various discounts for mini-packages of basic programming.

Hence, franchise reform is the precursor and the logical first step on the trajectory toward a more complete set of reforms that will permit consumers to become more important players in the new marketplace of multi-channel programming. Whereas the first cable revolution directly addressed the issue of whether consumers would be willing and able to pay for additional program diversity and thus break the myopic view that television should be "free," the current revolution is focused on freeing consumers from the tyranny of monopoly control, and the regressive direct and indirect excise taxes (franchise fees) that have become built in features of the current system. If the private telecommunications marketplace can be leveled so that all stakeholders have an equal opportunity to engage in commerce, then Adam Smith's "invisible hand" will guide the players to achieve the greatest wealth of nations, and the telecommunications and information sector will achieve even greater prominence.

The new freedom of choice in multi-channel marketplace will place a premium on evaluating the utility of all program services, to see if they fit in with the consumers' objective of maximizing utility. One artifact of the current franchise process is the provision of mandatory access channels, to serve public, educational and governmental

needs. While no longer federally mandated, these channels can be required by local cable franchise authorities in order to receive the initial franchise or have it renewed. Even not mandatory, it is easier for the cable applicant to provide them than to risk losing the franchise or have the negotiations prolonged. In addition, other institutional channels may be demanded by franchise authorities to facilitate communication between offices and other government business. In a new telecommunications open environment, these mandatory services may no longer command as much attention and may have to fend for themselves rather than be cross subsidized by other services.

In essence, these services are what economists call "merit goods" that are supposedly needed to fulfill the democratic process of educating and enlightening the citizenry. In reality, they are quite boring, with little programming value and scant citizen support. They require some kind of uneconomic cross subsidization to survive. They were provided by the cable system since the market would almost certainly fail for such services if left alone. In economic terms, this entire process is known as "taxation by regulation." Such indirect taxes, divert resources from more promising uses and are generally passed along to consumers as regressive taxes. These merit goods should be given a chance to live in the new deregulatory environment and alongside state and federal government proceedings (e.g., CSPAN 1&2, MGTV 1 &2) they could be offered and marketed as "democracy channels."

The other issue associated with franchise reform, is the cable franchise fee that has come to be an accepted feature of the current marketplace. This fee was originally intended to cover the city costs of awarding, renewing and generally overseeing the franchise process along with extra costs associated with disruption of city services during new builds or rebuilds. Many of these costs are no longer valid and would certainly evaporate with statewide franchising. If some costs still remained, they could easily be covered from the infrastructure fund associated with tier 1 pricing, rather than the excise fee that is currently levied on basic system revenues and passed along to consumers as a "regulatory fee." The welfare enhancing aspects of gradually sunsetting these fees would create an immediate benefit for consumers of \$2.50 per month, once fully implemented. The reason for gradually reducing these excise taxes is that some cities have become quite dependent on them to provide non-cable services such as police or fire protection that should not be immediately withdrawn.

Rationale for Deregulation

To fully comprehend the issue of regulatory reform, it is useful to recall the economic conditions that necessitated regulation in the first place, and then to inquire whether these conditions still hold or have significantly changed. The issue of the local cable monopoly rests on the economic concept of widespread economies of scale as illustrated by a continuously declining long-run average cost curve. Industries with such underlying cost structures are said to naturally evolve into a monopoly since it most cost effective to have a single provider of service than to have competitors with a duplicate, heavy fixed cost infrastructure. As a quid pro quo for the government sanctioned right to operate as a monopolist within the franchise area, the firm agrees to submit to some form

of price/profit regulation to protect consumers from the natural tendency of monopolists to be tempted by the poison fruit of market power. All of these factors were ascribed to the roll out of new and rebuilt cable systems during the years of the so called "cable revolution." However, there is one distinguishing factor between utilities and the cable television product of diversity; the former are necessities while cable diversity is considered a normal good that is closer to the polar extreme of a luxury on the necessity-luxury continuum. Normal or superior goods seldom are regulated in modern times except when they are "clothed with a public interest" or create a strategic bottleneck that "stands at the gateway of commerce and extracts a toll from all who pass." While multichannel television and broadband may not have originally met these criteria, their increasing importance to consumers is making them indispensable and irresistible aspects of modern life.

