

head-to-head DBS price competition is DBS's own finance calculation, not some structural or regulatory limitation.

### C. Telephone Company Provision Of Video Programming.

As Congress recognized when it enacted the Telecommunications Act of 1996, telephone companies have unique abilities and incentives to enter the video marketplace, and the incentives are only increasing. As one analyst has observed,

video could turn out to be a cash-generating service that can at least help justify the cost of making meaningful infrastructure upgrades. It may be tough for telcos ever to justify upgrade costs simply to deliver better POTS, especially since competition is likely to drive down what telcos can charge for that service. But add in some potential big-ticket services like video and high-speed data, and those cost-justification models start looking a little friendlier.<sup>26</sup>

Also, telephone companies appear to recognize that so long as they continue to provide local exchange service to almost 100% of residential households, they have a distinct advantage in marketing additional residential communications services. Thus, a spokesman for Bell Atlantic Video Services recently acknowledged that

[c]learly one of the ways we can market is when people move. They have to disconnect their phone. They call, they're reconnecting, you can make a guess that they're probably reconnecting their cable so you might offer them the phone service (and) did you know we have a video offering.<sup>27</sup>

Accordingly, the telephone companies are pursuing a range of alternative means of including video programming among the services that they offer in their local telephone service areas. And because the telcos have the means, incentive and staying power to market a video

<sup>26</sup> C. Weinschenk, "The Return of the TV Telcos," *Tele.com*, Oct. 1997, [www.teledotcom.com/1097/features/tdc1097telcos.html](http://www.teledotcom.com/1097/features/tdc1097telcos.html).

<sup>27</sup> *Cable World*, *supra*.

programming service throughout those immense, contiguous service areas, cable operators must – as Congress recognized in 1996 – respond to their competitive threat now by providing better value and service and not wait until the telcos acquire a sizable share of video customers in the market.

### 1. Infrastructure Upgrades and Wireline Provision of Video.

Ultimately, telephone companies may have no choice but to upgrade their plant to provide digital broadband services. As one observer has pointed out, “the shortcomings of telco twisted-pair copper networks aren’t just an impediment to delivering future services; they also are a liability when it comes to the core business of delivering plain old telephone service, demand for which is growing at a furious rate.”<sup>28</sup> What seemed to be the inevitable upgrading of telco facilities fueled expectations in Congress and elsewhere that telephone companies would soon be providing wire-based video programming services in competition with cable operators.

Whether inevitable or not, this wire-based competition has not developed quite as quickly as some may have hoped. Some telephone companies appear to have put off deploying their own broadband facilities – although, as discussed below, they have generally sought to market video programming through other means until they are able to upgrade their existing plant. Others, however, have begun deploying broadband facilities (though not always the integrated voice/video/data facilities that had been anticipated) and have begun providing multichannel video programming service – i.e., cable service – over those facilities.

Ameritech, for example, has chosen to deploy facilities for the provision of video programming separate from their telephone facilities. In other words, it has chosen to overbuild cable systems in their telephone service areas with their own hybrid fiber-coaxial (HFC) cable

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<sup>28</sup>

Weinschenk, *supra*.

systems, but it “says it has no plans to transfer its core telephony services to its HFC installations.”<sup>29</sup> Ameritech has acquired cable franchises in 75 Midwestern cities and towns containing more than one million households and a total population of more than two million. It is already providing cable service in 54 of those communities.<sup>30</sup>

Meanwhile, Southern New England Telephone Corp. (SNET) has begun upgrading its facilities and providing competitive cable service in the anticipated way. It has begun a 15-year project of replacing its copper plant with hybrid fiber-coaxial broadband facilities, which it ultimately intends to use for both video and telephony services. The company holds a unique statewide cable franchise, which is intended to simplify its regulatory dealings in entering the market.<sup>31</sup>

Bell Atlantic was one of the first telephone companies to announce plans to deploy switched digital broadband systems to provide video programming. It is continuing to deploy such systems in a number of communities in its large telephone service area, although its system in Dover Township, New Jersey – which was originally built as a “video dialtone” system before the statutory ban on cable-telco crossownership was eliminated – is still its only operational system.<sup>32</sup>

BellSouth is deploying HFC systems and acquiring cable franchises to provide video programming over these systems – but not generally in areas already served by cable systems.

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<sup>29</sup> *Id.*

<sup>30</sup> Presentation of Donna Garofano, Vice President, Public Affairs, Ameritech New Media, Inc., Strategic Research Institute 1998 Forum on Cable/Telco Franchising and Competition, June 25, 1998.

<sup>31</sup> See Weinschenk, supra.

<sup>32</sup> *Id.*

BellSouth's wireline cable systems are, for the most part, being built "in brand-new residential developments in suburban markets."<sup>33</sup> This does not mean, however, that BellSouth is avoiding head-to-head competition with other franchised cable operators. But for now, as discussed below, BellSouth is using MMDS systems – which are less expensive than HFC to deploy – to provide video programming in communities within its telephone service areas that are already served by cable systems.

