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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of	)	
Telecommunications Service Inside Wiring	)	CS Docket No. 95-184
Customer Premises Equipment	)	
In the Matter of	)	
Implementation of the Cable Television Consumer Protection and Competition Act of 1992:	)	MM Docket No. 92-260
Cable Home Wiring	)	

To: The Commission

REPLY COMMENTS OF INDEPENDENT CABLE &
<u>TELECOMMUNICATIONS ASSOCIATION</u>

INDEPENDENT CABLE &
TELECOMMUNICATIONS ASSOCIATION

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Dated: March 2, 1998

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REPLY COMMENTS OF INDEPENDENT CABLE & TELECOMMUNICATIONS ASSOCIATION

The Independent Cable & Telecommunications Association ("ICTA") hereby submits these reply comments in connection with the Second Further Notice of Proposed Rulemaking (the "Second Further Notice") in the above-encaptioned proceeding.[1]

[1] DirectTV, while a member of ICTA, does not join in these comments, but rather submits its own response to the Second Further Notice.

DISCUSSION

I. The Record Establishes That Exclusive Contracts Promote Competition By New Entrants Except Where Such Contracts Are Perpetual In Nature

In its initial comments in this Second Further Notice, ICTA extensively briefed why the ability of new entrants to execute exclusive contracts with MDU owners is a critical ingredient to insuring competition in the video programming marketplace, the primary reason being to attract and justify the capital investment associated with MDU service. The vast majority of other commenters agreed that the use of exclusive contracts has proven beneficial, and especially emphasized that the MDU arena is a highly competitive one. See, e.g., Comments of U S West at 3 (opposing "artificial imposition of term caps on privately-negotiated contracts for video programming service" since MDU marketplace "already highly competitive"); Comments of Time Warner Cable at 2-3 (since provision of service to MDUs "is a highly competitive area" FCC " should continue to refrain from interfering with contracts that have heretofore been negotiated entirely by the parties involved); Comments of Tele-Communications, Inc. at 21-26 (exclusivity beneficial to MDU residents in terms of better price and service offerings); Comments of Community Associations Institute at 2-4 (exclusive contracting often brings service and rate benefits to residents); Comments of GTE Service Corporation at 13-15 (ability for new entrants to contract exclusively is "necessary to jump start competition between MVPDs"). Given the FCC's overriding objective to spark and extend competition in the provision of video services nationwide, it would appear that the MDU market is one market that should not be subjected to any further regulatory controls except where clear evidence exists of anticompetitive activity -- such as in the case of contracting in perpetuity.

The expert report of Dr. Michael D. Whinston wholly supports ICTA's conclusions in this regard. See Attachment A hereto ("Report"). Professor Whinston was retained by ICTA to analyze the competitive effects of exclusive contracts between multichannel video programming distributors ("MVPDs") and MDU owners, particularly private cable operators ("PCOs"). Professor Whinston opines "that there is little risk of competitive harm arising from the use of exclusive contracts by PCOs." Report at ¶ 7. To the contrary, his report advances a sound rationale for why exclusive dealing contracts "serve important pro-competitive functions by making exchange relationships work more efficiently." Id. at ¶ 25. At For example, the paramount ability to protect via an exclusive contract against a "socially inefficient" overbuild, i.e., one in which the PCO as an initial investor necessarily faces unrecoverable economic loss, achieves a pro-competitive result since without that ability, PCOs would not be able to invest in the MDU in the first place. Id. at ¶¶ 27-31. This is in part due to the uncertainty of the future investments which a PCO will undoubtedly incur, be it for technology upgrades, additional competitive programming services or other "non-contractible investments." Id. at ¶ 25-26. Even the level of current investment undertaken at the time of initial MDU entry is greatly affected by the ability to obtain exclusivity, since the certainty of recovery for that investment allows for supracompetitive offerings redounding to the benefit of MDU residents. When these items are considered beyond the boundaries of a single MDU, it is clear that PCO overall market entry and growth has been and will continue to be directly linked to PCO's ability to engage in exclusive contracting.

This is perhaps most dramatically evidenced, as Professor Whinston points out, by the lack of competition to incumbent franchised cable operators in mandatory access states.