New Equilibrium and Enhanced Consumer Welfare

When there is a disturbance, shock or significant change that shifts a market from its current equilibrium state on a trajectory towards a new one, there is likely to be a change in the welfare of existing and new consumers of the product. Economists measure consumer welfare by the concept of consumer surplus which is a kind of bonus, dividend or rebate to the consumer when infra-marginal (early) demanders only pay what the product is worth to the marginal user not to them. The difference between the price they would be willing and able to pay and the lower price they actually pay is the metric known as consumer surplus. Looking at the accompanying graph (see Figure 1) of a downward sloping demand curve for broadband, multi-channel television, as we move down the graph by lowering price, the early demanders receive a surplus indicated by the shaded triangle.

Suppose we settle at a monopoly determined price of P*, then the monopolist earns producer surplus (also known as rent or excess profits) of the shaded rectangle above average cost and the remainder is held by consumers. The monopolist is "skimming the surplus" away from consumers and transforming it into its own surplus or profits. Now if a change in regulatory policy stimulates new entry and thereby creates more rivalry that forces prices down to a lower price P**, then consumers recoup their lost surplus plus a new group of consumers is now included who have their own surplus, indicated by the shaded triangle (also known as the deadweight welfare loss). To summarize, competition has lowered prices (although still above costs), thereby redistributing consumer surplus by restoring it to the original group of consumers and giving it to the new group of consumers who can finally afford to be included. These two new areas of consumer surplus can be calculated based on standard estimates of the elasticity of demand; their combination represents the cost of maintaining the status quo, that is NOT DEREGULATING!—and the loss is not recoverable and continues to accrue until the status quo equilibrium is changed.

Figure 1 Consumer Welfare Gains Due to Cable Deregulation

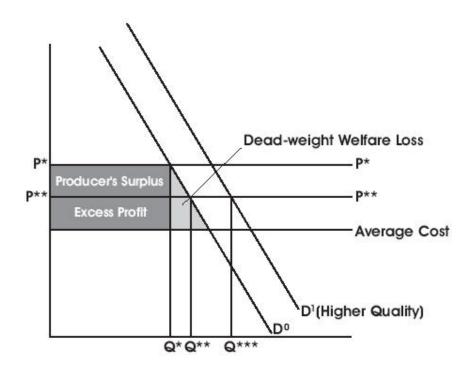


Table 1 New Michigan Cable Customers			
Price Elasticities			
Hypothetical Rate Decreases	e = .50	e = .75	e = 1.00
10% (\$5)	130,145	195,218	260,290
20% (\$10)	260,290	390,435	520,580
30% (\$15)	390,435	585,653	780,870
Assume Base Cable Rate for Enhanced Basic = \$50 Current Michigan Cable Customer Base = 2,602,900 (NCTA)			

Table 2 Current Consumer Annual Benefits From Sustained Price Cuts					
Hypothesized Price Cuts	Hypothesized Annual Savings Current Annual Benefits				
10% (\$5)	\$ 60	2,602,900	\$ 156.174		
20% (\$10)	\$ 120	2,602,900	\$ 312.348		
30% (\$15)	\$180	2,602,900	\$ 468.522		

Table 3 New Consumer Annual Benefits				
Price	Price One half Price Elasticities			
Cuts	Price Cuts	e = .50	e = 1.0	
10% (\$5)	\$ 30	130,145 = \$3,904,350	260,290 = \$7,808,700	
20% (\$10)	\$ 60	260,290 = \$15,617,400	520,580 = \$31,234,800	
30% (\$15)	\$ 90	390,435 = \$35,139,150	780,870 = \$70,278,300	

Table 4				
Total Approximate Benefits from Cable Deregulation				
Hypothesized Price Cuts	Hypothesized Price Cuts Total Benefits Total Benefits			
	e = .5 (million)	e = 1.0 (million)		
10%	156 + 3.9 = \$160	156 + 8 = \$164		
20%	312 = 15.6 = \$331	312 + 31 = \$343		
30%	468.5 + 35 = \$ 503	468.5 + 70 = \$ 538		

Table 5 Present Value of Future Benefits (2006-12)			
Hypothesized Price Cuts	Annual Benefits (million)	Present Value @ 8% Discount (million)	
10%	\$ 162	\$ 749	
20%	\$ 337	\$ 1,558	
30%	\$ 521	\$ 2,409	
Hypothesized Price Cuts	Annual Benefits	Present Value @ 10%	
	(million)	Discount (million)	
10%	\$ 162	\$ 706	
20%	\$ 337	\$ 1,468	
30%	\$ 521	\$ 2,269	

Table 4 represents the sum of befits from existing customers and new customers per year. It is based on only two price elasticities of demand, .50 and 1.0, respectively Table 5 then projects that sum of benefits under the different price regimes for a 6 year time horizon with two conservative compound discount rates (8% and 10%). The results are net benefits that could exceed several billions of dollars depending on the actual price cuts and actual price elasticities.

