cable market HHI is over 1300 (see Table 2).

14. Moreover, cable markets are not national in scope, they are local. Here the progress of concentration has been just as rapid. At the point-of-sale which is access to multi-channel local viewing, cable remains a firmly entrenched monopoly in the overwhelming majority of markets.[9] There is virtually no head-to-head competition between cable systems.[10] Even if alternative multi-channel systems were effective competition for cable, their market share remains far too small to challenge the market power of cable operators at the local level.[11] Furthermore, clustering of systems has enabled companies to monopolize wider regional markets.[12] Alternatives technologies have not proven to be effective competitors for cable.[13]

3. CONDUCT

15. Conduct within the industry has been equally ominous from the point of view of competition. Over the past several years, the industry and many of its most powerful participants fought a running battle with one of the few strong potential independent competitors anywhere in the entertainment business, Rupert Murdoch's News Corp. News Corp. failed to gain access to viewers for his twenty-four hour news service due to resistence from entrenched cable operators who have ownership interests in competing

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is essentially local and regional (Third Annual Report, p. 61), although it is interesting to calculate national market shares, since certain characteristics of the industry may be influenced by national decisions. However, one cannot use an equal shares index, as the FCC does (Third Annual Report, p. 63). Ignoring market shares is unacceptable. This consciously and incorrectly ignores the market reality. Instead of using the actual market structure, it assumes a market structure in which all firms are equal in size. It should come as little surprise that it is hard to find actual concentration when the index simply assumes it away. The inclusion of such a conceptually and empirically flawed index distorts and destroys the evidence presented. Public policy must begin with the actual market structure as its starting point.

[9] Third Annual Report, p. 63.

[10] Third Annual Report, pp. 18, 128.

[11] Third Annual Report, p. 63, estimates the HHI for local markets based on the actual penetration of multi-channel providers at 7905, a monstrously concentrated market.

[12] Third Annual Report, p. 70 estimates that half of all cable TV subscribers are now served by regional cluster systems.

[13] Third Annual Report, p. 66 .

programming and was assured by cable operators of a long drawn out legal battle over inclusion of local programming in his proposed nationwide satellite service.[14] In the face of this opposition, Murdoch capitulated to the incumbents. He has now joined forces with the most powerful participants[15] in the industry and begun attacking independent programmers in the sports marketing area, one of the cornerstones of local market entry.[16]

16. A pattern of denial of programming to those who want to enter the MSO end of the business has also continued.[17] Similarly, denial of access to viewers for independent programmers has continued[18]

C. CONCLUSION

17. Thus, in the past year we observe a dangerous shift in industry behavior which has resulted in sharply increased market power, anticompetitive actions and unprecedented price increases. These development make it incumbent upon the FCC to take action to reverse these trends.

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[14] Jeanine Aversa, "Cable Industry Takes Aim at Murdoch's Satellite," Washington Times, March 20, 1997; Mark Robichaux, "Critics Target Murdoch's 'Death Star'," Wall Street Joural, March 17, 1997.

[15] The abrupt abandonment of the Echostar star deal and switch to Primestar was a dramatic shift from promising to compete with the entrenched industry to joining hands with it. Mark Robichaux and John Lippman, "Muroch Sets Satellite-TV and Cable Deals," Wall Street Journal, June 11, 1997.

[16] Richard Sandomir, "Broadcast Giants View for Control of Regional Sports Markets," New York Times, September 1, 1997.

[17] Third Annual Report, pp. 72-78, Appendix H.

[18] One of the more obvious examples was the effort to remove MTV from several systems (see also Multi-channel News, September 2, 1996, for a description of Lifetime efforts to avoid being bumped).

II. THE ENDURING MONOPOLY STRUCTURE OF THE CABLE INDUSTRY

18. These recent developments in the industry are built on a long history of anti-competitive structure. There is nothing in the nature of the industry to suggest it will change its stripes. Without vigorous public policy intervention, market power will continue to be acquired and abused, at the expense of the public.

A. BASIC CONDITIONS

1. THE DEMAND-SIDE

19. On the demand side, a low to moderate price elasticity and a positive income elasticity are crucial characteristics of the industry. They convey market power and an ideal opportunity for the cable industry to exploit consumers.

20. Econometric analyses of demand elasticities for the cable industry yield estimates that are quite low. Prior to deregulation in 1984 they were at or below 1. Since deregulation estimates have been somewhat higher, although credible estimates are still in the range of 1 to 2.[19] The abusive pricing of cable services since deregulation may have driven demand into its more elastic range. Even if the elasticity is in the range of one-to-two, such a market is extremely problematic from the point of view of the exercise of market power.[20] Demand has little ability to discipline price behavior.

21. The same is true of the income elasticity. At the most macro level, income

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[19] Mayo, J. W. and Y. Otsuka, "Demand, Pricing and Regulation, Evidence from the Cable TV Industry," Rand Journal of Economics, Autumn, 1991; Pacey, P. L., "Cable Television in a Less Regulated Market," Journal of Industrial Economics, September, 1985; Webb, G.K., The Economics of Cable Television (Lexington: Lexington Books, 1983); Duncan, K. R. and C.F. DeKay, Estimation of an Urban Cable Demand Model and Its Implications for Regulation for Major Markets, Center for Metropolitan Planning and Research, Johns Hopkins University, March 1976; Charles River Associates, Analysis of the Demand for Cable Television, April 1973; Noll R.G., M.J. Peck, and M.J. McGowan, Economic Aspects of Television Regulation (Washington, D.C.: The Brookings Institution); R.E. Park, "Prospects for Cable in the 100 Largest Television Markets," Bell Journal of Economics and Management Science, Spring, 1972; Commanor, W.S. and B. M. Mitchell, "Cable Television and the Impact of Regulation," Bell Journal of Economics and Management Science, Spring, 1971, all find demand elasticities less than 1.5, even in large urban markets.