Id. at ¶ 34. Mandatory access statutes prevent MDU owners and PCOs from engaging in exclusive contracts because the incumbent franchisee has a right to force entry into the MDU to provide service to residents.[2] ICTA has documented that competition is more than twice as vigorous in non-mandatory access states, and more often than not, the competition that does exist in some mandatory access states existed prior to the passage of the forced access legislation and thus the capital investment was made at a time when overbuilding was unexpected.

Equally important is Professor Whinston's analysis concerning the existence of certain factors in the MDU context militating against any conclusion that exclusive contracting by new entrants poses anticompetitive concerns. The two guiding principles leading to findings of anticompetitive effects, i.e., third party buyers or sellers negatively impacted by the exclusive contract who are not part of the negotiations prior to the contract's execution, are simply not present in the competitive milieu of MDU access battles occurring in markets where competitive alternatives exist.[3] Id. At ¶¶ 11-16. It has been well documented by all parties to this proceeding

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[2] Of course, as set forth in ICTA's initial comments at 11, these mandatory access statutes do not prevent the incumbent franchised operator from engaging in exclusive contracting since alternative MVPDs do not fall within the scope of such statutes and thus cannot force an overbuild of the incumbent franchisee. While some commenters in this proceeding assert, without discussion, that mandatory access statutes allow MVPDs other than incumbent franchisees also to force access, such is not the case. See ICTA ex parte notice of Feb. 24, 1997. Thus, ICTA continues to urge this Commission at a minimum to prohibit franchised operators from obtaining exclusive contracts in mandatory access states and at a maximum to preempt discriminatory mandatory access statutes.

[3] Again, this cannot be true in mandatory access states because no negotiations actually take place -- the incumbent franchised operator has the right to force access irrespective of whether its offerings are the "best." The MDU owner's leverage to bargain amongst providers, thereby increasing programming choice, ensuring customer service protections and decreasing subscriber rates, is totally defeated. Thus, as ICTA has oft advocated, mandatory access statutes are anti-competitive, protectionist laws passed at the behest of the franchised cable industry under the guise of increasing tenant "choice." The end result is no choice, since non-franchised

that where competitive alternatives exist, MDU owners actively and aggressively solicit service proposals from numerous vendors, weighing each proposal against the others in negotiations and ultimately obtaining supracompetitive offerings in part through an exchange of exclusivity. As Professor Whinston observes, "when all affected parties are involved in the negotiations over the contract, the exclusive contract will be signed precisely when it is efficient," and thus marketplace "choice" is advanced rather than eliminated. Id. at ¶ 15.[4]

Such is typically not the case, however, with exclusive contracts lasting for the term of the franchise and all renewals and extensions, i.e., de facto perpetual contracts. In the vast majority of jurisdictions where the use of such perpetual contracts is widespread, MDU owners had no choice but to enter into contracts with a term linked to the continuation of the franchise because no competitive alternatives existed at the time.[5] When faced with a "take it or

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competitors cannot make the case for economic viability to their investors under circumstances where their market share can be eroded by the incumbent franchisee who in turn can completely insulate its market share from erosion given its sole continuing ability in such states to enter into exclusive contracts. Report at ¶ 22.

[4] This presumes, as found likely by Professor Whinston, that negative externalities across buyers would not arise because the "extremely low level" of economies-of-scale enjoyed by PCOs renders it "highly unlikely that any PCO could profitably seek to use exclusive dealing contracts for anti-competitive ends" under market conditions where "all sellers are actively competing for contracts."

[5] It is totally contrary to all evidence gathered by Congress during the passage of the 1992 and 1996 Cable Acts, as well as evidence gathered by this Commission, for Time Warner Cable to claim that competitive alternatives to cable franchisees has existed nationwide in the MDU market "for twenty years" and that "vigorous competition" has therefore been present. While small pockets of SMATV and MMDS competition have realistically been present for perhaps ten years, many markets have been entered only during the last five years and a great many more markets still remain to be entered. Thus, Time Warner Cable's stated rationale for when the FCC has employed fresh look policies in the past is directly applicable here, i.e., "to make way for new entrants where no competitive alternatives previously existed" and "where the contracts in