## 2. Telco Provision of DBS

While, as noted above, Bell Atlantic is continuing to deploy switched video networks in some of its telephone service areas, it now has a new "preferred and primary way [to] bring video entertainment into people's homes."<sup>34</sup> Specifically, Bell Atlantic has announced that it is partnering with DirecTV and USSB to sell those companies' DBS services to its residential telephone subscribers. Bell Atlantic's spokesman has indicated that the company will be ready to market DBS to its subscribers "in a big way," beginning this year.<sup>35</sup> And SBC, which is not actively deploying wireline systems for the provision of video programming, has also announced plans to market the services of DirecTV and USSB to its residential customers in multiple dwelling units.<sup>36</sup>

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<sup>33</sup> *Id.*

<sup>34</sup> *Cable World, supra.*

<sup>35</sup> *Id.*

<sup>36</sup> See "DBS Finally Rings Up Bells," Multichannel News, Mar. 9, 1998, p. 1:

USSB spokesman Patrick Milan said the deals will create distributors that can match cable operators' local connections. And Bell Atlantic Video Services president, Dick Beville, declared that his company's offering "will basically be a cable-replacement product." (emphasis added).

Bell Atlantic's service area includes 13 states and the District of Columbia, and it currently provides 43.7 million access lines in that area.<sup>37</sup> Using DirecTV and USSB to offer consumers "a full suite of services from a single provider" increases the competition to cable television systems in two ways. First, having their services marketed directly to virtually all households by the monopoly local exchange carrier can only augment the competitive presence and potential of DirecTV and USSB. Second, to the extent that the video, voice and data markets are converging into a marketplace of full-service providers, the addition of established video services to Bell Atlantic's already available phone and Internet offerings will require continued efforts by cable operators to ensure that their own service offerings compare favorably, dollar for dollar, with Bell Atlantic's.

### **3. Telco Provision of MMDS.**

Bell Atlantic's choice of DBS as its primary means of distributing video programming to its subscribers was preceded by a short-lived plan to rely instead on multichannel multipoint distribution systems (MMDS). Bell Atlantic's planned acquisition of CAI Wireless, Inc. in 1996 put MMDS in the spotlight as a more prominent competitor in the video marketplace – a spotlight that seemed to dim when the acquisition was ultimately abandoned. In fact, however, MMDS not only remains on the scene as a competitor in the video marketplace but, as discussed below, it appears to be growing again as a reinvented digital service.<sup>38</sup> And another telephone company – BellSouth – is actively deploying MMDS as a principal means of providing video programming in its telephone service areas in Atlanta and New Orleans.

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<sup>37</sup> FCC, 1997 Preliminary Statistics of Communications Common Carriers at 13. Bell Atlantic recently proposed merging with GTE. The combined company would serve customers in 34 states and the District of Columbia with 62.5 million access lines.

<sup>38</sup> See Part 1.E., *infra*.

BellSouth launched its New Orleans service last November, and it claims that its subscribership there is “exceeding company expectations.”<sup>39</sup> It launched in Atlanta last month and expects to roll its service out quickly, “targeting more than 700,000 households, or about one-half of the local market” right from the beginning. Like DBS, the marginal costs of serving additional MMDS subscribers is low once the transmitting equipment is operational. As BellSouth’s spokesperson pointed out, “one of the benefits of entering a new market with MMDS technology is that the company can blanket a city with the technical ability to serve the market much quicker than would be possible with wireline technology. . . . And you only have to invest in customer homes, not in every home passed.”<sup>40</sup>

BellSouth’s Atlanta system offers 160 digital channels, including Americast’s package of programming, which includes virtually all of the most popular and most commonly carried cable programming networks. Its packages also include “digital-quality local broadcasts, access to Express Cinema pay-per-view and commercial-free audio-only channels.”<sup>41</sup> According to BellSouth, the new digital wireless technology being used by the system has so far “exceeded the company’s expectations,” and “the service has not run into weather or atmospheric problems.”<sup>42</sup>

The full-scale revival of MMDS technology by BellSouth appears to be related to the revived convergence of video, voice and data service providers. Thus, while BellSouth will “count on the strength of its brand name” to compete with the incumbent cable operator

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<sup>39</sup> “BellSouth Brings Digital Cable to Atlanta,” *Multichannel News*, June 8, 1998, p.8.

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

(MediaOne) in the provision of video programming in Atlanta, “the two companies will also compete for telephone and Internet customers.”<sup>43</sup>

**D. Competitive Facilities-Based and Municipally-Owned Providers**

The Telecommunications Act of 1996 has spurred the development of competitive local exchange carriers (CLECs), which are in many cases, deploying broadband facilities to be used in the position of local and long distance telephone service, Internet service, and video programming service. These providers, many of which are partnering with local and regional power companies, are targeting large metropolitan areas and intend to compete head-to-head with incumbent cable operators as well as incumbent telephone companies.