[20] W. M. Landes and R. A. Posner, "Market Power in Anti-trust Cases," Harvard Law Review, 94:1981.

growth and increasing penetration are correlated. At the most micro level, higher income households are much more likely to subscribe. Lower income households are much less likely to subscribe. Virtually every econometric study of the cable industry which includes this variable finds a moderate, positive income elasticity, generally in the range of .5 to 1.[21]

22. Low to moderate price elasticity and low to moderate income elasticity both feed off fundamental television viewing patterns that have been established over four decades. Americans watch a significant amount of television -- in the neighborhood of eight hours per day. Television has come to be the premier source of information and entertainment in American life. Deeply entrenched viewing patterns and strong demand for entertainment, news, information, and sports make the market potential for cable huge. The ability to deliver large numbers of channels gives cable a huge advantage in meeting this demand.

2. THE SUPPLY-SIDE

23. On the supply-side the natural monopoly characteristics of the technology along with its rapid development are crucial factors.[22] As a young, capital intensive, network industry, the naturally increasing cable subscriber base increases the market size, attracting new suppliers to the industry. Increasing penetration also spreads the fixed costs of a highly capital intensive industry over larger volumes, leading to declining unit costs.

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[21] Over time, however, the income elasticity declines as cost relative to income declines and the commodity comes to be seen more and more as a necessity. Studies finding positive income elasticities include Pacey, op. cit.; Parks, op. cit.; Mayo and Otsuka, op. cit.; Charles River Associates, op. cit.; Noll, Peck and McGowan, op. cit.; Commanor and Mitchell, op. cit.

[22] Webb, op. cit., specifically mentions geographic natural monopoly. Others, such as Eli Noam (Monopoly and Productivity in Cable Television (Columbia University, Graduate School of Business, Research Program in Telecommunications and Information Policy, October 24, 1984; "Economies of Scale in Cable Television: A Multi-product Analysis," in Eli Noam, (Ed.), Video Media competition: Regulation, Economics and Technology (New York: Columbia University Press, 1985) identify economies of scale and scope, but stop short of calling the industry a natural monopoly. Even those who argue against natural monopoly concede economies of scale (see Smiley, A.K., Direct Competition Among Cable Television System (Economic Analysis Discussion Paper, Department of Justice, June 5, 1985, "Regulation and Competition in Cable Television," Yale Journal of Regulation, 1990; Hazlett, T. W., "Duopolistic Competition in Cable Television: Implications for Public Policy," Yale Journal of Regulation, 1990). In the debate over regulation/deregulation, the question is whether the economics are large enough to preclude competition. For the purposes of establishing reasonable rates in the absence of competition, the important point is to recognize that economies of scale exist and to take them into account in setting rates.

24. Moreover, because cable is a high fixed cost industry, increases in penetration lead to declining unit costs. As volume goes up, profit per unit increases. Hence, constant prices can yield higher returns, making price increases unnecessary to improve quality. The difference in cost between a forty percent penetration rate and a sixty percent penetration rate can be as high as fifty percent.[23]

25. While these basic conditions affect market structure, so too does public policy and private action. Key structural characteristics in the cable industry are a small number of buyers and sellers at a number of key points in the production process.[24] These include programming and local distribution. There are also barriers to entry and vertical integration which impede competition. The local franchising process, and the 1984 Cable Act which all but turned the franchise into a perpetual right, are also crucial basic conditions.

26. One of the most crucial basic supply-side characteristics of the industry is that over-the-air systems have not proven to be ineffective competitors of cable systems.[25] Consumers increasingly value cable for the specialized movie, sports, adult and cultural programming carried by cable.[26] With its limited channel capacity and the cable industry's strategy of bundling network programming into larger packages, or forcing subscribers to buy access to the diverse programming of multi-channel offerings in basic rates, there is simply no way that over-the-air television can be seen as delivering a near enough substitute to effectively check cable's market power. Nor

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[23] Leland L. Johnson and David P. Reed, Residential Broadband Services By Telephone Companies? (Santa Monica, Rand, 1990), Appendix G, shows the cost of a contemporary cable system with broadband backbone and coaxial feeder loop, of $368 per home passed and $614 per subscriber, at 60 percent penetration. By implication, a penetration rate of 40 percent would generate costs of $920 (see also, Shooshan and Jackson, Measuring Cable's Market Power: Recent Developments, December 1988.

[24] Third Annual Report, p. 47

[25] James A. Ordover and Yale M. Braunstein, "Does Cable Television Really Face Effective Competition?," in Competitive Issues in the Cable Television Industry, Subcommittee on Antitrust, Monopolies and Business Rights, Committee on the Judiciary, United States Congress, March 17, 1988, at 561; "Testimony of William B. Finneran, Chairman New York State Commission on Cable Television," in Competitive Issues in the Cable Television Industry, Subcommittee on Antitrust, Monopolies and Business Rights, Committee on the Judiciary, United States Congress, March 17, 1988;
Third Annual Report, p. 51.

[26] Consumer Reports; The Roper Organization, America's Watching The 1989 TIO/Roper Report (1989), at 4.

does it provide support for creating new independent programing.[27]

27. Over-the-air stations are caught between a rock and a hard place. With limited channel capacity, they cannot compete with the specialized and diverse programming cable offers. Yet, as cable becomes more pervasive, the over-the-air networks need to be part of the basic package to preserve their audience.[28]

28. Only alternative delivery mechanisms, such as wireless cable and, perhaps, overbuilding of franchise territories present a credible threat. Overbuilding remains an extremely limited approach to competition.[29] Although a small number of overbuild is taking place, the decision of the Regional Bell Operating Companies to pull back from the vigorous plans to enter the cable TV market with integrated systems,[30] indicates that overbuilding is not likely to be a major force within in the industry.[31]

29. The inability of Direct Broadcast Satellite to compete effectively with cable was underscored in a recent announcement by TCI (See Table 3). In seeking to assure Wall Street that it could make its price increases stick, it presented analysis which showed that the effective price of equivalent service from DBS was over twice the cost of cable.[32] The FCC echoes this analysis.[33] The analysis suggests that another decade of severe price increases would be sustainable before DBS is to be the disciplinary force in the marketplace.