leave it" contract by a monopolist, MDU owners "take it" in light of the uneconomic alternative of drastically reduced tenant occupancy rates in buildings without video programming services. Here, unlike the market conditions surrounding exclusive contracting by new entrants who at a minimum face negotiating competition from the incumbent cable franchisee, exclusive perpetual contracts appear classically anti-competitive according to Professor Whinston's model because of the existence of third parties, such as PCOs, "negatively impacted by such contracts who were not part of the negotiations over it" and because MDU owners might "not have foreseen any possibility of future competition in the video programming distribution" market and thus would have extracted very little in exchange for that exclusive perpetual arrangement. Report at ¶ 24. While this is similarly true even for non-perpetual exclusive contracts entered into by incumbent franchisees prior to the time period in which MDU owners had competitive alternatives available, at least exclusive contracts containing a term of years guarantee that at some definite point in the future the MDU contract will again be subject to competitive bidding. By contrast, perpetual exclusive contracts "lock-up" the buyer beyond the point of social efficiency. It is telling that not one franchised cable commenter presented any economic evidence or other business justification for why contracts lasting in perpetuity are pro-competitive.[6]

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question had been rendered unreasonable due to a change in a regulatory policy which had previously protected monopolies." Comments of Time Warner Cable at 9.

[6] Arguments tended to center on why such contracts are not perpetual at all or are very few in number. With respect to the former, this Commission is well aware of the incredible rarity of any revocation or other non-renewal of a cable franchise. While Time Warner Cable attempts to pretend that the actual expiration date of a franchise is actually something other than theoretical, marketplace experience proves the wiser. See Comments of Time Warner Cable at 5. It simply cannot be gainsaid that MDU owners with a contract linked to the term of the franchise and any and all renewals or extensions, especially given that those same contracts allow for assignment

This is why ICTA and other commenters have advocated the adoption of a "fresh look" period during which property owners are empowered, on a voluntary basis, to renegotiate perpetual contracts with full consideration of today's service alternatives and from a position of much more equal bargaining power, subject only to the limitation that the new contract must provide for termination on a date certain.[7] See, e.g., Comments of Community Associations Institute at 5-6; Comments of Wireless Cable Association International, Inc. at 11-16. The presumption by franchised cable operators opposing a fresh look policy that such a policy results in the loss of that operator's service contract for that MDU is unfounded. See, e.g., Comments of U S West at 6. Nothing in ICTA's fresh look proposal prohibits an MDU owner from continuing with the perpetual contract, or from renegotiating a term of years contract with the cable franchisee as opposed to an alternative MVPD. What the fresh look proposal does accomplish, however, is the restoration of a competitive balance that heretofore monopoly franchising conditions prevented. It should also be remembered that the fresh look period is an

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and continuation, are stuck with the incumbent franchise holder ad infinitum. With respect to the latter, ICTA vehemently disagrees. Whole markets such as, but not limited to Lansing, Michigan; Phoenix, Arizona; jurisdictions in Baltimore County and Montgomery County, Maryland; San Diego, California; jurisdictions in Orange County, California; and Miami and other jurisdictions throughout Florida, are subject to such contracts and such contracts have routinely been used by such operators as Cox Cable, Time Warner, TCI, MediaOne and Adelphia Cable to name but a few. Contrary to the assertion in U S West's comments at 7, ICTA members have repeatedly alleged that "such agreements are keeping them out of the MDU video programming marketplace" where such agreements saturate a market.

[7] For the reasons set forth at 13-14 in ICTA's initial comments in the Second Further Notice, for a fully competitive market to evolve, a fresh look mechanism must apply to both exclusive and non-exclusive perpetual contracts given the market reality that new entrants will not overbuild an incumbent franchisee. For this same reason, the Commission should reject Time Warner Cable's arguments at pages 10-11 of its comments that any fresh look policy should only allow MDU owners to negate the exclusivity portion of a perpetual contract, not the actual provision of service on a perpetual basis.

extremely limited three year process commencing on the effective date of the FCC's adoption of rules in this regard and is only triggered on a building-by-building basis.

Finally, this Commission should reject the arguments of many incumbent cable franchisees that should the Commission decide to place restrictions on exclusive contracts, including those lasting in perpetuity, those restrictions should only pertain to future exclusive contracts. See, e.g., Comments of U S West at 6; Comments of Cox Communications, Inc. at 4-8; Comments of NCTA at 2-4. ICTA agrees with the basic proposition at page 8 of the Comments of RCN Telecom Services, Inc. that the "worst possible scenario for advancing competition would be one where cable operators are permitted to keep their long-term exclusive contracts while new [entrants] are denied the ability to enter into similar agreements."

