Commission's implementing rules have contributed to the growth of wireless cable as a viable competitor in the multichannel video marketplace.

However, on June 6, 1995, the United States Court of Appeals for the District of Columbia Circuit handed down a decision reversing the *Third Order on Reconsideration* in part and exempting cable systems that face "effective competition" from the uniform pricing requirement of Section 543(d).[45]

In its ruling, the Court interprets the 1992 Cable Act so as to limit the application of Section 543(d) to only cable systems that are subject to rate regulation. The Court holds that the uniform pricing requirements of Section (543(d) are a form of rate regulation.[46] Consequently, in the Court's view, the uniform pricing requirement cannot apply to cable systems that are subject to "effective competition" and therefore exempt from rate regulation.[47] The Court's recent holding is a most significant development, particularly as Congress is considering measures to liberalize the "effective competition" test further so as to deregulate more cable systems. Whatever the merits of the Court's logic, the WCAI believes that the Commission's view that a geographically uniform

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[44](...continued)

> franchise areas, whether or not the cable system is exempted from rate regulation by the effective competition provisions of Section 623(b).

*Id.*

[45]*See Time Warner Entertainment Co., L.P. v. FCC*, No. 93-1723, slip op. at 10-11 (opinion for the Court by Rogers, J.) (D.C.Cir. June 6, 1995).

[46]*See id.*, at 10.

[47]*See id.*, at 10-11.

pricing structure must be extended to all cable systems is sound policy, and is consistent with the congressional intent supporting the 1992 Cable Act.

This pro-consumer and pro-competitive policy should be reflected in the Communications Act. The Commission has previously recognized that one of Congress' goals in passing the 1992 Cable Act was protect consumers and assure the benefits of competition. The Commission's uniform pricing rules protects all cable programming consumers from discriminatory pricing between customers based on whether a competitive service is available in the area or subscribed to. In its 1995 Section 19(g) report, the Commission should urge Congress to amend the Communications Act to make clear that all consumers within a franchise area enjoy the benefits of competition, even consumers that either cannot, or choose not to, subscribe to an alternative provider.

*C. If Necessary, The Commission Should Seek From Congress Authority Over Internal Cabling Devoted To A Single Multiple Dwelling Unit, Even If Such Cabling Is In Common Areas.*

As WCAI has previously demonstrated to the Commission in MM Docket No. 92-260, *Implementation of the Cable Television Consumer Protection and Competition Act of 1992: Cable Home Wiring*, wired cable operators have frequently exploited the wiring used to provide cable service as a weapon against emerging competition.[48] The pending petitions for reconsideration in MM Docket No. 92-260 spell out in detail the flaws in the rules adopted by the Commission to govern the ownership of inside cabling once a

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[48]*See* Comments of WCAI, MM Docket No. 92-260, at 8 (filed Dec. 1, 1992); Reply Comments of WCAI, MM Docket No. 92-260, at 2-3 (filed Dec. 14, 1992).

consumer terminates cable television service. While in the interest of brevity WCAI will not repeat the many arguments before the Commission in MM Docket No. 92-260, the pleadings establish that in order to promote competition in multiple dwelling units ("MDUs"), the Commission should revise its designation of the demarcation point for cable home wiring in MDUs as the point at or about twelve inches outside of where the cable enters the subscriber's individual unit.

As Liberty Cable Company, Inc. noted in its petition for reconsideration in MM Docket No. 92-260, the Commission's designated demarcation point is impractical because "wire within twelve inches of a subscriber's premises is buried in a brick, concrete or cinder block wall or concealed in a conduit and is not, therefore, readily accessible without causing substantial damage to the building and the subscriber's apartment."[49] Similar sentiments were expressed by WCAI, wireless cable operator WJB-TV Limited Partnership, USTA, Bell Atlantic, Pacific Bell, Nevada Bell, and the NYNEX Telephone Companies.[50] WCAI has urged the Commission to afford each resident of an MDU

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[49]Petition of Liberty Cable Co. for Reconsideration and Clarification, MM Docket No. 92-260, at 3 (filed April 1, 1993).

[50]*See* Comments of WCAI, MM Docket No. 92-260, at 1 n. 2 (filed Dec. 1, 1992); Response of WJB-TV Limited Partnership, MM Docket No. 92-260, at 2-5 (filed April 15, 1993); Reply Comments of USTA, MM Docket No. 92-260, at 5-6 (filed June 2, 1993); Response of Bell Atlantic, MM Docket No. 92-260, at 3-4 (filed May 18, 1993); Petition for Reconsideration of the NYNEX Telephone Companies, MM Docket No. 92-260, at 3-4 (filed April 1, 1993); Comments of Pacific Bell and Nevada Bell, MM Docket No. 92-260, at 2 (filed May 18, 1993).

control over any and all wiring and associated devices devoted exclusively to the provision of service to his or her individual unit.

The cable industry, however, has opposed efforts to give each resident of an MDU effective control over the wiring devoted to his or her unit by claiming that the Commission lacks authority to govern cabling extending beyond the interior premises of a consumer's individual unit.[51] That argument has been effectively refuted -- the Commission has ample authority under the Communications Act of 1934, as amended (the "Communications Act"), to afford a consumer control over all of the wiring devoted exclusively to providing service to his or her individual unit.[52]

Should for whatever reason the Commission determine it lacks authority to establish a new demarcation point, WCAI urges the Commission to specifically report on that defect in the Communications Act and seek additional authority from Congress. Certainly, there can be no public interest justification for permitting continued abuse by wired cable of inside cabling in MDUs.

[51]*See* Time Warner Entertainment Co., L.P. Response to Petitions For Reconsideration, MM Docket No. 92-260, at 4-5 (filed May 18, 1993); Opposition of Nat'l Cable Television Ass'n to Petitions for Reconsideration. MM Docket No. 92-260, at 5 (filed May 18, 1993).