30. With a national average cable price of just over $24 for basic and expanded

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27 Third Annual Report, pp. 49-50.

28 Chapman, op. cit.

29 Third Annual Report, p. 18.

30 Mark Landler, "Baby Bells' TV Developers Are on Hold and Frustrated," New York Times, August 5, 1996; Leslie Cauley, "Baby Bells Push the Pause Button Again on Tele-TV Interactive Unit," Wall Street Journal, June 7, 1996.

31 It remains true, however, that wherever head-to-head competition takes place, we observe vigorous price and quality competition (see Third Annual Report, pp. 95 to 103, for the latest examples of this process).

32 David Liebeman, "TCI to Boost Cable TV Rates," USA TODAY, March 13, 1997.

33 Third Annual Report, p. 19.

basic service, satellite is clearly at a severe disadvantage.

31. Consumers are left with a situation in which cable market power is restrained only by a weak demand-side. Antitrust authorities would never accept an antitrust defense that said, "there is no competition on the supply-side, but we are charging only the limit price on the demand-side."[34]

B. MARKET STRUCTURE OF THE CABLE INDUSTRY

32. Through a series of mergers and acquisitions, the industry has become highly concentrated horizontally and vertically (see Table 2). This horizontal concentration and vertical integration is of special concern in an industry which produces goods and services that have not only economic, but also cultural and political significance.[35] Cable operators who control access to large numbers of viewers can extract concessions from programmers who need to reach a large audience.[36] Because they have market power over consumers, the multiple systems operators (MSO) realize this market power as excess profits.

33. Furthermore, although this concentration is evidenced even at the national level, the nature and structure of the industry is dominated by its monopolistic underpinnings at the point-of distribution.[37] Less than 2 percent of cable subscribers are served by more than one cable company.[38] Including other multi-channel

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[34] For a discussion of the strategy and effects of limit pricing see Sherer, op. cit., at 232-258.

[35] The political and cultural importance of mergers in media industries is noted in the Testimony of George E. Garvey, Subcommittee on Economic and Commercial Law, Committee on the Judiciary, U.S. House of Representatives, March 14, 1989, at 5. See also, Peter L. Kahn, "Media Competition in the Marketplace of Idea," 39 Syracuse L. Rev. 737 (1988); Paul Fahri, "The World in His Hands?", Washington Post, March 16, 1994; Howard Kurtz, "Time Warner, Sitting on the News," Washington Post, July 10, 1997.

[36] Sylvia M. Chan-Olmsted and Barry L. Litman, "Antitrust and Horizontal Mergers in the Cable Industry," Journal of Media Economics, Fall, 1988, at 9-10; Ordover and Braunstein, op. cit. at 574; Pitofsky, Steiger and Varney, p.7, argue that it takes between 40 and 60 percent of subscribers to launch a new channel, which equal roughly 25 to 50 million viewers.

[37] Chan-Olmstead and Litman, op. cit; Ordover and Braunstein, op. cit.

[38] "Testimony of Gary R. Chapman, on Behalf of the National Association of Broadcasters," in Competitive Issues in the Cable Television Industry, Subcommittee on Antitrust, Monopolies and Business Rights, Committee on the Judiciary, United States Congress, March 17, 1988; Third Annual Report, p. 18.

providers lowers cable's market share to about 89 percent. For a variety of price and quality reasons noted above, these other technologies are not effective competitors with cable.

34. The fact that alternative providers have been increasing their customer base has not necessarily come at the expense of cable expansion. Figure 3 shows five indicators of the growth of cable systems — the total number of homes passed, the total number of subscribers, the penetration rate measured as the percentage of homes passed which subscribe, the capture rate measured as the percentage of potential subscribers that were added,[39] and the expansion rate measured as the number of new homes passed in a year.[40]

35. Subscribership grew dramatically throughout the 1980s before and after deregulation. There was a slight slowing beginning in 1991. This reflects the fact that the number of homes passed slowed in growth during this period. Cable has dramatically reduced its efforts to reach new markets geographically. Capture rates were extremely high in the early 1980s and declined through 1985. They stabilized through 1990, then declined again beginning in 1990.

36. The recent expansion of other multi-channel providers has had little if any impact on cable growth. In the three years from 1994 to 1996, when other multi-channel systems added six million subscribers and satellite went from virtually nil to over 3.5 million, cable's growth has been steady. It has added over 11 million subscribers. Its capture rate has been higher than the previous three years. This supports the suggestion that satellite is a different commodity, competing for a different market, or at best a small niche market that it shares with cable.[41] An intriguing hypothesis is that satellite may be going places that cable could not or would not.

37. Market power can also be exercised by companies that control the supply of

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[39] This is calculated as the number of homes not subscribing in the previous year plus the number of new homes formed.

[40] Cooper, Cable Economics, gives a more detailed discussion of these trends.

[41] Yasuji Otsuka, "A welfare Analysis of Local Franchise and Other Types of Regulation: Evidence from the Cable TV Industry," Journal of Regulatory Economics, 11 (1997), shows that other multi-channel technologies provide much more competition for premium services than for basic; Tom Wolzien, Initiating Coverage with an Outperform Rating (Bernstein Research for Cox Cable, Oct. 11, 1996), cited in Third Annual Report, p. 66.

very popular programming. These powerful programmers can extract concession from large cable operators, who rely on these programs to attract viewers, by manipulating prices and program availability. Again, because of market power at the point-of-sale, the costs of these anti-competitive strategies are passed forward to consumers.

