of a presumption that carriage rates are just and reasonable have not been met.[2] At the request of the Joint Parties, I had earlier filed a declaration[3] pertaining to certain economic issues raised in the FCC's proceeding on OVS[4] and had responded to the assertions of other parties. In my present submission, I analyze the FCC's proposed application of the ECPR to pricing OVS carriage and conclude that (i) the proposed application misconstrues the meaning and purpose of the ECPR, (ii) the FCC's description of the proposed "imputed rate approach" misstates the ECPR principle and, in any event, is not necessary in the presence of effective competition in the video programming market.

II. Background

In the OVS Order, the FCC establishes a "strong presumption" that OVS carriage rates are "just and reasonable and not unjustly or unreasonably discriminatory"[5] where "... at least one unaffiliated video programming provider, or unaffiliated providers as a group, occupy capacity equal to the lesser of one-third of the system capacity or that occupied by the open video system operator and its affiliates, and where the rate complained of is no higher than the average of the rates paid by unaffiliated programmers receiving carriage from the open video system operator."[6]

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[2] Implementation of Section 302 of the Telecommunications Act of 1996 Open Video Systems, *Second Report and Order*, CS Docket No. 96-46 (released June 3, 1996). (OVS Order)

[3] Declaration of William E. Taylor, Before the Federal Communications Commission, CS Docket No. 96-46, April 10, 1996.

[4] Implementation of Section 302 of the Telecommunications Act of 1996 Open Video Systems, *Notice of Proposed Rulemaking*, CS Docket No. 96-46 (released March 11, 1996). (OVS NPRM)

[5] *Telecommunications Act*, 1996, Section 653(b)(1)(A).

[6] OVS Order, ¶114.

In cases where these conditions are not met, the OVS Order requires the "... operator to show that it charges the unaffiliated programmer *no more for carriage than it earns from carrying its own affiliates' programming.*"[7]

According to the FCC, this "... imputed rate approach is an application of the Efficient Component Pricing Rule to open video systems ... [which] *is particularly applicable to circumstances where a new market entrant, the open video system operator, will face competition from an established incumbent, the cable operator ... as opposed to circumstances where the pricing is used to establish a rate for an essential input service that is charged to a competing new entrant by an incumbent provider.*"[8] The OVS Order states further: "*If the carriage rate to an unaffiliated program provider surpasses what an operator earns from carrying its own programming, the rate can be presumed to exceed a just and reasonable level.*"[9]

The OVS Order demonstrates the FCC's clear intent to balance the public — and Congressional — interest in promoting competition for the provision of video programming services against its statutory obligation to ensure just and reasonable OVS carriage rates. It eschews many of the more overtly regulatory approaches proposed by commenting parties for meeting that obligation. Instead, the Order requires adherence to an explicit pricing standard only when the conditions for the presumption of just and reasonable rates simply cannot be met. While the FCC's imputed rate approach is preferable to more overtly regulatory prescriptions for setting prices, it is not an appropriate application of the ECPR. Moreover, it is not a necessary course of action for the purpose at hand.

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[7] OVS Order, ¶114 (emphasis added).

[8] OVS Order, ¶¶126-127 (footnotes omitted and emphasis added).

[9] OVS Order, ¶127 (emphasis added).

III. THE IMPUTED RATE APPROACH IS NOT AN APPROPRIATE APPLICATION OF THE ECPR

The FCC cites two papers by economists (including one I co-authored with Dr. Alfred Kahn)[10] as its reference source for the ECPR.[11] Both papers established the ECPR (also called the principle of "competitive parity" in our paper) as an economically sound approach to setting the price of monopoly inputs (also often called "bottleneck" inputs or "essential facilities"). The context examined in those papers is one in which the incumbent monopoly provider of an input is also a downstream competitor of all firms that purchase that input. That is, in that context, (i) the incumbent is the sole source of the input, (ii) all firms — including the incumbent — must use that input to produce the final product, and (iii) the incumbent competes with the other firms for providing the final product. This situation qualifies the input in question to be an essential facility, a fact that the antitrust literature and courts have recognized.[12] Both papers cited by the FCC addressed the issue of regulatory pricing standards for inputs that meet the essential facility conditions.[13]

Apart from establishing the standard for pricing essential inputs, the ECPR rule specifically applies to the *supplier* of the essential input. This would naturally be the *incumbent* supplier because its control of the essential input alone holds the key to the prospects for *any* competitive market entry and is, therefore, deserving of countervailing regulation. A new market *entrant*, on the other hand cannot logically be the supplier of the essential input because, if it were, the incumbent firm could not already be operating in the market. Thus,

[10] W.J. Baumol and J.G. Sidak, "The Pricing of Inputs Sold to Competitors," *11 Yale Journal on Regulation 171*, 1994; and, A.E. Kahn and W.E. Taylor, "The Pricing of Inputs Sold to Competitors: A Comment," *11 Yale Journal on Regulation 225*, 1994.

[11] OVS Order, ¶126.

[12] See, e.g., *MCI Communications Corp. v. AT&T Co.* in which the Seventh Circuit identified the characteristics (roughly the same as those listed above) necessary to establish liability under the essential facilities doctrine.