[52]*See, e.g.* Reply of Bell Atlantic, MM Docket No. 92-260, at 2-4 (filed June 3, 1993); Reply of the NYNEX Telephone Companies. MM Docket No. 92-260, at 3-4 (filed June 3, 1993).

*D. The Commission Should Reiterate Its Recommendation That Congress Amend The Communications Act To Permit The Use Of Wiring To Service Subdivisions, Townhomes, Trailer Parks And Other Areas That Can Be Wired Without Crossing Public Rights-Of-Way Without A Cable Franchise.*

As wireless cable has begun to emerge. operators have discovered that one of the greatest impediments to competition stems from legal restrictions on their ability to run wiring over private property to interconnect homes in subdivisions, townhomes, trailer parks or other types of dwellings without a cable franchise.

One of the perceived drawbacks of wireless cable is the need to mount a reception antenna at the subscriber's premises. As a result of recent technological advances, wireless cable reception antennas continue to get smaller, while new antenna shapes have been developed to make reception antennas unobtrusive. Nonetheless, the developers or governing boards of subdivisions and townhome communities and the owners of trailer parks sometimes refuse to permit wireless cable operators access to their property unless service can be provided from a single reception antenna connected to a coaxial cable distribution system.[53]

Under the current provisions of the Communications Act, wireless cable operators are legally barred from responding to requests for service under such circumstances. Section 621(b)(2) of the Communications Act mandates that every cable system operator have a cable franchise. Section 602(7) of the Communications Act, which defines a

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[53]In some cases, this refusal stems from agreements extracted by wired cable operators that ban antennas. In order to promote competition, Congress or the Commission should ban cable operators from seeking or securing such agreements. *See, infra* at II.E.

"cable system" as "a facility, consisting of a closed transmission paths and associated signal generation, reception, and control equipment that is designed to provide cable service which includes video programming and which is provided to multiple subscribers within a community . . . .," has been deemed to encompass systems that use wiring, even if strung entirely over private property, to interconnect individual buildings where the so-called "private cable exception" does not apply.

The flaw in Section 602(7) is patent; it extends the cable franchise requirement to systems that are located wholly upon private property and do not use any public right-of-way. In many cases, particularly where localities have imposed universal service requirements, it is not possible for the wireless cable operator to secure a franchise.[54] The Commission itself has recognized that the central basis for imposing franchise regulation on cable systems was that such systems use the public right-of-way.[55] Amending Section 602(7) to allow wireless cable systems to make limited, non-franchised use of wiring to interconnect dwellings without crossing public rights-of-way will promote the ability of alternative technologies to compete, without undercutting the fundamental predicate of local franchise regulation.

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[54]Moreover, as discussed in detail in the following section, the wireless cable operator is barred from owning and operating a "cable system" that overlaps its wireless cable protected service area.

[55]*See Definition of A Cable System*, 5 FCC Rcd 7638, 7642 (1990).

In its *1994 Competition Report*, the Commission's sole recommendation to Congress was that it modify 47 U.S.C. § 522(7)(B) so as to exclude from the definition of a "cable system" not only commonly-owned, but also separately-owned, dwellings interconnected by wireless which do not cross public rights-of way.[56] The Commission specifically found that "such a revision would promote the growth of wireless cable and SMATV systems as competitors to cable systems by substantially reducing the costs of expanding their systems."[57] Since Congress has yet to act in response to the *1994 Competition Report*, the Commission should reiterate its proposal and again stress the important, pro-competitive benefits that will redound from an amendment of the "cable system" definition.

*E. Congress Or The Commission Should Ban Cable Operators From Seeking Or Securing Deed Covenants and Other Restrictions On The Installation Of Antennas.*

In many areas of the country, particularly those that are experiencing rapid population growth and related new residential real estate development, cable operators have begun to pre-wiring residential units for cable service at no charge to the developer in exchange for deed covenants and other restrictions forever barring the homeowner from installing rooftop antennas. Congress or the Commission should ban this transparent anti-competitive practice. Whatever merit there may be for a developer to independently attempt to impose antenna restrictions (and WCAI believes that efforts to enforce such

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[56]*See 1994 Competition Report*, 9 FCC Rcd at 7558.

[57]*Id.*

restrictions through the judiciary raise significant First Amendment issues), it is unconscionable for a cable operator to seek and secure restrictions that effectively preclude residents from securing access to wireless cable or DBS services.

## III. Conclusion.

In short, although there is insufficient data available to draw conclusions with scientific precision, every indication is that wireless cable is emerging as an effective competitive check on the pricing and other practices of the cable monopoly. The pro-competitive provisions of the 1992 Cable Act and the Commission's implementing rules have met with approval from the financial community, spurring an unprecedented infusion of capital into the wireless cable industry. Chairman Hundt certainly had it right when, in addressing WCAI's most recent annual convention, he remarked that:

> We are here to celebrate the acceleration of wireless cable as a viable competitor in the United States and world markets. This is the end of seven lean years and the beginning of seven fat years. I am sure this is a celebration because I've seen people here lending money. In American business, debt financing is the highest form of congratulation.[58]

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[58]Hon. Reed E. Hundt, Speech Before The 7th Annual Wireless Cable Convention, Las Vegas, NV, June 22, 1994 (rel. June 29, 1994).

With the fine-tuning suggested above, Congress and the Commission can assure that the fat years predicted by the Chairman become a reality, benefiting wireless cable operators and consumers alike.

Respectfully submitted,

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June 30, 1995

ATTACHMENT A

# Vertical Integration and Program Access in the Cable Television Industry†

**David Waterman***



## INTRODUCTION

Effective competition for local monopoly cable systems would seem to offer a natural solution to nagging problems widely attributed to the cable industry, such as high prices and poor service. In regulatory and

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† This Article is based on DAVID WATERMAN & ANDREW A. WEISS, VERTICAL INTEGRATION IN CABLE TELEVISION (Sept. 17, 1993) (unpublished monograph, American Enterprise Inst.). A recent version of this Article was presented at the Telecommunications Policy Research Conference, Solomon's Island, Md., October 1994.