38. While one might hypothesize a set of conditions in which this bilateral monopoly operated in the public interest, that has not been the case in the cable industry. The shared interest of cable operators, with their local monopolies and, programmers, with their market power through production, has inflated cable rates.[42] Local markets at the distribution level and vertical integration at the local and national levels constitute the areas of concern and arenas of potential anti-competitive abuse. The ability to impede competition rests at the level of production and programming in efforts to increase penetration of its services through exclusion of competing programming. The ability to impede competition rests at the local level vis-a-vis other modes of delivery.[43]

39. The empirical evidence of these market structural trends and problems is quite clear. Under deregulation, the cable industry rapidly became dominated by a small oligopoly of interconnected vertically integrated firms.[44] As previously noted it is now at least moderately concentrated. The largest cable operator, Tele-Communications Inc. (TCI), accounts for over one-quarter of the market (see Table 3. Including all of its partially owned subsidiaries, and recognizing that these companies are not in a position to compete with or adopt policies that are in conflict with those of TCI, would raise its share of the market to over one-third.

40. The second largest firm (Time Warner) represents over one-sixth of the cable market. Moreover, one must recognize the close alliance that is emerging between TCI and Time Warner. The joint ownership of programming, swaps of systems, and the united front taken in the confrontation with Murdoch clearly suggests that these two entities are acting in concert and not competing. The Joint venture to swap systems and the addition of close associates of John Malone, TCI's CEO to the Time

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[42] The importance of taking cooperative arrangements and other relationships into account in assessing the effects of market structure has been emphasized in the context of merger analysis (see J. A. Ordover, A. O. Sykes, and R.D. Willig, "Herfindahl Concentration, Rivalry, and Mergers," Harvard Law Review, 95 (1982).

[43] Noam, 1984, op. cit., at 14-15; Noam, 1985, op. cit., p. 6. See also, James W. Olson and Lawrence J. Spiwak, "Can Short-term Limits on Strategic Vertical Restraints Improve Long Term Cable Industry Market Performance?" Cardozo Arts & Entertainment Law Journal, 13, 1995.

[44] Garvey, op. cit., Ordover and Yale, op. cit., Chan-Olmsted and Litman, op. cit.

Warner board only make this commonality of interests more apparent.[45] Thus it appears that over half of all viewers (55 percent) are tied up in a small cartel. No entity outside this cabal represents more than 8 percent of the market.

41. Because cable systems do not compete head-to-head, the concern about horizontal concentration stems primarily from monopsony power in programming and the pricing strategies applied by cable operators.[46] As cable systems become larger, they can inflate their programming prices and refuse to carry programming that would compete with their higher priced channels. If they are not given exclusive or favorable distribution terms, they can refuse to carry programming.[47] Without comparable viewing packages available to the public, competitive market forces are not strong enough to pressure hard bargaining between independent cable operators or to threaten integrated programmer/operators with loss of market share sufficient to drive prices down.

C. CONDUCT

42. Vertically integrated cable companies seek to reinforce their market power in programming and the monopoly at the point of distribution, enhancing their ability to increase producer surplus. In the cable industry, vertical integration has been combined with horizontal concentration and a vigorous campaign of anticompetitive

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[45] In spite of assurances about reducing TCI's direct interests in Time Warner/Turner, we now find John Malone's banker on the Time Warner Board (J. Carter Barcot, "The Media Conglomerate's Power Players," USA Today, May 12, 1997. We also have an extensive swap of systems and other joint ventures (see "Cable Venture Formed by 2 Industry Giants," New York Times, Septermber 4, 1997).

[46] Although recent antitrust implementation has generally not challenged vertical integration, concern about vertical integration is deeply rooted in the antitrust law. There is a growing body of theoretical and empirical analysis which has reinvigorated the concerns about the anti-competitive impacts of vertical integration, especially in the cable industry. On the cable industry see Ordover and Braunstein, op. cit. or more general arguments see Krattenmaker, T.G. and S. C. Salop, "Anti-competitive Exclusion: Raising Rivals' Costs to Achieve Power Over Prices," The Yale Law Journal, 92:2 (1986); Ordover, J., A. O. Sykes and R.D. Willig, "Non-price Anti-Competitive Behavior by Dominant Firms Toward the Producers of Complementary Products," in F. M. Fisher (Ed.), Antitrust and Regulation (Cambridge: MIT Press, 1985).

[47] On the cable industry see Ordover and Braunstein, op. cit.; Ordover and Braunstein, op. cit. For more general arguments see Thomas G. Krattenmaker and Steven C. Salop, "Anticompetitive Exclusion: Raising Rivals' Cost to Achieve Power Over Prices," The Yale Law Journal, 92:2 (1986); J. A. Ordover, A. O. Sykes, and R. D. Willig, "Nonprice Anticompetitive Behavior by Dominant Firms Toward the Producers of Complementary Products," in Franklin M. Fisher (Ed.), Antitrust and Regulation (Cambridge: MIT Press, 1985).

actions to ensure market power at the point-of-sale.

43. The two dominant firms are also thoroughly interconnected through a series of joint ventures. With independent sources of market power, they can avoid competing head-to-head in the marketplace by maintaining exclusive franchises and controlling access to the majority of the audience. They can drag their feet on mandated access to programming and find loopholes to avoid providing access. They can also increase prices for programming, creating a profit center in programming, while squeezing their system operations. Non-integrated operators are also squeezed and forced to pass excessive programming costs through to consumers. Because all operators have a virtual monopoly at the point of sale, they can make the price increase stick, but the profits end up in the programming arm of the dominant firms. Joint ventures become a mechanism for enhancing market power and creating larger barriers to entry for potential competitors.