The Commission should also reject the arguments of incumbent cable franchisees and other commenters that exclusive contracts should be limited to five years. See, e.g., Comments of Cox Communications, Inc. at 10; Comments of Bell Atlantic at 2-4; Comments of Cablevision Communications, Inc. et al. at 4. While these commenters baldly conclude that five years is a sufficient period of time to "recover investment," any reasoned examination of the market, especially for new entrants with low economies-of-scale, easily supports the opposite conclusion. ICTA extensively briefed in its initial comments at 4-11 why marketplace variables render such attempts to establish a "cap" totally arbitrary and, as Professor Whinston's Report clearly concludes at ¶ 8, balancing the low risk to competition posed by exclusive contracting by new entrants versus the pro-competitive benefits achieved in the market due to such exclusive contracting, the Commission should simply refrain from placing artificial constraints on the duration of exclusive contracting by new entrants. Accord, Comments of Building Owners and

Managers Association International et al. at 2-4. Moreover, as also set forth in ICTA's initial comments at 5, 8, there are many benefits extracted by a MDU owner on behalf of its residents in exchange for exclusivity that raise a PCO's investment far beyond just capital costs, e.g., specialized programming offerings, reduced rates, bulk agreements, customer service protections. Recovery of this investment must also thus be taken into account. Accord, Comments of Tele-Communications, Inc. at 27-28.

In sum, ICTA urges this Commission not to impose a "cap" on the length of exclusive MDU contracts by new entrants, or in the alternative, that any "cap" that is adopted should not be less than fifteen years. Since contracts lasting in perpetuity, be they exclusive or non-exclusive, pose an entirely different anti-competitive barrier to entry, ICTA urges the Commission to adopt a "fresh look" policy along the lines advocated by ICTA.

II. The Commission Should Exempt Small Operators As Currently Defined From Signal Leakage Reporting Requirements

ICTA reiterates its support for the Commission's proposal to exempt small broadband providers from the annual signal leakage reporting requirements set forth in Section 76.615(b)(7). Opponents to the Commission's proposal have simply not made the case that aeronautical safety will be compromised by such an exemption which would appear to be the sole rationale for not creating the exemption. After all, an exemption from the annual reporting requirement does not release such operators from their actual testing obligations or in any way reduce the Commission's enforcement power. In light of congressional directives to reduce regulatory burdens where feasible and non-injurious to public welfare, adoption of the exemption represents good policy-making.

III. The Vast Majority Of Commenters Oppose Forced Sharing Of Home Run Wiring

In its initial comments at 17, ICTA suggested that any sharing of home run wiring should remain a voluntary, marketplace decision by the parties involved given the technical and economic variables surrounding that use and the potential for Fifth Amendment takings challenges. Most other commenters similarly objected, focusing in large part on the lack of a technical solution allowing a simultaneous, non-interfering use of a single piece of coaxial cable by multiple providers. See, e.g., Comments of U S West at 8-9; Comments of Time Warner Cable at 20; Comments of NCTA at 8-12. In light of the extensive opposition and trepidation over the ability to technically, practically, economically and legally force a shared simultaneous use of home run wiring, the Commission should leave the existence and timing of such dual use up to the players in the marketplace.

CONCLUSION

For the reasons discussed above, ICTA believes that the Commission should adopt rules and regulations consistent with ICTA's comments herein.

Respectfully submitted,

INDEPENDENT CABLE &
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Dated: March 2, 1998

ATTACHMENT A

Report on the Competitive Effects of Exclusive Contracting for Video Programming Services in Multiple Dwelling Units

by

Michael D. Whinston

March 2, 1998

1. My name is Michael D. Whinston. I am currently a Professor of Economics at Harvard University, where I have taught since 1984, and a Visiting Professor of Economics at Northwestern University. I have recently accepted an endowed chair at Northwestern University as the King Professor of Business Institutions, effective September 1, 1998. I received my Ph.D. from the Massachusetts Institute of Technology in 1984, my M.B.A. from the Wharton School of the University of Pennsylvania in 1984, and my B.S. in Economics from the Wharton School of the University of Pennsylvania in 1980. Since receiving my Ph.D., I have taught courses in Industrial Organization (Ph.D. level and undergraduate) and Microeconomic Theory (Ph.D. level).