The costs of inaction and maintenance of the status quo are quite injurious to consumer welfare as demonstrated in these tables. To do nothing is to ignore these substantial enhancements in consumer welfare.

However, there are other dimensions of demand that need to be mentioned since their impact on consumers and the deregulation debate can be quite substantial. When the demand for broadband, multi-channel TV was drawn, it was assumed that the QUALITY of the product was fixed. Yet, this assumption is not realistic in the multichannel environment. It is just as likely that the competitive instinct will surface as well in such quantity dimensions as diversity of program offerings. The diversity of programming includes the number of channels offered, the depth of channels within each program category and the breadth of program categories. In short, there is an array of quality dimensions that affect the demand situation. If the incumbent and newcomer both decide to increase their basic channel offerings by 20%, then this represents a better value for consumers since the price per unit of quality has fallen in real terms. This can be handled in two ways on the graph (see Figure 1). First, we could define price per unit of quality and use this as the metric on the vertical axis. Hence, if either actual price falls or quality increases, this is a real decrease in price and it will increase the customer base depending on the price elasticity of demand. If both the actual price falls while quality simultaneously increases, then the real negative price change is magnified for consumers. This process is somewhat cumbersome since we don't know or can disentangle whether actual price has changed or the quality diversity array.

The better approach is to separate out the two factors by including quality changes as creating movements of the demand curve itself, rather than just movements along the

curve. By following this approach, the demand curve would shift rightward with increases in quality and leftward with decreases. This greatly simplifies the analysis by disentangling these two factors. In both cases, consumers benefit from lower prices and enhanced quality of product. More consumer surplus is generated than in the original example since we are now including the quality enhancements. On the diagram, we now have more new customers, Q*** and larger rectangles of surplus that have now been recovered from producers. Hence, the deregulatory movement may spawn even greater benefits than imagined if firms choose to compete in non-price dimensions as well as price. Referring back to Figure 1 and Tables 1-4, if there is a substantial quality response as well as the price response, then depending on the quality elasticity of demand, demand could increase say another 5-10% thus increasing the benefits thus obtained by this magnitude. Furthermore, if the franchise fee of \$2.50 were reduced to match the actual cost of local regulation of rights of way, the consumer welfare benefits would be further enhanced. If the basic channels were offered in smaller packages rather than the pure a la carte originally suggested, then consumers could determine their own optimal diversity and create very significant additional welfare.

The quality array need not be limited to only changes in diversity; it could also include a service dimension as well. Cable companies have been notorious in providing poor customer service and having a very bad attitude toward customers. This is a contributing factor to high churn in the industry. Competition may stimulate better appreciation of customers through quicker installation and repair, free introductory offers for various premium program services including digital, internet service, local telephone service, etc.--the entire bouquet of products that the system offers. Thus, everything is up for grabs in the new world of telecommunications deregulation. This bouquet may not be as easily measurable as that of standard program tiers. Some of these services are in their infancy and the data available are often unreliable. The broadband providers should be able to take advantage of the vast economies of scale accompanying networking and the creation of the "critical mass." There may also be significant economies from economies of scope as the interrelated product lines use the common property resource of the broadband connection. These significant cost savings can permit them to pass along these additional benefits to consumers while continuing to earn moderately high profits. Once again, it should be recalled that franchise reform is just the first step towards a complete metamorphosis of the multi-channel telecommunications industry, propelled by the desire of consumers for freedom of choice at affordable rates—the new consumer telecommunications revolution.

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Conclusions and Recommendations

Introduction

Michigan is currently one of a dozen states to be actively engaged in the debate over legislation to allow statewide video franchising. Most realize that much is at stake for both the telecom vendors and the citizens of Michigan. While the goal of reaching a bi-partisan compromise and passing a progressive bill that has immediate, positive impact on Michigan consumers, breaks down barriers that retard economic development, and provides a catalyst for economic growth is clear, the path to reform must overcome both real and imaginary issues if legislative success is on the horizon. Something can be learned from the five states (Texas, Indiana, Kansas, Virginia and South Carolina) that have successfully traveled this road over the past six months.