44. As the number of actively competing programmers declines, the possibility of cartel pricing is dramatically enhanced. With vertical integration, the task of entry becomes even more formidable. One must simultaneously enter the programming and cable operation segments as the joint ventures of vertically integrated firms proliferate.

45. Concentration, interconnection and vertical integration enhance market power through their potential as a trigger, or by creating the conditions for impeding the ability of competitors to have access to vital inputs. Two strategies to accomplish this are holding a bottleneck and real foreclosure.

46. Clearly, the franchise nature of cable systems has an element of bottleneck in it. Given the franchise monopoly and market power over distribution, control over programming becomes a critical problem. Raising the price of this crucial input or otherwise manipulating the terms and conditions of its sale to disadvantage competitors becomes profitable when there are subscribers subject to market power.

47. Many cable operators, in concert with their programmer-owners, have engaged in vigorous anticompetitive actions to prevent head-to-head competition (which is described pejoratively in the industry as "overbuilding").[48] Legal resistance to overbuilding is pervasive. Potential competitors have been thwarted by cable

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[48] The concern about overbuilding among MSOs and some of the efforts to prevent it are mentioned in Competitive Issues in the Cable Television Industry, at 152-157. The Third Annual Report reflects the continuing opposition to overbuilding.

operator-programmers denying them access to consumers and programming by overcharging for or restricting the use of programming that is made available.

48. A similar pattern typifies the response to close substitutes. Competition from close substitutes could be provided by proven technologies such as wireless, or satellite dishes. These have been resisted by a variety of tactics including refusals to deal, exclusivity arrangements and manipulation of terms and conditions.

49. Efforts to impose or obtain exclusive arrangements have become ever present controversies in the industry including efforts to prevent competing technologies from obtaining programming, as well as to prevent competition from developing within the cable industry.[49] Price discrimination against competitors and other strategies, such as placing programming of competitors at a disadvantageous position on the dial have also been evident in recent years.[50]

50. Allegations of anti-competitive cable practices are not limited to industry critics. The practices within the industry became so bad that even major players became involved in formal protests. Viacom and its affiliates, a group not interconnected significantly with the top two cabals in the industry, filed an antitrust lawsuit against the largest chain of affiliated competitors in its New York territory -- Time, HBO, ATC, and Manhattan cable. Ultimately, it sold its distribution business to its competitors.

51. The landscape of the cable industry is littered with examples of these anti-competitive behaviors. These include, for example

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[49] HBO, a subsidiary of Time, played a key role in the effort to prevent TVRO operators from obtaining programming (see Chan-Olmsted, op. cit., at 11), and the effort to sell overbuild insurance (Competitive Issues in the Cable Television on Industry, Subcommittee on Antitrust, Monopolies and Business Rights, Committee on the Judiciary, United States Congress, March 17, 1988, at 127, 152-174. The current efforts to impose exclusive arrangements have raised numerous complaints from potential competitors (see for example "Statement of William Reddersen on Behalf of Bell South Enterprises (hereafter, Bell South)," and "Testimony of Deborah L. Lenart on Behalf of Ameritech (hereafter, Ameritech)," Subcommittee on Telecommunications, Trade and Consumer Protection, Committee on Commerce, U.S. House of Representatives, July 29, 1997.

[50] Competitive Issues in the Cable Television Industry, Subcommittee on Antitrust, Monopolies and Business Rights, Committee on the Judiciary, United States Congress, March 17, 1988. More recently, for example, The Time Warner, Turner merger as originally proposed included preferential treatment for TCI (see "Separate Statement of Chairman Pitofsky and Commissioners Steiger and Varney," In the Matter of Time Warner, File No. 961-0004. Efforts to exclude non-affiliated program have also been in evidence, as Viacom's most popular programming (MTV) has been bumped.

- exclusive deals with independents that freeze out overbuilders,[51]

- refusals to deal for programming due to potential loopholes in the law requiring non-discriminatory access to programming,[52]

- tying arrangements,[53] and

- denial of access to facilities.[54]

III. SYSTEM PERFORMANCE BEFORE AND AFTER DEREGULATION

52. Unfortunately, as described above, when cable systems were deregulated in 1984 competition did not develop.[55] The implementation of the 1992 addressed the pricing problem for a time, but not the underlying structural problems. The result has been significant shortcomings in market performance including excessive price increases under deregulation and the misallocation of resources. Rather than stimulated innovation and declining prices, rates began to rise excessively and resources were inefficiently allocated after deregulation. The benefits of increasing size and quality -- cable's historical developmental pattern -- were still evident, however they were accompanied by monopoly rents.

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[51] Bell South (p. 4)cites examples of suspected exclusive arrangements involving Eye on People, MSNBC, Viacom, and Fox, as does Ameritech (p. 7).

[52] The potential loophole will be terrestrial transmission to regional clusters, thereby avoiding the requirement to provide non-discriminatory access to satellite delivered programming. Bell South gives examples of Comcast in Philadelphia and Time Warner in Orlando (p. 5). Ameritech cites Cablevision in New York (p. 8). A similar process seems to be developing in Detroit.

[53] Bell South gives examples including NBC/CNBC, Scrips Howard/Home and Garden (p. 5).

[54] "Testimony of Michael J. Mahoney on Behalf of C-TEC Corporation Subcommittee on Telecommunications, Trade and Consumer Protection, Committee on Commerce, U.S. House of Representatives, July 29, 1997.

[55] Glenn B. Manishin, "Antitrust and Regulation in Cable Television: Federal Policy At War With Itself," Cardozo Arts & Entertainment Law Journal, 6:1 (1987).

A. THE ABUSIVE POST-DEREGULATION MARKETPLACE

1. PRICE

53. As previously noted, Between early 1986 and early 1993, when price was not regulated prices at an annual average rate of just over 8.3 percent per year. As Table 1 above shows, in real terms prices were increasing by about 4.3 percent per year.