2. I have published extensively in academic journals on the topics of industrial organization and microeconomic theory. I have received a number of awards and professional recognitions, including an Alfred P. Sloan Foundation Research fellowship, election as a Fellow of the Econometric Society, a fellowship at the Center for Advanced Study in the Behavioral Sciences, and National Science Foundation research grants. I have also served as a Co-Editor of the *Rand Journal of Economics*, the leading professional journal in the field of industrial organization, and on the editorial boards of

other professional journals. Within the area of industrial organization, a number of my articles deal with the topic of exclusive dealing contracts.

3. I have been retained as a consultant and/or expert witness on matters of antitrust policy in numerous matters, including by the U.S. Department of Justice.

4. A copy of my curriculum vita is included as Appendix A to this report.

SUMMARY OF OPINIONS

5. I have been retained by the Independent Cable and Telecommunications Association (ICTA) and its members to analyze the competitive effects of exclusive contracts between multichannel video programming distributors (MVPDs), primarily private cable operators (PCOs), and multiple dwelling unit owners (MDU owners).

6. In the course of analyzing competition in the market for video programming in MDUs, I have examined documents and reports relevant to competition in this market, I have reviewed comments filed in this proceeding, and I have interviewed a number of PCOs and MDU owners.

7. My analysis leads me to believe that there is little risk of competitive harm arising from the use of exclusive contracts by PCOs. The very low levels of economies-of-scale present in the PCO distribution technology indicates that a PCO is highly unlikely to be able to use exclusive contracts to reduce competition in the MDU market and earn supra-normal profits. Moreover, exclusive contracting with PCOs serves an important pro-competitive role in this market, and in particular, may be essential for assuring the competitive participation of PCOs in this market.

8. Given the low risk of any anti-competitive effects arising from PCOs' use of such contracts, and the important pro-competitive role that they play in the market, the FCC

should be very cautious about imposing administrative limits on PCO's use of exclusive contracts, and about imposing administrative limitations on their duration, over the judgements of the marketplace. Particularly detrimental would be any limitations that jeopardize PCOs' abilities to recover their investments and thereby compete effectively in the marketplace.

ANALYSIS OF POTENTIAL ANTICOMPETITIVE CONCERNS

9. As a general matter, sophisticated parties contracting in a complex environment may find it optimal to write contracts that differ from the simple types of exchange contracts contemplated in the classical perfectly competitive model. For example, these contracts may include incentive provisions, they may give one or another party options of whether and how much to trade, and they may include exclusivity provisions.

10. Such contracts can serve a variety of purposes. Typically, they are adopted for pro-competitive, efficiency-enhancing purposes. Sometimes, however, they may be employed to achieve anti-competitive ends.

11. When two parties writing a contract choose to include a provision such as exclusivity, it may be presumed that such a contract is an efficient choice for the parties in the sense that it maximizes their joint payoff (i.e. their monetary and other benefits). Were this not the case, there would be an alteration of the contract that, when combined with an appropriate monetary transfer between the parties, increases both parties' individual payoffs. This observation leads to a first principle for evaluating the anticompetitive potential of an exclusive contract: to present a threat to the efficiency of market outcomes, the exclusive contract must generate some kind of external effect on third parties. In

general, these affected parties could be other buyers or sellers in the market, or even participants in related markets.

12. A second principle is that for an anticompetitive exclusive contract to be signed, the third parties who are impacted by the contract must not be present in the bargaining and negotiations over the contract in questions. The reason for this is that, if they were, these parties would have an ability and an incentive to make offers to mitigate the negative impacts they anticipate from the contract in question. Thus, if the contract in question is signed despite these efforts, we must conclude that it is efficient.[1]

13. As an example of these two principles, it is instructive to consider an economic model of a hypothetical situation in which two sellers compete for the business of one buyer. Suppose that the first seller would earn 2 absent an exclusive contract and 6 with an exclusive contract, that the second seller would earn 0 if the first seller has an exclusive and 1 if the first seller does not have an exclusive, and that the buyer would have benefits of 2 if the first seller has an exclusive contract and 3 if the first seller does not have an exclusive contract. What will be the outcome of negotiations in this case? Note that the second seller is willing to offer the buyer up to 1 to *not* sign an exclusive contract with the first seller. Thus, including this payment, the buyer sees a net benefit of 4 if he does not give the first seller an exclusive contract, and 2 if he does. Hence, the first seller will need to pay the buyer 2 to sign the exclusive contract. In the present case, he will find this worthwhile (since his extra benefit from an exclusive is 4) and an exclusive contract will be signed. Note, however, that this outcome is *efficient* here – an exclusive contract results in an aggregate payoff of 8 (6 for the first seller and 2 for the buyer), while the aggregate

payoff is only 6 without it (2 for the first seller, 1 for the second seller, and 3 for the buyer).