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legislative proceedings leading up to the Cable Television Consumer Protection and Competition Act of 1992,[1] however, potential or existing competitors to local cable systems complained that cable programming networks[2] either refused to do business with them or offered them programming only on discriminatory terms.[3] These competitors include home satellite dish (HSD) owners and program distributors, satellite master antenna system (SMATV) operators, multichannel multipoint distribution system (MMDS) operators, "overbuilt" cable system operators, and operators of direct broadcast satellite (DBS) systems.[4] According to these complaints, established cable system operators are to blame for pressuring the networks, many of which are vertically affiliated with those operators, to engage in this discrimination and thus handicap the cable operators' competitors.

As a result of the 1992 Cable Act, the Federal Communications Commission (FCC or Commission) established regulations intended to encourage competition for established cable operators by ensuring that these alternative multichannel video programming distributors (MVPDs) have

1. Pub. L. No. 102-385, 106 Stat. 1460 (codified in scattered sections 47 U.S.C. §§ 521-611 (Supp. V 1993)).

2. Throughout this Article, the term "network" is used to refer to program suppliers, as distinct from a network of hardware serving communications needs at the facilities level—such as local exchange carriers, satellite master antenna television systems, or even cable systems themselves. Facilities-level firms that offer or might offer video services are either termed "cable systems" or following FCC parlance, as "alternative multichannel video programming distributors (MVPDs)."

3. *Cable TV Consumer Protection Act of 1991: Hearing Before the Subcomm. on Communications of the Senate Comm. on Commerce, Science, and Transportation*, 102d Cong., 1st Sess. (1991); *Cable Television Regulation Part 2: Hearings Before the Subcomm. on Telecommunications and Finance of the Senate Comm. on Energy and Commerce*, 101st Cong., 2d Sess. (1990); *Cable TV Consumer Protection Act of 1989: Hearings Before the Subcomm. on Communications of the Senate Comm. on Commerce, Science, and Transportation*, 101st Cong., 2d Sess. (1990); *Media Ownership: Diversity and Concentration: Hearings Before the Subcomm. on Communications of the Senate Comm. on Commerce, Science, and Transportation*, 101st Cong., 1st Sess. (1989); *Competitive Issues in the Cable Television Industry: Hearings Before the Subcomm. on Antitrust, Monopolies and Business Rights of the Senate Comm. on the Judiciary*, 100th Cong., 2d Sess. (1988) [hereinafter *Cable Competition Hearings*]; *In re* Competition, Rate Deregulation and the Commission's Policies Relating to the Provision of Cable TV Service, *Report*, 5 FCC Rcd. 4962, paras. 112-30 (1990) [hereinafter *1990 FCC Cable Report*].

4. As a result of the FCC's 1992 "video dialtone" decision, local exchange carriers are also beginning to offer common carrier video services and could soon be allowed to enter the market as full-fledged providers of cable services. *In re* Telephone Co.-Cable TV Cross-Ownership Rules, §§ 63.54-63.58, *Memorandum Opinion and Order on Reconsideration*, 7 FCC Rcd. 5069, para. 269 n.15 (1992) [hereinafter *Video Dialtone Order*].

adequate access to programming.[5] As required by Section 19 of the Act, the FCC promulgated regulations on April 1, 1993, that require cable program suppliers in which cable systems have an "attributable interest" to make programming available on the same terms and conditions to all competing delivery systems.[6] Based on the language of Section 19, the FCC singles out *vertically integrated* cable program suppliers—which it defines as those in which *any* cable operator has a 5 percent or greater equity interest—for specific regulations.[7] Among other restraints, the regulations prohibit these integrated program suppliers from any price discrimination in the distribution of cable programming in any market, except for differences the programmer can justify on the basis of costs, volume differences, creditworthiness, or similar factors. Vertically integrated programmers are also prohibited from entering into exclusive dealing contracts (or, implicitly, from refusing to deal) with any cable operator unless the program supplier can demonstrate to the FCC that those contracts are in the public interest.[8] As the FCC notes, Section 19 also prohibits "unfair methods of competition" and "unfair or deceptive acts or practices" by "all cable operators," so that cable operators do not have to be vertically integrated to be subject to a program access complaint.[9] Apart from this general language which applies indirectly to the behavior of nonintegrated cable program suppliers, the FCC's program access regulations apply only to vertically integrated programming suppliers.

The 1990 FCC Cable *Report* on the cable industry expressed a favorable view of industry vertical integration in general, but its conclusions on program access were less sanguine.[10] The *Report* concluded that "vertically integrated cable operators often have the ability to deny multichannel video programming distributors access to cable programming services in which such cable operators hold ownership interests, and there is considerable anecdotal evidence that some have used this ability in anticompetitive ways."[11] The singling out of vertically integrated cable

5. *In re* Implementation of §§ 12 and 19 of the Cable TV Consumer Protection and Competition Act of 1992: Dev. of Competition and Diversity in Video Programming Distribution and Carriage, *First Report and Order*, 8 FCC Rcd. 3359, para. 9 (1993) [hereinafter *First Report & Order on Competition and Diversity*]. Section 19 of the Act creates a new § 628 of the Communications Act of 1934 which embodies the program access provisions of § 19. *Id.* paras. 1-3.

6. *Id.*

7. *Id.* para. 11.

8. *Id.* paras. 16, 62-67. This same provision also applies to "all satellite broadcast programming vendors" (that is, superstations), whether integrated or not. *Id.* para. 10.

9. *Id.* para. 10.

10. *See 1990 FCC Cable Report*, *supra* note 3.