54. In the two years (1993-1995) when the FCC began cracking down on abusive pricing, rates declined by about 2.8 percent per year and about 5.2 percent in real terms.

55. In the year and a half after the Going Forward Rules were adopted up until the passage of the 1996 Act, prices increased by about 4.5 percent per year, or about 1.3 percent in real terms. The passage of the 1996 Act seems to have opened the door to much larger price increases. Since the Act, prices have been increasing by about 8.2 percent per year, or about 5.6 percent per year in real terms.

56. Prices are now higher than the Federal Communications Commission expected when it published the Going Forward Rules (see Figure 2).

57. This abusive pricing is not limited to aggregate levels. As market power has grown, the cable companies have also engaged in greater price discrimination and repackaged services to camouflage rate increases. Prior to deregulation, prices for basic services and expanded or premium services moved together. After the 1984 Act basic rates have skyrocketed, while prices for premium services have not (see Figure 4).
Instead of charging for the extended and premium services, retiering forced consumers to pay for access to these services in their basic rates. Operators bundled services to justify excessive rate increases.

58. It is clear that pricing/packaging in this way is intended to transform consumer surplus into producer surplus. Although consumers would be less willing to pay for certain elements of the larger cable programming package, they swallow the whole thing since their access to those elements they really want is tied those they do not want.[56]

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[56] There is a formal theory of the extraction of consumer surplus that can be found in the economic and marketing literatures. The following is a recent statement of the approach from the Joseph P. Guiltinan, "The Price Bundling of Services: A Normative Framework," Journal of Marketing,

B. MONOPOLY RENTS

59. Abusive pricing behavior is one direct measure of a failure of market performance. Excessive profitability is another such measure. Our analysis of both cable industry behavior and market prices for cable systems (the ratio of sales price to what it would cost to build a system from scratch) has shown the clear existence of monopoly rents.[57]

60. Table 4 shows estimates of the transactions price for cable systems compared to estimates of reproduction costs. There is no doubt that there was a tremendous increase in q ratios after deregulation.

61. These numbers show that at the time of deregulation systems were being sold at about 1.5 time what it would cost to build them from scratch. This ratio rose steadily until 1990, when systems were selling at over three times their reproduction cost. Uncertainties surrounding legislation in the early 1990s appear to have restrained prices for a time. However, once regulation took effect, prices started rebounding and again appear to be between two and three times reproduction costs.

62. This means that if entrepreneurs could simply enter the market and put up competing systems, they could do so at a much lower cost. Needless to say, if competitors could actually enter the market, there is no way that incumbent firms could command such a premium price for their systems. In the cable industry, entry is extremely difficult. Incumbents hold a franchise and they resist over-building with a vengeance. Moreover, even if a potential entrant exists, the integrated nature of the

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51: April (1987), at 75,

> Consider, for example, a case in which we have two products or services and can estimate the distributions of reservation prices (the maximum amounts buyers are willing to pay) for each product. by bundling the products together, we essentially create a new product. If the two products are independent in demand, some customers who would only by one of these if they were priced individually will now by both products. The reason is that the value these customers place on one product is so much higher than its price that the combined value of the two products exceeds the bundled price. In economic terminology, the consumer surplus (the amount by which the individual's reservation price exceeds the actual price paid) from the highly valued product is transferred to the less valued product.

[57] Direct estimates of price cost margins are virtually non-existent. Robert Rubinovitz (Market Power and Price Increases for Basic Cable Service Since Deregulation, (Economic Analysis Regulatory Group, Department of Justice, August 6, 1991), finds that about half of the price increases since 1984 are due to the exercise of market power.

industry denies that entrant access to programming, which is necessary to compete. The best and most direct interpretation of Tobin's q in this case is that it represents a massive monopoly premium, earned by cable operators who possess market power.

B. CONCLUSION

63. The analysis of the structure, conduct and performance of the cable industry leads me to conclude that market forces are weak, at best, in the industry and becoming weaker. As a result, consumers are being abused by the exploitation of market power. This problem has become critical in the period since the passage of the Telecommunications Act of 1996.

64. Thus, in the past year we observe a sharp and dangerous shift in industry behavior which has resulted in sharply increased market power, anticompetitive actions and unprecedented price increases. These developments make it incumbent upon the FCC to take action to reverse these trends.

65. Therefore, the Commission should act immediately to restrain these abuses, utilizing its remaining power to regulate prices to reverse the recent dramatic price increases imposed on the public. Simultaneously, it should exercise its continuing regulatory authority to attack the underlying problem of market power and economic concentration in the industry.

TABLES

TABLE 1
CABLE PRICE INCREASES UNDER VARIOUS PRICING POLICIES (AVERAGE ANNUAL INCREASE)

	NOMINAL	REAL
1984 ACT DEREGULATION January 1986 - April 1993	8.3	4.3
1992 ACT REGULATION April 1993 - September 1994	-2.8	-5.2
GOING FORWARD RULE October 1994 - July 1997	6.3	3.6
PRE- 1996 ACT October 1994 - February 1996	4.5	1.3
POST-1996 ACT February 1996 - July 1997	8.2	5.6

TABLE 2
TRENDS IN CABLE CONCENTRATION

NATIONAL LEVEL CONCENTRATION RATIOS

YEAR	FOUR FIRMS CONCENTRATION RATIOS		
	UNADJUSTED	ADJUSTED FOR JOINT OWNERSHIP	
1969	16.3		
1971	21.7		
1973	27.2		
1975	26.4		
1977	23.1		
1979	24.0		
1981	27.3		
1983	28.1		339
1984	29.0		357
1985	29.4		369
1986	27.0		352
1987	28.1		662
1987		43.1	784
1990		45.6	866
1991		46.0	872
1992		48.2	928
1993		47.2	880
1994		47.2	898
1995		54.6	1098
1996		61.4	1326

SOURCES: 1969-1981 - (1) Sylvia M. Chan-Olmsted and Barry R. Litman, "Antitrust and Horizontal Mergers in the Cable Industry," Journal of Media Economics, Fall, 1988, at 8, 9, 19; 1983- 1987 National Telecommunications and Information Administration, Video Program Distribution and Cable Television: Current Policy Issues and Recommendations, June 1988, Attachment 2, Table 1; 1990-1996 - Third Annual Report, Appendix F, Table 2.