[13] For example, Baumol and Sidak specifically examined the case of intraLATA toll competition with intrastate switched access as the monopoly input controlled only by incumbent local exchange carriers. We, too, considered a similar example.

ECPR-based pricing for *inputs* (the obverse of "imputation" in the pricing of *outputs*)[14] applies only to (i) incumbent firms, not new market entrants and (ii) essential inputs for which new market entrants have no feasible alternatives. From this standpoint, the FCC's reliance on ECPR for regulating rates charged by new *entrants* (such as local exchange carriers or LECs providing OVS) is without justification.[15]

At a practical level, even the particular imputed rate approach espoused by the FCC for carriage provided by entrant OVS operators is incorrect. As our paper pointed out, ECPR or competitive parity has two requirements. First, the incumbent firm that competes in the retail market must "pay" the same price for the essential input that it charges its competitors, except to the extent that the incremental costs of providing that input to itself and to its competitors differ. Second, the incumbent's retail price must be no less than the sum of its incremental cost for the retail product and the price it charges others for the essential input (adjusted, of course, for any differences in the costs of supplying the input).[16] The corollary of this requirement, it can be shown,[17] is that the price the incumbent charges for its essential input must be no higher than the sum of its incremental cost to provide the input and the contribution in its retail price.

[14] This obverse property, also referred to below, arises as follows. Let P_R, P_W, IC_R, and IC_W denote the prices and incremental costs of the retail service and the essential input respectively. The ECPR states that $P_W \leq IC_W + [P_R - IC_R]$. Efficient imputation, on the other hand, requires that $P_R \geq IC_R + [P_W - IC_W]$. These two inequalities are consistent only when equality holds for both and $P_W = P_R - [IC_R - IC_W]$.

[15] This application of ECPR to the pricing of an entrant's, not the incumbent's, input service is hard to reconcile with the FCC's apparent recognition that the ECPR was designed to apply to the *incumbent's essential* input service. See, e.g., Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, *Notice of Proposed Rulemaking*, CC Docket No. 96-98 (released April 19, 1996), ¶147. The FCC's apparent readiness in the present docket to embrace ECPR for pricing purposes is particularly surprising in view of its tentative conclusion in the Local Competition docket (¶148) that ECPR would be "... inconsistent with the section 252(d)(1) requirement that [prices for interconnection and unbundled network elements] be based on 'cost,'" and that states be barred from using ECPR for such pricing. Ironically, the FCC has adopted ECPR in a context for which it was not designed and tentatively rejected it in the context in which it is appropriate.

[16] An equivalent formulation of this rule that accounts for the possibility that the incremental cost of self-supplying the essential input and supplying the input to competitors may differ is: the firm's retail price must be no less than the sum of its retail incremental cost and the *contribution* (i.e., price less incremental cost) it earns from sale of the essential input to competitors. This contribution is the opportunity cost of providing the retail product.

[17] See *supra*, note 13.

In attempting to describe this standard, however, the FCC's imputed rate formula misstates the ECPR requirements. Twice the OVS Order compares the carriage *rate* charged to unaffiliated program providers to what the OVS operator *earns* from carrying its own programming. In economics, earning refers to the excess of income over costs (or expenses) which, when expressed per unit of sales, is simply contribution in the sense I have used the term here. Thus, as phrased, the FCC would consider the OVS operator's carriage rate to others *not* to be just and reasonable if it exceeded merely the contribution in its retail service. This is incorrect because ECPR-based pricing of essential inputs (assuming for the moment, for the sake of argument only, that OVS carriage is indeed an essential input) would require that the price charged to unaffiliated programmers for carriage not exceed the *sum* of that contribution *and* the incremental cost of providing carriage. By failing to include the incremental cost component, the FCC's stated rule for pricing carriage sets an incorrect and artificially low threshold for judging whether that price is just and reasonable.

The FCC's stated rule can also have other perverse consequences. For example, suppose that the incumbent cable operator (which initially serves all subscribers) reduced its retail prices for video services one or more times. Those reductions, possibly motivated by the desire to compete against OVS or other entrants, would be unobjectionable as long as the resulting retail prices remained compensatory, i.e., covered the corresponding retail incremental costs. The OVS entrant would likely respond by reducing *its* retail prices, but it could do so only up to the point that all earnings (contributions) from its retail services were dissipated (as prices fell toward incremental costs). Assuming that that point of earnings dissipation was reached, the FCC's version of ECPR would then result in a *zero* price for OVS carriage. In this situation, not only would the OVS operator have to bear the risks and burden of a competitive price war, it would also have to provide OVS carriage to unaffiliated programmers (which would be largely unaffected by the retail price war *per se*) for free. In other words, despite incurring a real cost to provide such carriage, the OVS operator would be deprived of even fair compensation for that service. Moreover, while the OVS operator (at the point its earnings are dissipated) would only break even for its retail services, the unaffiliated programmers to which it provides carriage would get a free ride and experience positive earnings. This is because the unaffiliated programmers' retail revenues would have to recover only *their* non-carriage incremental costs (i.e., those due to programming and packaging) but not also the (real) costs of carriage, which would go unpaid.