11. *Id.* para. 128.

programmers in the 1992 Cable Act indicates that Congress reached a similar, if not stronger, conclusion regarding the role of integration in limiting access for alternative MVPDs.

This Article addresses whether the separate treatment of vertically integrated and nonvertically integrated program suppliers in the program access regulations is justified. The analysis is primarily based on the empirical record established by the congressional hearings and FCC proceedings leading up to the 1992 Act. Since October 1993, several complaints and petitions involving program access have been filed, and in June 1994, the Commission began to rule on some of these cases. At the end of this Article, this more recent regulatory activity is discussed.

This Article argues that although there are viable economic models that can explain attempts by established cable operators to bar competing delivery systems from the market by restricting access to programming, the singling out of vertically integrated firms for blame is not justified for two main reasons. First, the record makes clear that both integrated and nonintegrated program suppliers have engaged in the same potentially anticompetitive behavior in question. While vertical integration may facilitate any foreclosure behavior by cable operators, the basic source of the behavior must be horizontal market power at the cable system level, or at the Multiple Cable System Operator (MSO) level, in the market for programming. To the extent that this horizontal market power exists, the empirical record suggests it can be exerted either in the presence or the absence of vertical ownership ties. Second, the record suggests that to the extent cost differences fail to explain variations among programming prices that suppliers charge to different MVPDs, simple variations in outcomes of the network-MVPD bargaining process are more likely to be responsible. Unlike a foreclosure strategy, bargaining outcomes are determined by the horizontal market power of the seller vis-à-vis the buyer. These outcomes have little to do with whether the seller is vertically integrated.[12]

This Article concludes that whatever FCC program access regulations there may be, they should apply equally to all program suppliers—regardless of the ownership relations those suppliers may have with cable systems, or with any other MVPDs. Singling out program suppliers that are vertically affiliated with cable operators, as the regulations now do, essentially excludes from control numerous other suppliers having basically

12. The argument of this Article—that differences in input prices can be explained as variations in bilateral bargaining outcomes—could also be explained from the seller's point of view as unilateral price discrimination. Here, the argument is framed in terms of bargaining outcomes because neither buyer nor seller in this market is necessarily a price maker.

the same behavioral incentives to participate in the exclusion of competitors as integrated suppliers. To the extent that the regulations impact sales practices of integrated programming suppliers, evasion of the regulations by means of vertical divestiture will be encouraged. The intent of the regulations would thus be undermined and the playing field tilted arbitrarily in favor of some firms and not others. Whatever the utility of the program access regulations in general, they should be applied without respect to ownership relationships.

Part I of this Article outlines the empirical state of vertical ownership in cable. Part II discusses the economic theory of vertical foreclosure and the role of integration. Part III considers the empirical record and the viability of alternative foreclosure and economic efficiency explanations for this evidence. Part IV concludes with a policy analysis, emphasizing the importance policymakers should place on the origins of market power at the facilities level.

## I. The Empirical State of Vertical Ownership in Cable

The underlying concerns about cable television's "bottleneck" monopoly power over program suppliers are suggested by the market structure of the MVPD industry. Very few cable subscribers are currently served by overbuilt cable systems,[13] and the nationwide penetration of SMATV, MMDS, and DBS aggregate to less than 3 percent of U.S. TV households.[14] About 4 percent of households own home satellite dishes, but a large proportion of these households are outside cable franchise areas or do not subscribe to multichannel video services.[15]

In terms of subscribership and revenues, vertical integration between cable television networks and cable systems—usually via common corporate ownership ties between MSOs and cable networks—is extensive, though by no means ubiquitous. In its September 1994 report on the status of competition in the cable industry, the FCC reported that 56 of the 106 nationally distributed programming services it identified had vertical ties with MSOs and 50 did not.[16] These data understate the economic significance of vertical integration since MSOs (or their parent companies)

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13. *In re* Implementation of Section 19 of the Cable TV Consumer Protection and Competition Act of 1992, *First Report*, 9 FCC Rcd. 7442 (1994) [hereinafter *1994 Cable First Report*]. The FCC reported in 1990 that there were 41 to 49 "overbuilt" systems out of a national total of approximately 10,000 and that the extent of overbuilding "seems to have remained quite limited." *Id.* paras. 55, 60.

14. Paul Kagan Associates, Inc., *Kagan Media Index*, Aug. 31, 1994, at 8.

15. *1994 Cable First Report, supra* note 13, paras. 73-74.

16. *Id.* para. 161 n.434.

held 5 percent or greater equity in 12 of the 15 most widely viewed commercial basic cable networks[17] and in 4 of the 5 largest premium networks.[18] Notably unaffiliated with any cable operators, however, were ESPN and Lifetime—the fourth and seventh most widely viewed basic networks[19]—and the Disney Channel, the third largest national premium network.[20]

Joint ownership of a cable network by more than one MSO was fairly common; the equity of twenty-eight of the fifty vertically affiliated networks reported by the FCC was shared by two or more MSOs or their parent companies.[21] As these data suggest, minority ownership ties between cable networks and MSOs were also common; for 21 of the 50 vertically affiliated networks, no individual MSO (or its parent company) owned greater than a 50 percent share of the network, although in 19 of these 21 cases, the individual minority shares of 2 or more MSOs aggregated to more than 50 percent of the network's equity.[22]

The overwhelming proportion of equity ownership in nationally distributed cable networks was accounted for by the largest twelve MSOs or their parent companies. Eleven of these twelve MSOs (serving 67.4 percent of all U.S. cable subscribers as of March 1994) had a 5 percent interest in at least one cable network. A disproportionate amount of network equity ownership was accounted for by three MSOs. Tele-communications, Inc. (TCI), owner of the largest MSO (serving 24.8 percent of all U.S. cable subscribers), was vertically affiliated with twenty-three nationally distributed cable networks.[23] Time Warner, Inc., owner of the second largest MSO (serving 12.5 percent of all U.S. cable subscribers) was affiliated with sixteen national networks.[24] Finally, Viacom, Inc., owner of the tenth largest MSO (serving 1.9 percent of all U.S. cable subscribers), was also affiliated with sixteen national networks.[25]