TABLE 3
THE COST OF DIRECT BROADCAST SATELLITE FOR SERVICE EQUIVALENT TO CABLE

	DBS AVERAGE	
EXPANDED BASIC	$25.99	
EQUIPMENT	13.83	
SECOND SET FEE	6.31	
EQUIVALENT PREMIUM CHARGE	2.65	
SUBTOTAL		48.78
COST OF LOCAL (BASIC CABLE)	11.97	
TOTAL COST	60.75	

Source: TCI handout.

TABLE 4

MARKET SHARES OF DOMINANT FIRMS TAKING AFFILIATIONS INTO ACCOUNT

DOMINANT FIRM	DIRECT		PRORATA		ALL AFFILIATES	
	#	%	#	%	#	%
TCI	16014	26	17746	28	19828	32
CABLEVISION			2445		2445	
			20191	32	22273	36
TIME WARNER					11843	19
TOTAL CABAL					34116	55

Paul Kagan, "Top Cable System Operators: As of December 31, 1996," The Operating Market

TABLE 5
ESTIMATES OF SALES PRICE AND REPRODUCTION COST FOR CABLE SYSTEMS BEFORE AND AFTER DEREGULATION

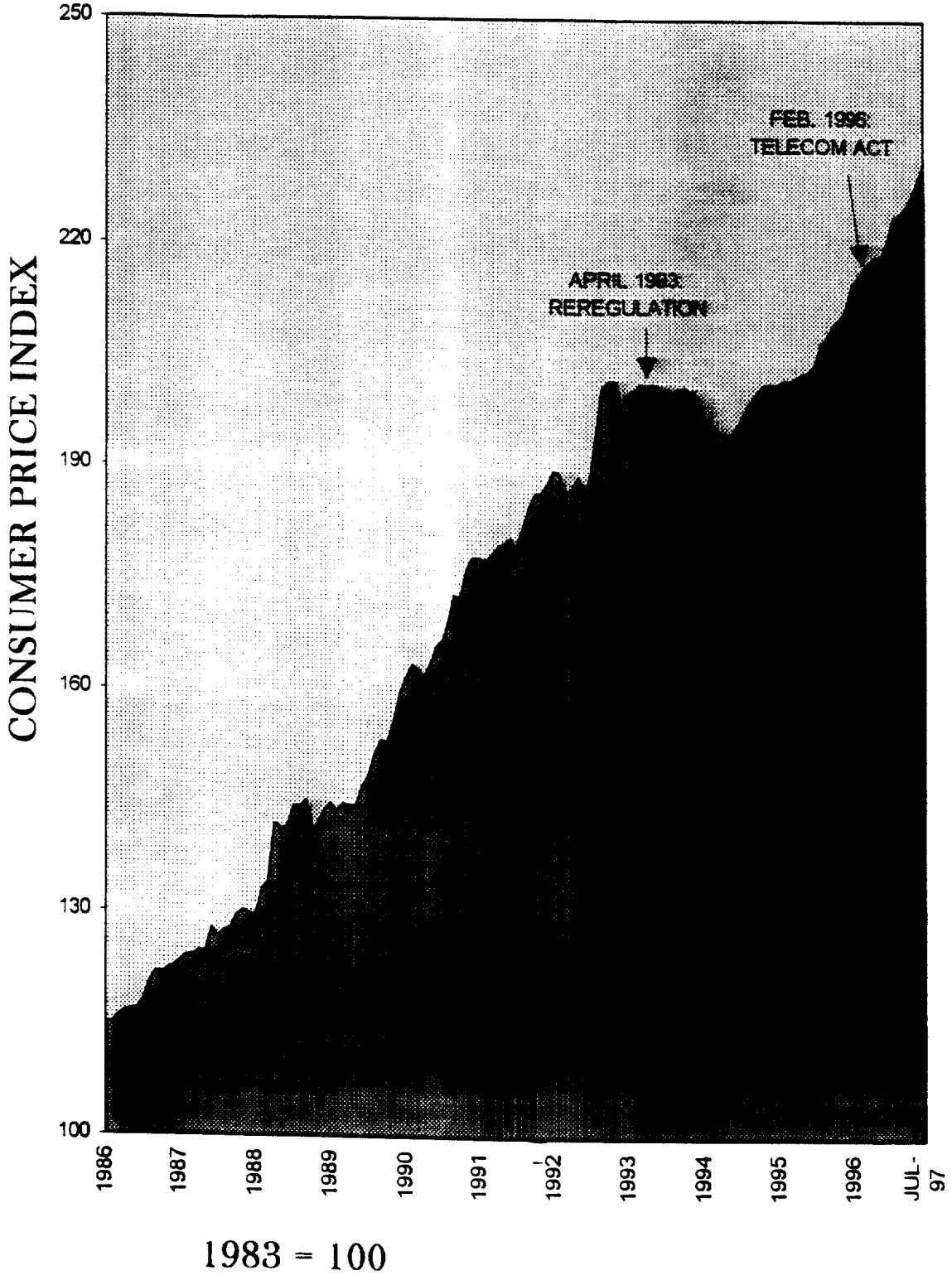
YEAR	AVERAGE PRICE a/	REPRODUCTION
1977	391	
1978	355	
1979	426	
1980	657	
1981	793	
1982	922	
1983	1026	645 b/
1984	948	
1985	1008	
1986	1341	400 to 723 c/
1987	1723	
1988	1998	603 d/
1989	2293	490 e/
1990	2031	
1991	1753	
1992	1766	706 f/
1993	2165	
1994	1869	828 g/
1995	1836	
1996	2078	