14. By way of contrast, suppose instead that the first seller receives a payoff of only 3 under an exclusive contract. In this case, an exclusive would not be efficient (total payoffs would be 5 with an exclusive and 6 without an exclusive). Note, however, that the first seller would also not find it worthwhile to pay the buyer to obtain the exclusive: he would need to pay the buyer 2 for the exclusive, but would gain only 1 from it.

15. Indeed, these observations reflect a very general point: when all affected parties are involved in the negotiations over the exclusive contract, *the exclusive contract will be signed precisely when it is efficient.*[2] Among other things, note that this tells us that the "lock-up" of the buyer for the period of the exclusive should not – in and of itself – be a cause of concern. This is in notable contrast to the view sometimes expressed by some observers that exclusive contracts are inefficient because they "eliminate choice." Rather, if competition at the contract formation phase works well (in the sense that all affected parties are involved in the bargaining process), then contracting outcomes will be efficient.

16. The lesson that follows from these two principles is that to identify cases in which exclusive contracts are signed with anti-competitive (i.e. inefficiency-causing) effects, we must identify third parties who are negatively impacted by the contract, and who are not part of the negotiations over it.

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[1] This is a version of the well-known Coase Theorem: if all interested parties are able to bargain together, efficiency is achieved.

[2] Indeed, this remains true when other contracting possibilities (such as an exclusive contract with seller 2) are allowed. For a general statement of this result, see B.D. Bernheim and M.D. Whinston, "Exclusive Dealing," JPE (106), February 1998, pp. 64-103, Sections II and III.

17. One set of parties who may at first appear not to be part of the negotiations are tenants. However, such an appearance would be deceptive. Because of the competitve nature of the market for real estate rentals, MDU owners are forced by the marketplace to act as *de facto* representatives, or proxies, for their tenants. To not do so would be to place their ability to rent their units at jeopardy. Or, put slightly differently, in a competitive marketplace, if an MDU owner is able to increase the value of being a tenant in its building by some amount (say, through arranging for better cable service), it can capture this through increased rental levels. Thus, MDU owners have every incentive to act as effective proxies for their tenants in negotiations.[3] Moreover, with their increasing level of sophistication, MDU owners have every ability to do so as well.

18. Given that tenants are effectively represented, the leading case in which problems could in principle arise occurs when significant scale economies are present in the efficient method of production and distribution in a market. In such a situation, a firm needs to be able to capture a significant share of business in the market to be a viable competitor. As a result, if one firm is able to sign enough buyers (here, MDUs) in the market to exclusive contracts, other firms will be unable to enter and compete for business. This creates precisely the sort of negative externalities described above, because when a buyer (MDU) signs an exclusive contract it reduces the likelihood of future competition in the market, and thereby has a negative effect on other buyers (MDUs).[4] Moreover, buyers are

[3] It is instructive to note in this regard that the contracts signed by cooperative associations for video programming services look very much like the contracts signed by MDU owners.

[4] See, for example, B.D. Bernheim and M.D. Whinston, "Exclusive Dealing," JPE (106), February 1998, pp. 64-103, Section IV; E. Rasmusen, J. M. Ramseyer, and J. S. Wiley, Jr., "Naked Exclusion," *American Economic Review* (81), December 1991, 1137-45; and I. Segal and M.D. Whinston, "Naked Exclusion and Buyer Coordination," Harvard Institute of Economic Research Discussion Paper No. 1780, September 1996.

typically not involved in each others' negotiations, and so have no means for mitigating these effects.

19. However, a notable fact about the provision of video services by PCOs is that the efficient scale of operation for these operators is very low relative to a typical market's size. PCOs offer service to an MDU primarily in one of two ways. The first possible method involves installing a dedicated headend for reception of satellite signals for that MDU; the signals are then distributed via wiring internal to the MDU from this headend to individual dwelling units. The second involves instead reception of a signal via microwave transmission from a headend facility located on another building. The number of buildings that can be served in this manner from a single headend is limited by the fact that microwave signals require line-of-sight transmission, by the fact that they are effective only up to a distance of approximately 3-8 miles, and by the fact that physical space and other limitations typically exist that significantly limit the number of microwave transmissions that can be made from a single headend facility. Indeed, my understanding is that it is very rare for a single headend to serve more than 5-10 buildings. The result of these facts is that, to a great degree, the costs incurred by a PCO in providing video services are incurred on an MDU-by-MDU basis. That is, economies of scale in signal reception and distribution are very minimal for PCOs.