Michigan can take pride in the fact that it was one of the first states in 2005 to recognize the failures of federal telecommunication policy in addressing the rapid changes in the telecommunications landscape since 1996. Written in 1993, the Telecommunications Act of 1996 was outdated by the time it was signed into law. While the intent was to remove residual restrictions of the consent decree and create a statutory environment that would stimulate deployment of a national infrastructure and foster the emergence of a new digital information economy, the reality is a slightly different story. Michigan joined with 14 other states in 2005 to restructure regulations and focus on price and quality of service and not on the specific provider. It also encouraged the introduction of new services, entry of new providers, development of new technologies, and an increased investment in the telecommunication infrastructure. It did not, however, deal with the primary barrier to entry for new video firms, the costly market-by-market local franchise requirement.

New legislation is now on the table, namely SB 1157 and HB 5895, which establish procedures for issuance by the Michigan Secretary of State of state-wide authorization to provide cable or video service, and authorizes use of public rights-of-way for the placement of facilities for the provision of cable or video services. These Acts retain the same level of control over rights-of-way issues exercised by municipalities today.

Conclusions

Numerous economics studies suggest direct price competition across industry boundaries promise rapid, significant consumer benefits. Price competition from the entry of new broadband providers can create significant windfall consumer benefits in the form of consumer surplus for both existing and new customers. This study finds that Michigan cable subscribers will save between \$156 million and \$468 million annually, and would permit more Michigan consumers and businesses to share in the pursuit of information, entertainment and communication. New broadband infrastructure can also

create new direct and spillover jobs and can act as a catalyst for attracting new investment in Michigan.

The rationale for statewide franchising reform is vested in twenty years of data collected by federal agencies and independent scholars. Franchise reform is long overdue, and reflects the current reality of cross platform competition and the archaic nature of the local franchise. Regardless of the self-serving, anti-competitive campaign of disinformation by the cable lobby, or the well-intentioned yet misinformed opposition of the Michigan Municipal League (MML) and the Michigan Townships Association (MTA), the success of the first four states (Texas, Indiana, Kansas and Virginia) to craft meaningful, bi-partisan legislation that addresses the key objections of municipalities must be noted in Lansing.

The position of the Michigan opponents (MML and MTA), that telephone companies obtain local franchise agreements before they offer cable-like television service ignores the post-1996 economic and technical reality of the telecommunication landscape in America. In an open, competitive marketplace, the entry of new firms should be encouraged not encumbered and delayed. It's today that Michigan needs all the benefits that accrue to a state with a robust broadband infrastructure. The failure to reach a realistic compromise on the issue of statewide franchising will be, as some call it, the "show stopper" for all the citizens of Michigan.

Recommendations

A recent editorial in Crain's Detroit Business made a number of interesting observations. First, Michigan could simply punt the franchise issue to the feds. While this is technically true, the chance for federal intervention on this issue in the near term is a matter of speculation. Most in Washington give the current legislation less than a 50 percent chance of success this year as special interests and lobbyists weigh in on the national reform debate and other contentious issues such as "net neutrality" muddy the water. History shows us that telecom reform at the federal level is a cumbersome and time consuming process at best, often taking years to craft and pass legislation. If individual states believe they have standing on this issue, the prudent response would be to individually pass reform legislation that sends a clear message to Washington that recognizes (1) the dramatic change in the telecom competitive environment since 1996; (2) the need to improve national broadband deployment, on a state-by-state basis if necessary, and restore the U.S. to a leadership position in the global information economy, and (3) a collective agenda of important state issues for future codification at the federal level.

Second, the retention of requirements for public, education and government (PEG) access channels is a goal that serves the public interest of each community. This issue has already been addressed by each state that passed statewide reform legislation these past six months with no major objections by the telephone lobby.

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³² "New vide rules must protect public," <u>Crain's Detroit Business</u>, p. 8 (May 15, 2006).

Third, the need to develop a state template for access to local rights-of-way is important. Proposed legislation (SB 1157 and HB 5895) retains the same level of control over rights-of-way issues exercised by municipalities today. Cable company complaints over the fairness of statewide franchising are disingenuous at best and anticompetitive at the outside. Cable has been a *de facto* monopoly for over fifty years. Now, with the promise of direct competition on the horizon, the cable industry complains about "fairness". History shows us a different side to the cable industry and local franchising. As early as 1984, the cable industry had complained to Congress that rate restrictions in the local franchise agreements prohibited the industry from making the necessary capital investments to defend itself from a satellite industry poised for "rapid expansion" and, in turn, direct competition. Capitol Hill buckled under the pressure of cable industry lobbyists and deregulated rates beginning in 1986. The threat from satellite never materialized in the near term. In fact by 1993, "satellite" had only captured three percent of the subscription video market share compared to 95 percent for "cable" that same year

After deregulation, and with no direct competition, cable rates began to skyrocket at three times the Consumer Price Index (CPI). Due to rate increases of 60 percent since 1986, and a landslide of consumer complaints, Congress was forced to revisit and reinstitute cable rate regulation with the passage of the Cable Television Consumer Protection and Competition Act of 1992. Things are no better this year as Comcast announced it was raising rates again by an average of six percent in all markets, including Michigan, the highest rate hike among the nation's largest cable operators.