a) Kagan Associates Inc., Cable TV Master Database, various issues.
b) H. L. Vogel, Entertainment Industry Economics (Cambridge University Press, Cambridge, 1986).
c) Shooshan and Jackson, Opening the Broadband Gateway: The Need for Telephone Company Entry Into the Video Services marketplace, October 1987.
d) Shooshan and Jackson, Measuring Cable Industry Market Power, March 2, 1990.
e) Leland L. Johnson and David P. Reed, Residential Broadband Services By Telephone Companies? (Santa Monica, Rand, 1990).
f)David P. Reed, Residential Fibre Optic Networks (Artech House, Boston, 1992), Tables 5.3 and B.8).
G) Bell Atlantic, In the Matter of the Application of : The Chesapeake and Potomac Telephone Company of Maryland and Virginia for Authority Pursuant to Section 214 of the Communications Act of 1934, as amended, to Construct, Operate, Own and Maintain Facilities and Equipment to Provide a Commercial Video Dialtone Service within a Geographic Territory Defined by the Maryland and Virginia Portions of the Washington Local Access Transport Area, December 1994 Exhibit 3.
I) U.S. West, In the Matter of the Application of U.S. West, Inc., for Authority Pursuant to Section 214 of the Communications Act of 1934, as amended, to Construct, Operate, Own and Maintain Facilities and Equipment to Provide a Commercial Video Dialtone Service in Portions of Colorado Springs.

FIGURES

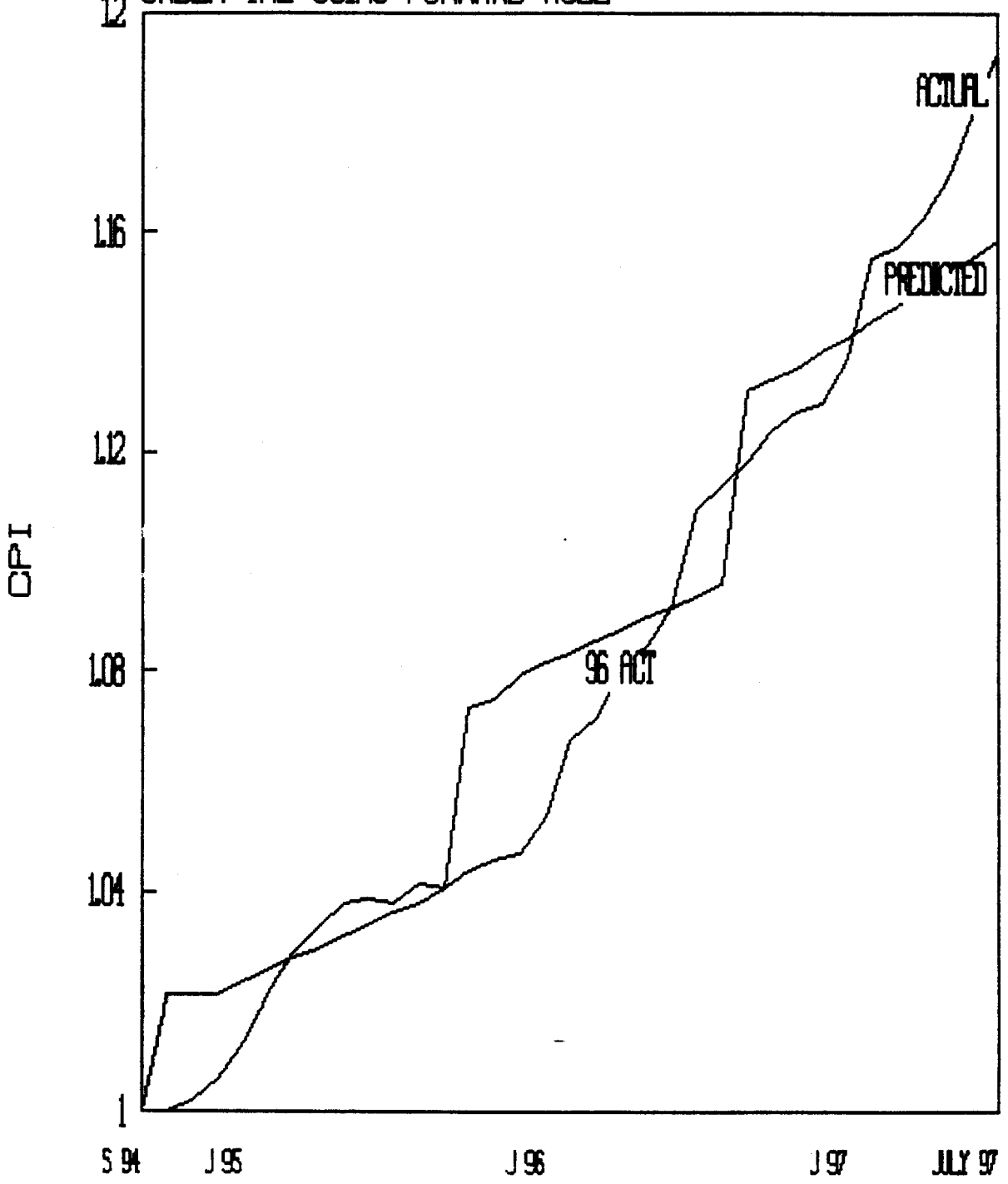
FIGURE 1

CABLE RATES SINCE DEREGULATION IN THE 1980s



Source: Bureau of Labor Statistics

FIGURE 2
PREDICTED AND ACTUAL RATES
UNDER THE GOING FORWARD RULE



SEPTEMBER 1994 = 100