For example, RCN Corp. now “provides bundled phone, video and Internet-access services in New York, Boston, New Jersey and Pennsylvania.”<sup>44</sup> It already “has at least 63,000 video customers in Manhattan and Boston and recently expanded cable service to Queens.”<sup>45</sup> And it is currently “building a \$300-million, 350-mile fiber network in the Washington region with a local utility, Potomac Electric Power Co.” to provide similar bundled services.<sup>46</sup>

Another CLEC, Knology Holdings, Inc., is building broadband networks to offer similar bundled services in Southeastern states. Knology’s Augusta, Georgia Cable TV service will offer approximately 65-70 analog channels of basic programming and another 70-80 digital channels. It claims that “[p]ricing of the analog services will be similar to existing cable

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<sup>43</sup> *Id.*

<sup>44</sup> “RCN Tries To Elbow Its Way Into Cable’s Turf,” *CableWorld*, June 8, 1998, p. 20.

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

companies; however, delivered through the fiber/coax network that is presently available from existing cable providers.<sup>47</sup>

In addition, there appears to be a resurgence of municipal overbuilds accompanying the convergence of digital broadband services. In particular, municipal power utilities are offering bundled broadband services. For example, Tacoma City Light is to begin providing cable service imminently in Tacoma, Washington, using a 750 MHz, HFC facility.<sup>48</sup>

While municipal overbuilds have had only limited success in the past, Tacoma City Light sees unique advantages to the provision of digital broadband services by a municipal power company. Thus, its system's manager, believes that the overbuild "is different because it is a case of a utility company building a fiber optic network that will 'enhance management of energy services' in a deregulated and competitive environment."<sup>49</sup> She maintains that "TCL's move into cable is 'more significant' than a cable overbuild because it's also designed to protect the core electric-utilities business and to offer telecommunications are high-speed-data services that will pay back the high cost of capital to build the fiber systems."<sup>50</sup>

The growth of these competitive CLECs and municipal utilities providing cable bundled with phone, Internet and utility services will provide new competitive challenges and bring new marketing abilities that will augment the already established competitive forces provided by DBS, incumbent telephone companies and others.

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<sup>47</sup> "Knology to Build New Broadband Network – Competition Brings Choice in Local Service Providers," Knology Press Release , Jan. 21, 1998.

<sup>48</sup> "Tacoma Ready to Compete With TCI," *Multichannel News*, July 27, 1998, p. 8.

<sup>49</sup> *Id.*, p. 16.

<sup>50</sup> *Id.*

### E. MMDS

As discussed above, the most prominent new competition from MMDS appears to be BellSouth's use of MMDS as the video portion of its full package of communications offerings in New Orleans and Atlanta. But non-telco MMDS providers also are planning to use new digital and two-way technologies to increase their competitive presence in the marketplace.

Digital compression has been a "key addition" to MMDS in the past year, "allowing quadrupling of [the] number of channels that wireless cable can carry."<sup>51</sup> Moreover, the CEO of Wireless One anticipates that the "[a]rrival of 2-way wireless communications will be [a] 'nuclear blast' for [the] wireless cable industry, giving it [a] huge new opportunity to compete for financing and customers."<sup>52</sup> Two-way wireless cable technology is "here today, and it works," according to the CEO of American Telecasting, which plans to use such technology to augment its video MMDS service with Internet access and "wireless local loop telephony."<sup>53</sup>

MMDS operators are currently seeking Commission approval for the commercial deployment of two-way MMDS technology. The Commission has indicated that it will adopt rules allowing two-way service this summer.<sup>54</sup>

### F. MDU Competition

For many years, before cable operators began to face video competition throughout their franchise areas from DBS and telephone company providers of wireline and wireless service,

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<sup>51</sup> "Wireless Cable Sees 2-Way as Chance To Renew Industry," *Communications Daily*, July 10, 1998, p.6.

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> See "Kennard Promises Quick Action on 2-Way Wireless Cable," *Communications Daily*, July 13, 1998, p.3.

they faced competition in multiple dwelling units (“MDUs”) from satellite master antenna television systems (“SMATVs”). These systems typically served a single apartment building, using a satellite receiving dish on the roof of the building.

To the extent that these systems do not use public rights-of-way, they are not “cable systems” for purposes of Title VI of the Communications Act of 1934, as amended. This frees them from, among other regulatory obligations, the requirements to obtain a franchise, pay franchise fees, provide public, educational, and governmental access channels, provide leased access channels, and comply with “must-carry” rules. Cable operators generally may not “cream skim” by serving only the most potentially lucrative areas, or engage in “redlining” by denying service to areas on the basis of income. SMATV operators are not subject to such restrictions.

This regulatory freedom gives SMATVs a distinct advantage in competing to win the right to serve entire MDUs or individual residents of MDUs. The advantage may, in some cases, be offset to some extent by the economies of scale that a franchised cable operator may have in serving the entire community. But because of the regulatory imbalance, competition from SMATV operators will not necessarily ensure a pro-competitive outcome that provides MDU residents with the service that best and most efficiently meets their needs and demands. And it may not always promote the public interest of the entire community.

The Commission has nevertheless taken steps in the past year to promote and increase the already substantial amount of video programming service provided to MDUs by SMATVs and other alternatives to the incumbent, franchised cable operator. First, as the Notice of Inquiry points out, the Commission has “established procedures for the orderly disposition of MDU wiring in the event the MDU owner wants to switch the entire building to an alternative provider or wants to permit an alternative provider onto the premises to compete for the right to use inside

wiring on a unit by unit basis.”<sup>55</sup> It is too soon to gauge the extent to which these new procedures, which were generally proposed and endorsed by the SMATV industry, will have the pro-competitive results that its proponents predicted.