These levels of vertical integration reflect relatively little change since the passage of the 1992 Cable Act. Among the larger networks, Viacom's 1994 divestiture of its one-third share in Lifetime left that network

17. *Id.* app. G, tbl. 8.
18. *Id.* app. G, tbl. 6; Paul Kagan Associates, Inc., *The Pay TV Newsletter*, Aug. 31, 1994, at 2.
19. *Id.* app. G, tbl. 8.
20. *Id.* app. G, tbl. 4.
21. *Id.* app. G, tbls. 9-10.
22. *Id.*
23. *Id.* app. G, tbls. 1, 2, 9-10.
24. *Id.* app. G, tbl. 2.
25. *Id.* app. G, tbl. 1A.

unaffiliated with any MSO,[26] and the Viacom-Paramount merger in 1994 resulted in MSO ties to two formerly non-MSO-affiliated networks, USA and the Sci-Fi Channel.[27] The FCC reported that twenty-two new cable networks had entered the industry since passage of the 1992 Cable Act.[28] Ten of these had MSO ownership ties, and thirteen of them did not, thus leaving the overall proportion of MSO-affiliated networks at about the same level.[29]

These data thus indicate that while the FCC's specific nondiscriminatory access provisions apply to most of the larger cable networks, there are many others to which they do not apply. The specific regulations affect most of the largest MSOs, especially TCI, Time Warner, and the cable system holdings of Viacom-Paramount. A major reduction in the extent of vertical integration—and thus in the coverage of the program access provisions—will soon result if Viacom-Paramount's January 1995 announcement that it has agreed to sell its cable system interests to RCS L.P. Intermedia Partners is consummated.[30] This transaction would convert eleven cable networks (including four of the fifteen most widely viewed basic networks) and two of the six largest premium networks, to non-MSO affiliated status.

## II. THE ECONOMIC THEORY OF VERTICAL FORECLOSURE AND THE ROLE OF INTEGRATION

To the extent that local cable operators enjoy monopoly profits, they have an obvious incentive to protect those profits by restricting entry. Leaving aside vertical integration for the moment, one can construct a variety of models that show conditions under which established cable operators could profitably retard the entry of competing multichannel providers—at either the local or the national level—by inducing program suppliers to limit these entrants' access to programming.[31] A necessary

26. *Id.* para. 165.

27. *Id.* para. 164.

28. *Id.* para. 166.

29. *Id.* app. G, tbls. 3-4.

30. *See* Eben Shapiro & Mark Robichaux, *After Setback in Senate, Viacom Seeks Other Ways to Sell Cable Systems to TCI*, WALL ST. J., Mar. 17, 1995, at A3.

31. The essential feature of one such model is that an established cable operator has made a sunk cost investment in constructing a physical plant on the expectation that over time operating revenues will cover not only operating expenses, but also amortization of the plant. LELAND L. JOHNSON, COMMON CARRIER VIDEO DELIVERY BY TELEPHONE COMPANIES 45–47 (1992). But now assume that a potential multichannel competitor later arrives on the scene. Because its existing plant is otherwise useless, the established operator will find it worthwhile to expend resources to prevent entry all the way up to the point that only its operating costs are covered. The result is that even if the potential entrant has a superior

condition in such foreclosure models is that the entrant cannot substitute programming from alternative sources. Although clearly an empirical question, there seems to be a consensus in the industry that the lack of more than one or two of the well-known networks such as ESPN, USA, CNN, and HBO, would seriously handicap a multichannel competitor to an established cable system.[32]

One role that vertical integration could play in such models is to facilitate the contracting process necessary to accomplish the foreclosure objective. For reasons comparable to those discussed in the "transactions costs" literature on vertical integration,[33] compensating or coercing a supplier to refuse to deal with an entrant is probably easier to carry out if ownership is involved. The risk of opportunistic reneging on the agreement by the network or the MSO is probably reduced, and there may be less risk of legal jeopardy. Also, if a written exclusive dealing contract is involved, integration is likely to smooth its dissolution if it should later become adverse to the interest of one party.

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technology and programmers could expand their subscribership with the new technology, the established operator may still be able to compensate program suppliers for a grant of exclusive rights by more than the entrant could profitably bid for those rights, thus preventing the entry. This model implicitly assumes as well that the entrant is unable to hold on as long as the established cable operator.

One could also posit a "reprisal" model of entry deterrence at the system level. In this case, the incumbent cable system does not compensate networks to induce them to refuse sales to competing delivery systems. Rather, the system keeps networks in line by establishing a reputation for punitive action (for example, by moving channel position or refusing to promote) against any network that might do business with the entrant. The basis for this model follows from David M. Kreps & Robert Wilson, *Reputation and Imperfect Information*, 27 J. ECON. THEORY 253 (1982) and Paul Milgrom & John Roberts, *Predation, Reputation and Entry Deterrence*, 27 J. ECON. THEORY 280 (1982).

32. *See 1990 FCC Cable Report*, *supra* note 3, para. 181 (testimony of Robert Thompson, Vice President of TCI, from the FCC Los Angeles Cable Television Field Hearing, Feb. 12, 1990); Comments of the Wireless Cable Association International, Inc. to FCC in MM Dkt. No. 92-265 (Jan. 25, 1993). The "contestability" of program supply at the actual production level is more likely because individual firms do not tend to develop brand names or consumer loyalties. For this reason, integration between cable systems and movie studios (as in the case of Time Warner, via its ownership of the studio, Warner Bros., Inc. as well as cable systems) is not likely to be a concern unless a large share of the market for program production were to be accumulated.