20. This is not to say that signal reception and distribution are the only costs incurred by a PCO in serving a local market. A PCO must maintain both marketing and service staff in a local market. But even with these costs, PCOs typically see themselves operating at an efficient scale when they have approximately 10,000-20,000 passings in a local marketplace, or assuming a 60% penetration rate, roughly 6,000-12,000 subscribers.

In fact, in a survey that ICTA recently sent to some of its members, the respondents (who included a number of the largest PCOs) had an average of 10,060 passings and 5,412 subscribers in the cities in which they were active. This number is very small when compared to the number of potential subscribers in most major, or even medium-sized, cities. For example, in 1995 the franchised cable operators in Chicago served a total of 335,000 subscribers; in San Francisco this number was 174,450; in San Diego it was 678,474; in Memphis it was 157,209; and in Seattle it was 431,352.[5] Even if one focuses on just MDUs, the number of potential MDU subscribers in these cities is clearly very large compared to an efficient scale of 9,000-12,000 subscribers (For example, the FCC's *Fourth Annual Report* on the state of competition in markets for delivery of video programming notes that as of 1990, MDUs contained roughly 28% of the total housing units nationwide; the share of total housing units in even a medium-sized city would obviously be much higher).

21. Another notable feature of the current contracting environment for contracts with MDU's is its highly competitive nature. This fact was explicitly noted in the FCC's *Fourth Annual Report*. There, the Commission notes "the emergence of a distinct MDU market, which is more competitive than other MVPD markets." (p. 76) It goes on to comment that the "competitive strategies of a number of firms that are focusing on the MDU market illustrate what appears to be a developing competitive trend for this market." (p.77) Indeed, PCO's must compete not only against the established franchised cable operator in a market (who has all of the advantages of incumbency, including buyer

[5] See the 1996 issue of the *Cable Fact Book*. These numbers represent the number of subscribers within the city limits. The number of subscribers would be much larger if we instead looked at the overall metro areas.

awareness), but also against each other, and increasingly against services provided by local telephone operators (LECs) and direct broadcast satellite (DBS) providers (see the *Fourth Annual Report*, p. 77). The contracting environment is made all the more competitive by the increasing sophistication and size of the MDU owners who are seeking contracts for video services on their properties (see again, the *Fourth Annual Report*, p. 77). In fact, the survey information recently collected by ICTA indicates significant competitive interaction even among PCOs. The respondents to this survey were 6 PCOs, including three of the four largest PCOs. Across the 45 cities in which these PCOs currently are serving subscribers, on average 1.24 of the 6 were active. That is, in roughly one quarter of these cities, 2 of the 6 respondent PCOs were already serving customers. More significantly, however, these responding PCOs also reported which other PCOs were current competitors in each of these cities. On average, there were 2.87 PCOs currently competing in these cities. Since this survey was potentially far from fully inclusive, these numbers should be thought of as lower bounds on the true number of PCO competitors.

22. We have already noted that in the absence of any economies-of-scale, negative externalities across buyers would not arise, and with all sellers are actively competing for contracts there would be no ability to use exclusive contracts for anti-competitive ends. Even though there are *some* economies-of-scale in PCO delivery, their extremely low level makes it highly unlikely that any PCO could profitably seek to use exclusive dealing contracts for anti-competitive ends. It is simply not feasible for a PCO to effectively eliminate competition from other PCOs, and thereby gain the freedom to price non-competitively in the MDU segment of the video programming distribution market, without

signing up essentially all of the MDUs in a city. The likelihood that such a strategy would prove profitable seems very remote.[6]

23. It is worthwhile noting that using exclusive contracts for anti-competitive ends may be a more plausible strategy for a franchised cable operator. In particular, for a franchised cable operator, the most efficient source of competition in the future may not be entirely clear at this point. In the event that PCOs turn out to be the most efficient alternative provider, exclusive contracts will help reduce competition for the franchise cable operator only if essentially all MDUs are signed up to exclusives. However, in the event that delivery by methods akin to those currently used by franchised cable operators turn out to be the most efficient alternative means of service to the franchised cable operator (i.e. if delivery by a LEC is much more efficient than delivery by a PCO), then because such means of delivery are characterized by substantial economies-of-scale, exclusives may well turn out to be a means for insulating the cable franchise operator from competition. Here, a franchised cable operator may foresee the possibility of future states of the world in which having a significant number of exclusive contracts with MDUs would reduce the extent of competitive pressure it faced.