Second, the Commission recently held that a system that provides video programming to multiple MDUs but uses a telephone company’s wires instead of its own to cross public rights-of-way between buildings is not a cable system and need not obtain a cable franchise.<sup>56</sup> The decision has been construed by analysts and potential overbuilders as broadly allowing private cable operators to evade franchising obligations by leasing common carrier lines, despite the Commission’s reluctance to concede this implication.<sup>57</sup> Thus, one analyst has noted that “PCOs no longer need rely on microwave to interconnect properties and may now safely begin to form arms-length alliances with telcos. . . . If the ECI decision stands up in court, it won’t be long before petitioners nibble away to make the loophole a sinkhole.”<sup>58</sup>

The Commission should ensure that this prediction does not come true. There is nothing pro-competitive about allowing “private” cable operators to compete against incumbent, franchised cable systems in significant portions of their franchise areas – or throughout those franchise areas – without any of the regulatory and public interest obligations of the incumbents, merely because they lease a telephone company’s wires to cross public rights-of-way.

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<sup>55</sup> Notice, ¶ 7(g) (emphasis added).

<sup>56</sup> *Entertainment Connections, Inc.*, Memorandum Opinion and Order, FCC 98-111, released June 30, 1998.

<sup>57</sup> *Id.* at ¶ 73.

<sup>58</sup> “FCC Allows MDU Wire Interconnects Sans Franchise,” *Wireless/Private Cable Investor*, June 30, 1998, pp.1-2.

In any event, any perceived need to give an artificial boost to wireline SMATV operators in order to promote MDU competition should be diminishing given the broad availability of DBS. The use of DBS as a surrogate headend to deliver a package of video services to MDUs reduces the cost of providing a competitive service offering. And, increasingly, MDU residents are receiving DBS service – either because they have subscribed individually and use their own dishes outside their residences; because their buildings have subscribed directly to a DBS service; or because their SMATV or private cable operator has chosen to acquire its programming from a DBS service.

For example, wireless cable operators that serve MDUs appear to be turning to DBS to serve MDUs more efficiently. According to Henry Burkhalter, the CEO of Wireless One, the wireless cable industry

has found [a] new opportunity in supplying DirecTV programming to multiple dwelling units via joint ventures. Burkhalter said his company alone has added 100,000 subscribers that receive DirecTV programming through SMATV-like service. In [the] case of Wireless One, [the] company gets to keep 20% of revenue, with rest going to DirecTV, which supplies equipment and programming.<sup>59</sup>

Arrangements like these indicate growing competition to cable on multiple fronts. The use of DBS may give alternative MDU providers efficiencies and scale economies that enhance their ability to compete with incumbent cable operators in individual MDUs. At the same time, it strengthens DBS providers in their competition with cable operators and other MVPDs nationwide.

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<sup>59</sup> “Wireless Cable Sees 2-Way as Chance To Renew Industry,” *supra*, Communications Daily, July 10, 1998, p.6.

## **II. COMPETITION IN THE MARKETPLACE HAS PRODUCED A COMPETITIVE RESPONSE BY CABLE OPERATORS.**

The steady, irreversible growth of competition in the video marketplace is apparent not only from the increasing presence and potential of DBS and other new competitors to cable. It is also apparent from the pro-competitive conduct of cable operators in attempting to make their service offerings more attractive and valuable to consumers than the offerings of their competitors.

### **A. Cable Is Responding to Competition by Improving its Offerings and Investing in the Future.**

In last year's annual report, the Commission noted that the entire cable industry – including not only systems that were deemed subject to “effective competition”, but also those that were not – “were generally in the process of adding channels, upgrading facilities, and improving customer service.” That continues to be the case.

Moreover, even though the rates for regulated tiers have been increasing, the effective rates for many subscribers have actually been reduced. As the study by Economists Incorporated that we submitted last year noted, the “addition of The Disney Channel and regional sports channels to expanded basic services has also reduced prices to consumers that previously purchased both expanded basic service and The Disney Channel or regional sports programming as pay services.”<sup>60</sup> For the large number of subscribers who enjoy those services but were unwilling to pay the former a la carte prices for them, cable service provided more value than

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<sup>60</sup> Economists Incorporated, “An Assessment of Multichannel Video Competition,” Appendix B to NCTA Comments, CS Docket No. 97-141, p.10 (July 23, 1997).

before. Furthermore, for most subscribers, the inflation-adjusted per-channel rates for cable have not increased in recent years.