33. For surveys of the extensive transactions costs literature, see ROGER D. BLAIR & DAVID L. KASERMAN, LAW AND ECONOMICS OF VERTICAL INTEGRATION AND CONTROL (1983) and Michael L. Katz, *Vertical Contractual Relations*, *in* 1 HANDBOOK OF INDUSTRIAL ORGANIZATION 655 (Richard L. Schmalensee & Robert D. Willig eds., 1989). The particular role of vertical integration in anticompetitive behavior is discussed in Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price*, 96 YALE L.J. 209 (1986).

Another role of vertical integration could be to coordinate collusion among networks when more than one network is involved in the entry deterrence. Say, for example, that an established cable system with a potential MMDS competitor in its local market area believes it needs to enlist refusals to deal from at least five networks to prevent or retard entry. The cable system might simply choose five networks and compensate them for this exclusivity. But any perception among the five that the foreclosure strategy might fail, especially if there are "first mover" advantages in signing on with the entrant, implies a risk of defection.[34] If the established cable system is vertically integrated with at least some networks, however, then the risks of defection perceived by nonintegrated networks are likely to be reduced, thus facilitating the strategy.[35]

Vertical integration might also facilitate collusion among MSOs to enforce foreclosure attempts carried out on a national basis. For locally-based entrants such as MMDS and SMATV, colluding MSOs could instigate a general policy against dealing with program suppliers that did business with entrants in any local market they control.[36] DBS, in contrast, is an inherently national technology and threatens all cable operators simultaneously. National MSO collusion might be facilitated if two or more MSOs are common owners of the same network or networks, or if equity in a sufficiently large number of separately owned networks is concentrated in the hands of a relatively few MSOs.

Concerns about nationally coordinated collusion among vertically integrated MSOs are implicit in the 1992 Cable Act. They are also implicit in the FCC's subsequent decision to prohibit any non-cost-based pricing by vertically integrated program suppliers in any market, regardless of whether

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34. For example, the first networks that an entering MVPD offers to its subscribers are likely to benefit by accumulating subscriber loyalty or from subscriber switching costs.

35. Such potential facilitation of collusion was the central rationale for the Justice Department's successful opposition to the merger in the early 1980s of Showtime and the Movie Channel under joint ownership of five corporate entities, including three of the major motion picture studios. The Justice Department's main rationale was that the new venture would facilitate collusion among the three motion picture producer-distributors upstream. *See* Lawrence J. White, *Antitrust and Video Markets: The Merger of Showtime and the Movie Channel as a Case Study, in* VIDEO MEDIA COMPETITION: REGULATION, ECONOMICS, AND TECHNOLOGY 338 (Eli M. Noam ed., 1985).

36. Similarly, the MSOs could discriminate against a network that is carried, such as by refusing to promote it to subscribers, or by moving it to an inferior channel position. Such strategies are, of course, likely to be less successful with more established networks such as CNN or USA.

the transaction takes place in a market where the supplier in question has a vertical relationship.[37]

In summary, then, the theoretical role of vertical integration in the above foreclosure models is to facilitate the exercise of horizontal market power, either at the network or at the facilities level. At the facilities level, such power might in theory be exercised by an established cable system or by coordinated action involving numerous systems by one or more MSOs.

## III. THE EMPIRICAL RECORD

### A. *Foreclosure or Efficiency?*

The question becomes whether these foreclosure models, and vertical integration's role in them, are plausible in the cable industry. As the FCC and many others have pointed out, the motives and effects of exclusive dealing between cable operators and cable networks can often promote business efficiency.[38] In the 1990 FCC Cable *Report*, for example, the FCC cited complaints by SMATV, MMDS, and overbuilt cable operators that TNT's policy of granting exclusive rights to established cable operators diminished the complainants' ability to compete with those established operators. But the FCC also noted TNT's claim that the exclusivity offer was designed to induce skeptical cable operators to accept TNT during the year following its 1987 launch, thus reducing the uncertainty of TNT's market value.[39] The Commission further noted a policy of Cablevision Systems—a large MSO having equity interests in several networks. Cablevision's programming subsidiary required wireless cable operators to

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37. Similar concerns were also a basis for settlements in 1994 of federal and state antitrust suits against Primestar Partners, a joint venture among ten firms—including the five largest vertically integrated MSOs—formed in 1990 to offer medium power DBS services in the United States. United States v. Primestar Partners, L.P., 1994-1 Trade Cas. (CCH) ¶ 70,562 (S.D.N.Y. April 4, 1994). The Primestar system utilizes transmission from an existing satellite transmitting in a low-frequency portion of the Ku-band and requires a home receiving dish 18 to 36 inches in diameter. More advanced "true" DBS systems use a higher-powered satellite transmitting in the upper Ku-band and will require a smaller home dish. Some provisions of these settlements parallel the Cable Act by enjoining the defendants' majority owned programming services from engaging in various exclusive contracting and discriminatory pricing practices.

Another proposed consent decree filed in 1994 by the Justice Department, United States v. Telecommunications, Inc. and Liberty Media Corporation, *Proposed Final Judgment and Competitive Impact Statement*, 59 Fed. Reg. 24,723-24 (1994), approves the remerger of these two firms but constrains the program services in which they have ownership interests from similar pricing and exclusivity practices.

38. *1990 FCC Cable Report, supra* note 3, paras. 116-117.