24. Moreover, franchised cable operators signed many MDUs to very long-term, and even perpetual, exclusive contracts well before any alternative providers were on the scene. At the time these contracts were signed, the owners of these MDUs may well not have foreseen *any* possibility of future competition in the video programming distribution,

[6] For a more explicit statement of this point, see I. Segal and M.D. Whinston, "Naked Exclusion and Buyer Coordination," Harvard Institute of Economic Research Discussion Paper No. 1780, September 1996.

and so it would have been particularly easy for the franchised cable operator to induce an MDU owner to accept an anti-competitive contract.

PROCOMPETITIVE ASPECTS OF EXCLUSIVE CONTRACTS

25. Exclusive dealing contracts can also serve important pro-competitive functions by making exchange relationships work more efficiently. One way in which this can happen is through the effect of an exclusivity provision on the investments undertaken by the parties to the contract. In particular, the economics literature has studied the ways in which exclusivity might affect investments that cannot be explicitly specified in the parties' contract (in the language of the economics literature, these are "non-contractible investments").[7] As I discuss below, such issues are potentially important ones in the context of the sale of video programming in MDUs, and in fact have some potentially important ramifications for the level of competition in these markets.

26. In the contracting problem facing PCOs and MDU owners, the initial investments of the PCO, their initial programming, and the prices to be initially charged are largely able to be contractually specified. What is much more difficult to specify contractually is the level of these items in the future. Future technologies are hard to imagine in the present, and therefore a contract cannot readily specify a PCO's or franchised cable operator's investment obligations in the future. Likewise, future programming is unkown, as are

[7] See, for example, B. Klein, "Vertical Integration as Organizational Ownership: The Fisher Body-General Motors Relationship Revisited," *Journal of Law, Economics, and Organization*, 1988 (reprinted in S. Masten, ed. *Case Studies in Contracting and Organization*, New York: Oxford University Press, 1996); S. Masten and E. Snyder, "United States v. United Shoe Machinery Corporation: On the Merits," *Journal of Law and Economics*, 1993 (reprinted in S. Masten, ed. *Case Studies in Contracting and Organization*, New York: Oxford University Press, 1996); H. Marvel, "Exclusive Dealing," *Journal of Law and Economics*, 1982, 1-25; and I. Segal and M.D. Whinston, "Exclusive Dealing and Protection of Investments," 1997, mimeo.

future programming tastes of consumers, and so it is difficult to specify what programming and price should be in the future. It is true that a recent trend in the contracts between MDU owners and PCOs has been toward the inclusion of some contractual provisions, such as technological most-favored-nation-type clauses, that offer the MDU owner some protection (such a clause might say that the PCO must keep the technology in the building up to "prevailing standards" or the PCO's "current standards elsewhere in the MDU's market area"). But such provisions are likely to offer far from complete protection, and the attempt to include them seems to indicate, more than anything else, the importance of the issue.

27. A significant concern regarding future investments within an MDU involves the incentives for an MDU owner to allow, or even encourage, an inefficient over-build (or upgrade investment) by a second cable provider once a PCO has made an initial investment in a building. In the case of a new MDU where a PCO is the first provider to wire the MDU, this could involve bringing the local franchised cable operator into the MDU. Where the local cable franchise operator is already in the building, the issue may be the incentive for the franchise holder (possibly encouraged by the MDU owner) to upgrade its facilities.

28. Without an exclusive contract, there is nothing to prevent such over-building. However, such overbuilding may very well be inefficient. Moreover, the prospect of such overbuilding may make the PCO unwilling to invest in the MDU in the first place.

29. To illustrate these points, consider the following simple example. Suppose that there is a new MDU and that a PCO must invest 220 to serve this MDU. The local franchise operator on the other hand, needs to invest 50 to serve the building (its costs