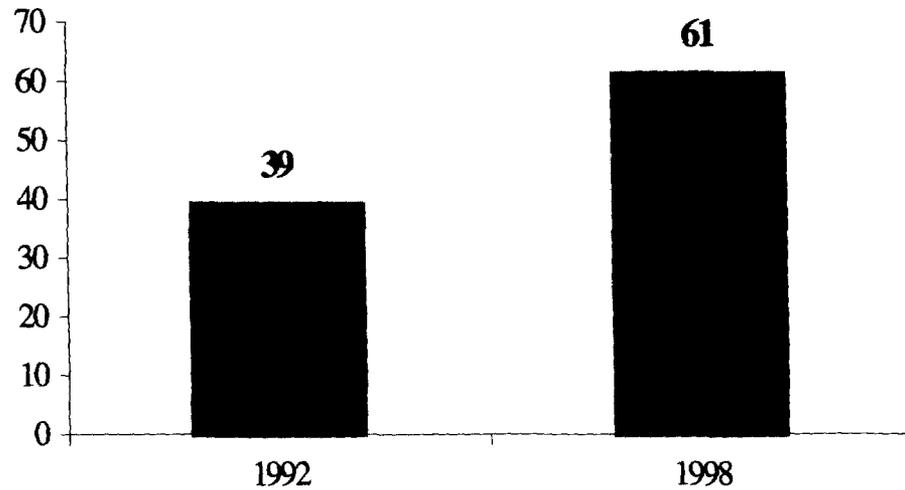
The explanation for why the entire cable industry is engaging in such seemingly competitive behavior is that the industry generally faces increasingly effective competition. DBS, which has the capacity and the “footprint” to serve subscribers throughout the United States, was obviously provoking a competitive response among cable operators, whether or not those operators face head-to-head wireline competition. And it continues to do so.

**1. Expanding the Quantity and Quality of Cable Programming Services and Facilities**

In the face of increasing competition, cable operators continue to expand the quantity and enhance the quality of the services that their customers demand. In their advertisements directly targeting current cable subscribers, DBS operators tout more channels of programming and the high quality video and audio that results from digital transmissions as principal reasons why customers should switch from cable to comparably priced DBS service. Cable operators are responding on both fronts, principally by upgrading their facilities to provide new digital tiers of service and spending more on new and existing programming services.

Using digital compression technology, cable operators can provide multiple channels of programming over a single 6-Mhz channel -- which could otherwise be used to provide only a single analog channel. Spurred by the deployment of digital tiers, the average channel capacity and number of program offerings of cable systems has continued to grow.

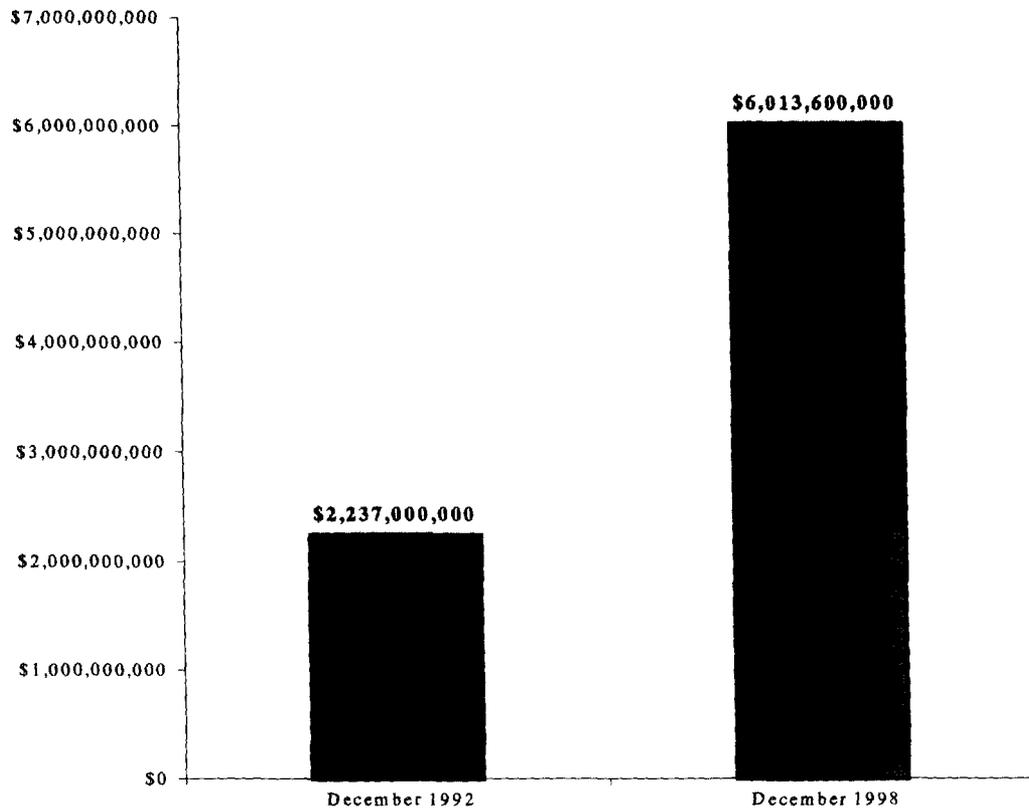
### Average System Channel Capacity 1992 versus 1996



Source: Based on analysis of Paul Kagan Associates data.