Last, the Crain article suggests that any carrier that seeks to use public right-of-way should be required to reach all households within an exchange area. Crafting any such build out requirement is problematic given the technical and economic limitations of existing broadband technologies. The most common argument used by incumbent cable firms and municipalities is the concept of a "level playing field". Unfortunately, the build out requirements are neither "fair" nor "level" in their application. For example, the cable industry has never had to meet the "universal service" requirements of the telephone industry, including franchised phone and data service. History shows cable firms take years to build out their plant, rarely according to franchise schedule or requirement, and never reach the 95 percent penetration of the incumbent telephone company. If this is so, then why lobby for a build out requirement at all? According to noted economist Thomas W. Hazlett, "Incumbents advocate build-out requirements precisely because such rules tend to limit, rather than expand, competition."

Unwarranted build out requirements are actually a barrier to entry by competing firms and a disincentive to attracting outside investment capital. Sparsely populated areas are already served by two competing national satellite providers, with the deployment of broadband wireless (WiMax) in the wings. As Hazlett concludes:

"Policies that prescribe entrant build-out patterns reduce the likelihood of any entry, creating 'equity' by eliminating gains for any class of consumer. The pro-

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³³ Dr. Hazlett is the former Chief Economist for the FCC. See: Thomas W. Hazlett, <u>Cable TV Franchises</u> as Barriers to Video Competition, George Mason University School of Law (March 5, 2006).

consumer policy response is not to erect barriers to entry, then, but to reduce such impediments, increasing the probability that entry will occur, lowering expected prices."³⁴

Finally, there is an interesting public policy twist to the whole franchising argument. Recently two states, Connecticut and Oklahoma, offered telephone companies, namely AT&T, support to move forward with the introduction of new video services without a franchise. Why? Because these two states have embraced the position of the FCC, supported by the Brand X decision, that IP enabled services, like cable modems and IPTV are, in fact, "information services" and not "telecommunication services" and therefore are not subject to state regulation. Further, information service providers do not have to pay franchise fees on revenues derived from IP traffic. While AT&T has not played this trump card to date, common sense would suggest that those states that do not move with some dispatch to take a leadership position and get a handle on the issue of statewide broadband deployment may be at the mercy of new federal policy, and preemption, in the not-to-distant future. Se

The General Assembly is to be applauded for progress made to date, but Michigan's representatives need to be firm and reject opposition rhetoric that is protectionism at best, and anti-competitive at the outside. What Michigan truly needs is bi-partisan leadership to pass a complete reform bill, including statewide franchising. It's about the information age, it's about new commerce, but most of all it's about the future of Michigan, and it's about time.

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³⁴ Ibid, p. 58.

^{35 &}quot;AT&T's IPTV Plan OK in Connecticut," [B&C/MCN] <u>Telco-IP Update</u> (5/16/2006).

³⁶ See National Cable & Telecommunications Assn. v. Brand X Internet Services, 543 U.S. 1018 (2004)

Appendix A

U.S. Global Broadband Penetration – January 2005

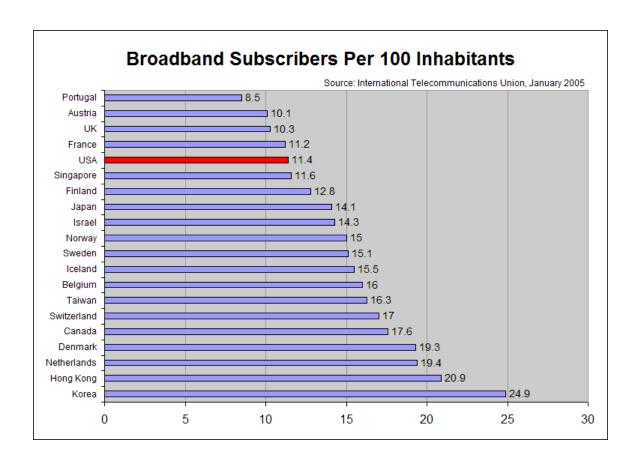


Figure 1: Broadband Penetration by Country per 100 inhabitants Source: <u>ITU.int</u>

Appendix B

About the Authors

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