39. *Id.* para. 114(a).

renegotiate their affiliation agreements with its vertically integrated networks once their market penetration reached 2 percent.[40] Cablevision argued such requirements were intended to prevent (among other things) "free riding" on the marketing efforts of cable systems in the same market area.[41]

These counterclaims about cable network marketing practices reflect classic economic arguments that exclusive contracting generally promotes efficiency. The circumstances under which exclusive contracting either promotes efficiency or serves as an aid to market foreclosure is a subject of intense debate in the economic literature.[42]

Given the evident incentives of established cable systems to retard competitive entry if they can, it would be surprising not to observe attempts at foreclosure behavior involving program access. In fact, the media offer a long history of attempts by established firms to stop the advance of technology by restricting access to programming. In the 1920s, when commercial radio was beginning to emerge, some newspaper members of the Associated Press (AP) tried to prevent radio stations from buying news information from the AP.[43] In the 1950s, motion picture theater operator trade associations repeatedly tried to organize boycotts against movie studios that sold old films to emerging broadcast television stations.[44] Broadcast stations and theater operators later joined forces to pressure studios not to supply movies to experimental subscription television (STV) and pay cable systems in the 1960s and 1970s.[45] Furthermore, extensive

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40. *Id.* para. 114(b).

41. *Id.*

42. This debate is beyond the scope of this Article. For a survey of these arguments, most of which rely on the "free rider" marketing problem or other moral hazard problems in the relationship between manufacturers and dealers, see Katz, *supra* note 33. For a recent survey of the economic justifications for exclusivity in antitrust cases, see GREGG FRASCO, EXCLUSIVE DEALING: A COMPREHENSIVE CASE STUDY (1991). Some recent economic models claim that exclusive dealing may have anticompetitive effects. See in particular, Michael H. Riordan & David J. Salant, Exclusion and Integration in the Market for Video Programming Delivered to the Home (July 7, 1994) (paper presented at the AEI Telecommunications Summit: Competition and Strategic Alliances). Riordan and Salant argue specifically that exclusive dealing in the cable television industry may have negative welfare consequences, in part because economies of scale in the distribution of programming are not realized. *Id.*

43. VICTOR ROSEWATER, HISTORY OF COOPERATIVE NEWS-GATHERING IN THE UNITED STATES 292-94 (1970).

44. William Lafferty, *Feature Films on Prime-Time Television*, *in* HOLLYWOOD IN THE AGE OF TELEVISION 235, 236-39 (Tino Balio ed., 1990).

45. *See Subscription Television: Hearings on H.R. 12435 Before the Subcomm. on Communications and Power of the House Comm. on Interstate and Foreign Commerce*, 90th Cong., 1st Sess. (1967); Richard A. Gershon, *Pay Cable Television: A Regulatory History*, COMM. & L., June 1990, at 3, 7-12.

antitrust litigation—much of it resulting in plaintiff victories—has been directed at alleged attempts by motion picture theater chains to prevent independently operated movie theaters from obtaining the films of major studios.[46] Some of these instances have involved vertical integration, and others have not.

It is speculative to assess the extent of foreclosure behavior involving program access that has occurred in the cable industry. However, the record shows that both integrated and nonintegrated cable firms have engaged in the same range of potentially anticompetitive behavior. It is also true that the charging of higher programming prices to an existing or potential entrant can be essentially equivalent in motive and effect to an exclusive contract or an outright refusal to deal. The role of vertical integration in differential pricing may be quite different from that of exclusive dealing, however, so these practices are considered separately.

### B. *Vertical Integration and Exclusive Dealing in Cable*

Many of the program access claims cited in the 1990 FCC *Report* involving exclusivity or alleged refusals to deal have involved vertically integrated firms. These include TNT, Bravo, AMC, and a number of the regional sports networks.[47] Among nonvertically integrated networks, however, the *Report* cited ESPN as having contracts prohibiting wireless cable operators from distributing ESPN within any cable franchise area. Also cited were assertions by Telesat, an operator of overbuilt cable systems in Florida, that the Nashville Network (then nonintegrated) refused to renew affiliation agreements with Telesat in its overbuilt markets.[48] The cases cited in the *Report* involved both localized incidents as well as the national contracting policies of certain vertically affiliated networks, such as TNT. Because the MSOs which owned equity in Turner Broadcasting System (the parent company of TNT) serve much less than 100 percent of U.S. cable subscribers, however, many of TNT's transactions were with unaffiliated MSOs.

Other evidence corroborates the involvement of both integrated and nonintegrated networks in claims of programming unavailability. In its 1988 report on the cable industry, the National Telecommunications and Information Administration (NTIA) cited data provided by the Wireless Cable Association (WCA) on the availability to its members of twenty-nine

46. MICHAEL CONANT, ANTITRUST IN THE MOTION PICTURE INDUSTRY: ECONOMIC AND LEGAL ANALYSIS 84 (1960).

47. *1990 FCC Cable Report*, *supra* note 3, para. 114.

48. *Id.*

national cable networks. Of seventeen vertically integrated networks, seven were reported "available" and ten "unavailable," while of twelve non-integrated networks, eight were "available" and four "unavailable."[49] Virtually all the major nonintegrated as well as integrated national networks have been mentioned in complaints about program access at one time or another. Examples of such complaints involving nonintegrated networks include the Disney Channel, Cable Video Store, A&E, the Weather Channel, Home Shopping Network, USA, ESPN, and FNN.[50]

By the time the 1992 Cable Act became law, the prevalence of exclusive contracts and claims of other outright refusals to deal with alternative MVPDs had apparently diminished. In its March 1993 comments to the FCC, for example, the Wireless Cable Association noted that "[a]lthough TNT and many regional sports services remain holdouts . . . most other programming services now will do business with wireless cable."[51] As the WCA also noted, political (or legal) pressures were very likely responsible for this shift.[52] However, since the FCC's program access regulations have come into effect, several new access claims involving exclusivity or refusal to deal have been filed.