Cable's total capital expenditures in 1998 exceeded \$6 billion – almost three times as much as in 1992:

### Total Cable Capital Expenditures 1992 versus 1998



Source: 1992 Paul Kagan Associates, *The Cable TV Financial Databook*, 1997 at 118; 1998: Morgan Stanley, *4Q/1Q Preview*, January 1997

Moreover, expenditures on existing programming have continued to increase. Some of cable's critics have asserted that these programming cost increases (a portion of which may be passed through as rate increases by rate-regulated cable systems) are artificially high and have largely been imposed by programmers that are owned by cable operators as a way for those cable operators to evade rate regulation. That is incorrect.

First, there is no evidence that fees charged by vertically integrated programmers are any higher than fees charged by non-integrated services.<sup>61</sup> Second, the Commission's rate regulation rules specifically prevent vertically integrated programmers and operators from agreeing to artificially high programming fees in order to circumvent rate regulation.

The rules currently permit operators to pass through costs for programming purchased from affiliated companies, but only if they are charged either the same "prevailing company prices" that unaffiliated third parties pay or the fair market value of the programming.<sup>62</sup> Thus, were there evidence that vertically integrated programmers charged affiliated operators more than the marketplace price paid by unaffiliated operators – and that the affiliated operators were passing through such higher charges to customers – the excess charges would have to be refunded.

Does increased investment in the quality and quantity of cable service prove that cable operators face increasing competition in the video marketplace? Not necessarily. Cable

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<sup>61</sup> Indeed, Leo J. Hindery, Jr., President of Tele-Communications, Inc., recently testified that during each of the last two years, TCI's costs for unaffiliated programming increased by a significantly greater percentage than its costs for affiliated programming. See Testimony of Leo J. Hindery before the Senate Committee on Commerce, Science, and Transportation, July 28, 1998, p. 14.

<sup>62</sup> 47 C.F.R. § 76.922(f)(6).

operators have been continually expanding their channel capacity and enhancing the quantity and quality of their services throughout the 50-year history of the industry.

But the increased investment (with some accompanying retail price increases) is wholly consistent with the expected behavior of companies in a competitive market. Cable operators would only incur the costs of expanding their facilities and programming if they expected such improvements to increase the total value of their services to subscribers -- even at the higher prices that might be necessary in light of the operators' increased costs.

That was certainly the case during the period of time immediately following enactment of the Cable Communications Policy Act of 1984, which generally deregulated cable rates. In the aftermath of that legislation, cable operators' expenditures on programming and facilities increased dramatically. These increases in expenditures were, as expected, accompanied by retail price increases. And they were followed by dramatic increases in subscribership and penetration. Recent expenditures by cable operators on programming and facilities have similarly been accompanied by increases in subscribership. This illustrates the point made by our comments in last year's annual inquiry -- namely, that companies often adopt a rational competitive strategy of raising the quality and the price of their products, and this strategy, if successful, enhances consumer welfare.

There are, to be sure, a couple of unique situations in which a company might, in theory, be expected to increase investments and raise retail prices even where those investments did not increase the value of its product to consumers -- but neither of those situations apply to recent cable expenditures. First, a monopoly provider of an essential service that is subject to rate-of-

return regulation might have incentives to “gold plate” its product.<sup>63</sup> Because such regulated entities automatically earn additional profits on any permitted increases to their rate base, and because demand for an essential product is, by definition, completely inelastic, such companies have incentives to make any allowable investments, regardless of whether or not they add value for consumers. This is one reason why the Commission decided to replace rate-of-return regulation of providers of essential local exchange service with “price cap” regulation.

Wholly apart from the availability of comparable services at comparable prices from DBS and other competitors, it is impossible to characterize cable service as an “essential” service, for which demand is wholly inelastic. Nearly 30 percent of the television households in the United States choose not to subscribe to any multichannel video service. In any event, if demand were inelastic and cable were an essential service, subscribership would be expected to have remained constant while rates and expenditures increased.

But, as noted above, subscribership has not remained constant; it has increased. And so has viewership of cable programming, as measured by ratings – both in absolute terms and vis-à-vis broadcast programming. During one week this summer, for the first time, primetime viewing of advertiser-supported cable networks surpassed that of the four major broadcast networks.<sup>64</sup> The basic cable networks were watched in almost 3.2 million more homes during that week than during the same period a year ago.

Even rate-regulated providers of non-essential services might, in theory, have incentives to gold-plate their services with expenditures that do not add commensurate value to subscribers

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<sup>63</sup> See, e.g., H. Averch and L. Johnson, “Behavior of the Firm Under Regulatory Constraints,” 52 Am. Econ. Rev. 1052 (1962).

<sup>64</sup> Cable Television Advertising Bureau, “Another TV First: Cable Tops the Four Broadcast Networks in Primetime Share in Week #41,” Press Release, July 7, 1998.

if they face no competition. For a non-essential service, any such effort to evade regulation and raise retail prices to non-competitive levels would, of course, result in reductions in sales. That is the principal vice of monopoly pricing: The seller earns more by restricting output and raising prices above costs than by meeting the larger demand for his product at a competitive price.

Again, that obviously is not what is happening in the cable industry – because as cable operators have increased their expenditures and passed through retail price increases pursuant to the Commission’s rules, the public has responded positively with increased subscribership and increased cable viewing.