IV. The Imputed Rate Approach is Not Necessary for Ensuring That OVS Carriage Rates Are Just and Reasonable

Even if the ECPR were applied appropriately in the FCC's imputed rate approach, there is simply no persuasive economic basis for resorting to that approach. As stated above, any ECPR-based pricing rule would only apply to incumbent firms that control essential inputs that their competitors need. The market for video programming services will simply not fit this mold.

The OVS Order devotes a considerable amount of discussion to the number of competing ways video programming can be delivered[18] and whether out-of-region LECs or non-LECs (in particular, cable operators) should be allowed to offer OVS carriage. The FCC concludes that the public interest, convenience, and necessity justify allowing non-LECs to become OVS operators,[19] with the sole caveat that cable operators only be so allowed if competition from alternative facilities-based operators like LECs already exists.[20] The FCC's particular interest in advancing the Congressional mandate for fostering effective competition for video programming suggests that it does not foresee any likelihood of monopoly constraints being placed on wholesale services like OVS carriage. I agree. Indeed, I fail to see how OVS

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[18] The OVS Order, ¶6, cites four alternative means for delivering video programming listed in Section 651(a)(1)-(4) of the *Telecommunications Act*, 1996. These are: (i) radio-based communication, (ii) common carrier transmission, (iii) cable systems, and (iv) open video systems. In reality, apart from coaxial cable-based systems of traditional cable operators, other feasible programming delivery options include over-the-air broadcasting, Direct Broadcast Satellite (DBS) systems, and Multichannel Multipoint Distribution Systems (MMDS) or wireless cable. See, e.g., L.L. Johnson, *Toward Competition in Cable Television*, Cambridge, MA: The MIT Press and the AEI Press, 1994.

[19] OVS Order, ¶12.

[20] OVS Order, ¶24. An exception to this rule would apply in markets where facilities-based competition would not be feasible.

carriage — particularly that offered by new market *entrants* — can possibly be an essential input. The very existence of incumbent cable operators, not to mention other feasible mechanisms for delivering video programming, makes any characterization of OVS carriage as an essential input fanciful and farfetched. Consequently, I conclude that the circumstances of the evolving video programming marketplace will not warrant the search for ECPR-based pricing standards. That marketplace should itself be able to determine the proper rates for OVS carriage.

Finally, the FCC offers the following further justification of its imputed rate approach:

> An open video system operator's price to its subscribers will be determined by several separate cost components. ... Contained in each [cost category] is a profit allowance attributed to the economic value of each component. When an open video system operator provides only carriage through its infrastructure, however, the programming and packaging flows from the independent program provider, who bears the cost. The open video system operator avoids programming and packaging costs, including profits. These avoided costs should not be reflected in the price charged an independent program provider for carriage.[21]

It is not entirely clear what the term "profit allowance" alludes to. I interpret it to mean the contribution that each discrete activity in the video programming market, namely, program creation, packaging, and program delivery, would earn on a stand-alone basis. When video programming is offered as a composite service to final subscribers, however, it is not clear in what manner the contribution in the retail product price can be "attributed" to the three component parts. Nor is such attribution needed or appropriate in a market where alternatives for *each* of the three cost components or activities are available. There is no question that, even today, there are multiple sources of competition in the provision of program creation and packaging. Given the FCC's own recognition of the multiple different ways to deliver programming — available today, I may add — I conclude that the pricing of OVS carriage should be left to competitive market forces. Any parallel with the pricing of intrastate switched

[21] OVS Order, ¶127.

access under ECPR-like rules or pricing of resold retail local exchange services under avoided cost rules would be vastly overdrawn and inappropriate.

William E. Taylor

Subscribed and sworn to before me this
3rd day of July 1996.

Notary Public

My Commission expires MY COMMISSION EXPIRES AUG. 23, 2002.

CERTIFICATE OF SERVICE

I hereby certify that on this 5th day of July, 1996 a copy of the foregoing "Petition of the Joint Parties for Reconsideration of the Second Report and Order" was sent by first class mail, postage prepaid, to the parties on the attached list.

Jonathan R. Shipler

* By Hand

Meredith Jones *
Chief, Cable Services Bureau
Federal Communications Commission
2033 M Street, N.W.
Room 918
Washington, D.C. 20554

John E. Logan *
Deputy Chief, Cable Services Bureau
Federal Communications Commission
2033 M Street, N.W.
Room 918
Washington, D.C. 20554

JoAnn Lucanik *
Chief, Policy & Rules Division
Cable Services Bureau
Federal Communications Commission
2033 M Street, N.W.
Room 406
Washington, D.C. 20554

Rick Chessen *
Assistant Division Chief,
Policy & Rules Division
Cable Services Bureau
Federal Communications Commission
2033 M Street, N.W.
Room 406
Washington, D.C. 20554

ITS, Inc.*
Federal Communications Commission
1919 M Street, N.W.
Room 518
Washington, D.C. 20554