The legal proceedings leading up to the FCC's program access regulations nevertheless showed no apparent diminution in claims that many programmers charge higher prices to MMDS, SMATV, overbuilt cable systems, HSD owners, and HSD program distributors.[53]

49. NTIA, VIDEO PROGRAM DISTRIBUTION AND CABLE TELEVISION: CURRENT POLICY ISSUES AND RECOMMENDATIONS 103 (1988).

50. *Id.* (Disney Channel); Comments of Telesat Cablevision to FCC in MM Dkt. No. 89-600, at 26-27, 30 (1990) (Cable Video Store, A&E, Weather Channel, Home Shopping Network); *In re* Competition, Rate Deregulation and the Commission's Policies Relating to the Provision of Cable Television Service, Reply Comments of NCTC in MM Dkt. No. 89-600, at 2 (1990) (FNN); FCC Los Angeles Cable Television Field Hearing (Feb. 12, 1990) (USA, ESPN).

51. Comments and Reply Comment to FCC in MM Dkt. No. 92-265 (the Wireless Cable Association, Peoples Choice TV, NRTC, and the National Private Cable Association), at 17-18 (Jan. 29, 1993) [hereinafter Wireless Cable Comments].

52. Such pressures, for example, are suggested by an instance involving HBO. In the mid-1980s, HBO announced it would offer cable operators the right of "wireline exclusivity" within their local market areas for a a rate surcharge of 25¢ per subscriber. HBO's announcement was met with a questioning letter from Senator Kerry (D-Mass.) regarding its effects on potential competitive video providers. HBO's offer was later dropped. *Cable Competition Hearings*, *supra* note 3, at 152-74.

53. *See generally* Wireless Cable Comments, *supra* note 51.

### C. *Vertical Integration and Input Price Differentials in Cable*

#### 1. The Available Evidence

While data are not conclusive, some rate comparisons submitted in earlier congressional and FCC proceedings suggest the extent of input price differentials between MSOs and MVPDs at issue. The 1990 FCC *Report* cites data provided by WCA for seven networks serving MMDS systems. These data (reproduced in Table 1) indicate that certain MMDS systems pay premiums for programming over the rates charged to comparably sized cable systems between 36.4 percent to 78.6 percent.[54] Data from the National Satellite Programming Network, Inc., a trade organization for SMATV systems, reported premiums ranging from 32 percent to 209 percent for nine networks available to certain SMATV systems.[55] The FCC *Report* also noted claims by National Rural Telecommunications Cooperative (NRTC), a distributor of cable programming to HSD owners, that while all networks were available to it, NRTC had to pay, on the average, rates 460 percent higher than did cable operators for access to eighteen basic cable networks.[56] Finally, Cross Country Cable, Inc., an MMDS operator, submitted data indicating that a package of seventeen basic cable networks available both to MMDS and to "the largest cable MSO's" cost approximately 200 percent more for the MMDS operators than for the MSOs.[57]

In nearly all cases indicated in Table 1, both affiliated and unaffiliated networks reportedly charged lower rates to cable systems than to alternative MVPDs. But while these input price differences seem substantial, the data indicate no discernible tendency for integrated programmers to be more inclined than nonintegrated programmers to charge higher prices to alternative MVPDs.

Evidence of price differentials was generally undisputed by program suppliers in FCC and other policy proceedings. A main reason for the differences cited by both integrated and nonintegrated programming suppliers was that serving non-cable system customers is more costly. Among reasons cited were a higher frequency of bad debts, higher marketing costs, higher advertising costs, and poor signal quality.[58]

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54. *1990 FCC Cable Report*, *supra* note 3, app. G, tbl. 11.
55. *Id.* app. G, tbl. 12.
56. *Id.* app. G, tbl. 9.
57. *Id.* para. 114(b).
58. *Id.* paras. 116-17.

While such factors are clearly plausible contributors to input price differences, two other explanations are possible. One explanation is that established cable operators are attempting to prevent entry or to raise the costs of existing rivals by inducing program suppliers to charge the rivals higher prices than they otherwise would. A fringe competitor such as an MMDS system would thus be prevented from gaining a stronger foothold or forced to exit the market. Or, the price differences could be a short term "raising rivals' costs" strategy. In the latter model, higher programming costs paid by a fringe competitor create a price umbrella under which the established firm can continue to charge monopoly prices to consumers.[59] That is, the higher consumer prices charged by the fringe competitor reduce the competitive pressure on the established cable operator to lower its own subscription prices.

While a possible explanation for the cable network price differentials, the policing of input price collusion among numerous networks, even in the presence of the fairly extensive vertical relationships in the cable industry, seems very discouraging to this model. Network-affiliate contracts specify confidentiality and are complex, often defining sliding scale input pricing formulas and other terms and conditions such as the sharing of marketing responsibilities.[60] The likelihood of undetected discounts to the entrant under these circumstances is high. Of course, an individual MSO should have little difficulty controlling the input price terms charged by a network in which it has a majority ownership investment. The minority ownership relationships prevalent between MSOs and many networks, however, would be less conducive to such price control, as would the absence of any ownership control over other cable networks. Even if only a single MSO or cable system were attempting to orchestrate the collusion among networks in a localized area, these coordination problems would seem forbidding. For several MSOs to coordinate this process would be even more difficult.[61]

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59. *See* Krattenmaker & Salop, *supra* note 33, at 238-40. The relevant model in this case is the "cartel ringmaster."

60. For a discussion of cable industry contracts, see DAVID WATERMAN & ANDREW WEISS, VERTICAL INTEGRATION IN CABLE TELEVISION, ch. 3 (Sept. 17, 1993) (unpublished monograph, American Enterprise Inst.).

61. The 1994 Primestar decrees provide some perspective. The Primestar Partners' original contract contained a "most favored nation" (MFN) clause which required the involved program suppliers to offer their programming to the Primestar DBS system at prices no higher than were charged to any other entity. The government interpreted this clause to be conducive to input price collusion among these suppliers for the possible purpose of preventing entry of a competing DBS system. *See generally In re* Implementation of Section 19 of the Cable Television Consumer Protection and Competition Act of 1992, *Notice of Inquiry*, 9 FCC Rcd. 2896, paras. 85-87 (1994). While this theory