Furthermore, it is not only cable operators but also their unregulated competitors that have chosen to invest in more and better programming and in the provision of higher quality audio and video transmission. None of those competitors appear to have attempted to compete with cable by purposely spending less and offering a smaller, lower-quality offering. Indeed, even direct overbuilders, such as Ameritech, are building state-of-the-art, high-capacity systems. They are attempting to offer virtually all the program services that are available to cable systems, and more channels than the incumbent cable operators with which they compete.

These competitors obviously have no perverse regulatory incentives to invest in more and better programming and facilities. They must simply believe that these investments – and these program services – result in a more competitive product that is more attractive to consumers. In making similar investments to upgrade the quantity and quality of their service offerings, cable operators have made the same judgment. They have behaved precisely as one would expect of a company facing marketplace competition from video and other leisure time competitors.

## **B. Rates and Competition.**

In the Notice of Inquiry, the Commission asks whether the rates of cable systems are at all indicative of whether or not cable operators face competition. Neither the rate increases identified by the Commission in its 1997 Price Survey nor the lower rates of systems facing wireline overbuilds suggest that cable operators' rates are generally unconstrained by competition.

### **1. Rate Increases**

The Commission points out, in the Notice of Inquiry, that its 1997 Price Survey "found that cable rates were rising faster than the national inflation rate."<sup>65</sup> This fact is often cited by cable's critics as evidence that cable has no effective competition. But it demonstrates no such thing.

First of all, it is wrong to assume that the costs of the inputs of any given industry will increase by no more than the rate of inflation. The inflation rate, as measured by the CPI or any other index, is simply an average of the price changes of many goods and services. There is generally a wide variation around the mean. A substantial number of price changes are significantly greater than the average inflation rate; a substantial number are significantly less. The most common explanation for this variance is a variance in the costs associated with producing a specific product or service.

One would expect cable prices to raise faster than the inflation rate, in any event, because cable operators continue to enhance the quantity and quality of their service offerings -- and these enhancements add costs above and beyond any inflationary increases in the costs of the previous level of service. With respect to quantity alone, the Commission's 1997 rate survey

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<sup>65</sup> Notice, ¶ 7(a).

found that the average number of channels provided by systems that do not face effective competition (as defined by the Act) increased from 44 to 47 between July 1, 1995 and July 1, 1996, and from 47 to 49.4 in the following year. During the same period, the average monthly rate per channel rose from \$0.60 to \$0.61 (1.7%) in the first year, and from \$0.61 to \$0.63 (3.3%) in the second year.<sup>66</sup> The Consumer Price Index increased by 3.0% in the first year and 2.2% in the second. In other words, the per-channel rate -- a useful measure of the quality-adjusted price of cable service -- did not increase faster than inflation.

Not all of cable's increased costs were attributable to new channels of programming (including the costs of the programming and the costs of adding and activating the channels). The costs of existing programming went up significantly, too. Cable networks spent more on originally produced movies and programming, on additional and renewed sports rights, and on syndicated programming. Programming expenditures by basic cable networks increased from \$3.0 billion in 1995 to \$4.0 billion in 1997,<sup>67</sup> and much of this increase (which resulted in significant increases in viewership) was passed on to cable operators.

All experience indicates that cable subscribers will continue to demand -- and respond positively to -- more and better service offerings as such services become technologically feasible. To ensure that their systems can efficiently provide the full range of services that subscribers will seek from them -- and from other providers in the converging video, voice and data marketplace -- they must continue to invest in costly system upgrades.

In light of these substantial increases in its own costs, it is not surprising that cable's prices have exceeded the average rate of inflation. But the increasing investment in

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<sup>66</sup> Report on Cable Industry Prices, *supra.*, 12 FCC Rcd at 22765.

<sup>67</sup> Cabletelevision Advertising Bureau, *Cable TV Facts, 1998*, p. 5

programming, facilities, and customer service that causes these above-average costs and rates is indicative of an industry facing competition.

## 2. Overbuilds

Wholly apart from rate increases, the Commission also asks why its 1997 Rate Survey found that cable systems not deemed subject to competition are generally charging higher rates for their services. Notwithstanding the increasing evidence that, as the Justice Department asserts, cable and DBS are now viewed by consumers as substitutable products, it is not altogether surprising that the prices of systems that face direct wireline overbuild competition have been somewhat lower than those that do not. Overbuild situations are particularly susceptible to price wars that are unsustainable over the long term.

First, competition from municipal overbuilds may drive prices down not because the incumbent cable operator had been charging supracompetitive prices but because the municipal cable operator is willing to operate without a profit -- *i.e.*, to charge prices that are below competitive levels. A recent study of three overbuilds by municipal power companies appears to confirm what has seemed obvious to cable operators for years. It shows that the low prices of municipal overbuilds cannot be sustained over the long term without permanent subsidization by the municipality.<sup>68</sup>

Specifically, the study found that

[t]hese municipal power companies have had to subsidize operating expenses and capital expenditures, provide interest-free loans and levy taxes in order to keep cable rates low.<sup>69</sup>

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<sup>68</sup> R. Rizzuto and M. Wirth, *Costs, Benefits and Long-Term Sustainability of Municipal Overbuilds* (May 1998).

<sup>69</sup> *Id.* at 15.

Second, even private overbuilders -- who obviously do have the profit motive that municipal overbuilders lack -- are likely to enter the market charging unsustainably low prices. This is largely because the economics of wireline cable systems require overbuilders to capture a substantial share of the market quickly if they are to have a chance of long-term survival. In this regard, the economics of wireline cable operators are very different from the economics of DBS. Once a DBS system is launched, it can operate profitably with far fewer than a majority of all MVPD subscribers nationwide. Yet even with a small market share, it can provide effective competition to cable systems nationwide, because it has the capacity to add new subscribers (including any disgruntled former cable subscribers) at a very low marginal cost.

Wireline overbuilders face a different break-even point. Cable operators generally require a much higher penetration rate among their homes passed in order to sustain the costs of a facility that reaches all the homes in the franchise area. In these circumstances, an overbuilder may be willing to charge less than a remunerative rate in the short term in order to capture the subscribers that it needs to survive (perhaps as the sole survivor) in the long term. But before long, they have to go up.

RCN, for example, entered the Boston market charging significantly less than the incumbent cable operator. But it recently raised its rates by as much as 25%. As its CEO admitted, "The original promotion was below our cost. . . . Now, we're trying to get up to a competitive level."<sup>70</sup> Similarly, when FutureVision began providing video programming service to subscribers in Toms River, N.J., it "promised that subscriber rates would always run 20% below the cable incumbent's."<sup>71</sup> But "[w]hen Bell Atlantic purchased FutureVision, the telco

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<sup>70</sup> "RCN Raises Rates in Boston System," *CableWorld*, Feb. 23, 1998, p. 6.

<sup>71</sup> "Telco Raises Video Rates in N.J.," *CableWorld*, Dec. 8, 1997, p. 6.

said it couldn't guarantee that the low-price promise would remain intact."<sup>72</sup> And, in fact, last December it raised rates for the basic package of 75 channels by 74% -- from \$14.95 (four dollars less than the incumbent cable operator's price for its 77-channel basic package) to \$25.95 (seven dollars more than the incumbent's prices).

The bottom line is that rates charged in overbuild situations do not reflect "competitive" rates. Municipal overbuilders may sustain rates that are below cost by subsidizing their service. In new private overbuild situations, initial low rates are no indication of where prices will ultimately settle after inevitable increases.

**C. Cable's Tiering Practices Are Pro-Competitive and Have Been Adopted by Cable's Competitors.**

Since the earliest days of cable television, most of the programming available on cable systems has been offered to subscribers in multichannel packages or "tiers." Before the advent of satellite-delivered cable programming services, cable operators generally offered only a single tier, which consisted of retransmitted local and distant broadcast television stations. The only services offered on a per-channel, à la carte basis were premium movie, sports and special events channels offered by cable operators as a supplement to their broadcast retransmission service.<sup>73</sup>

When cable operators began offering satellite-delivered cable programming services in addition to retransmitted broadcast signals, they generally either included these services in the same single "basic" tier with the broadcast signals or offered them in an optional additional

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<sup>72</sup> *Id.*

<sup>73</sup> The Commission effectively squelched the development of these à la carte premium channels for several years with rules that, in order to protect broadcasters, prohibited cable from providing certain first-run movie and sports programming. Those rules were ultimately struck down as unconstitutional by the United States Court of Appeals for the District of Columbia Circuit. See *Home Box Office, Inc. v. FCC*, 567 F.2d 9 (D.C. Cir.) *cert. denied*, 434 U.S. 829 (1977)

“enhanced” basic tier. As systems have upgraded their channel capacity and as more and more satellite networks have become available, these basic and enhanced tiers have become larger and larger. In some cases, operators have created additional optional “mini-tiers.”

But it remains the case that, except for premium movie and sports programming that is offered on a per-channel or per-event basis, cable channels are offered in tiers and not on an à la carte basis. Indeed, in recent years, some services that used to be offered as à la carte premium services (such as The Disney Channel and regional sports networks) have been “retiered” and included in basic or enhanced basic tiers.

Few consumers regularly watch all of the channels that are included in basic and enhanced basic tiers (just as few read every section and every column of a daily newspaper), and some argue that it is unfair to require consumers to pay for channels that they do not want. In fact, however, tiering has generally been the best way to provide the programming that subscribers do want at the lowest cost, in light of the costs incurred in offering services à la carte and the substantially greater non-subscriber (*i.e.*, advertising) revenues available to program services when they are included in tiers with other popular networks.

### **1. Technology**

In part, tiering of services is a technological imperative. The most important technical factor limiting an operator’s ability to offer programming on an à la carte basis is the *inability* to offer services on a discrete channel-by-channel basis without an addressable set-top converter that can “read” a tag indicating whether or not a subscriber is authorized to receive a particular channel. Most current analog technologies support up to 256 program tags--enough to assign all BST, CPST, NPT, MPT and premium analog channels a unique tag. The downside is that an