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Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
Implementation of Section 11 of the Cable Television Consumer Protection and Competition Act of 1992	)	CS Docket No. 98-82
Implementation of Cable Act Reform Provisions of the Telecommunications Act of 1996	)	CS Docket No. 96-85
The Commission's Cable Horizontal and Vertical Ownership Limits and Attribution Rules	)	MM Docket No. 92-264
Review of the Commission's Regulations Governing Attribution Of Broadcast and Cable/MDS Interests	)	MM Docket No. 94-150
Review of the Commission's Regulations and Policies Affecting Investment In the Broadcast Industry	)	MM Docket No. 92-51 ✓
Reexamination of the Commission's Cross-Interest Policy	)	MM Docket No. 87-154

FURTHER NOTICE OF PROPOSED RULEMAKING

Adopted: September 13, 2001 **Released: September 21, 2001**

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By the Commission: Commissioner Copps issuing a statement.

TABLE OF CONTENTS

Paragraph

I. INTRODUCTION

1. In *Time Warner Entertainment Co. v. FCC* ("*Time Warner*"),[1] the United States Court of Appeals for the D.C. Circuit reviewed the Commission's cable television horizontal and vertical ownership limits[2] and attribution benchmarks,[3] and reversed and remanded the rules. The Commission's horizontal limit bars a cable operator from having an attributable interest in more than 30 percent of nationwide subscribership of multi-channel video programming, and the vertical limit bars a cable operator from carrying attributable programming on more than 40 percent of channels up to 75 channels of capacity. The Commission's attribution rules serve to define the level of ownership interest implicated by these limits.

2. To address the consequences of horizontal concentration and vertical integration in the cable television industry, Congress adopted Section 613(f) of the Communications Act as part of the Cable Television Consumer Protection and Competition Act of 1992 ("1992 Act").[4] This provision directs the Commission to establish limits on the number of cable subscribers that may be reached through commonly owned or attributed cable systems and to prescribe rules limiting the number of channels that can be occupied by the cable system's owned or affiliated video programming. In response to a First Amendment challenge to the constitutionality of this provision, the D.C. Circuit in *Time Warner Entertainment Co. v. United States*,[5] upheld this provision of the statute as "facially constitutional" under the "intermediate scrutiny" test,[6] finding that it fostered governmental interests in diversity and competition.[7] Subsequently, in *Time Warner*, the D.C. Circuit found that the Commission's horizontal rule restricts cable operators' ability to reach viewers and that the vertical rule curtails their exercise of

[1] 240 F.3d 1126 (D.C. Cir. 2001).

[2] The ownership rules in question were adopted in *Implementation of Section 11(c) of the Cable Television Consumer Protection and Competition Act of 1992 Horizontal Ownership Limits*, Third Report and Order, MM Docket No. 92-264, 14 FCC Rcd 19098 (1999) ("*1999 Horizontal Order*").

[3] The attribution rules in question were adopted in *Implementation of the Cable Television Consumer Protection and Competition Act of 1992 Implementation of Cable Act Reform Provisions of the Telecommunications Act of 1996 Review of the Cable Attribution Rules*, CS Docket Nos. 98-82 and 96-85, Report and Order, 14 FCC Rcd 19014 (1999) ("*1999 Attribution Order*").

[4] Section 613(f) was adopted as Section 11(c) of the Cable Television Consumer Protection and Competition Act of 1992, Pub. L. No. 102-385, 106 Stat. 1460, codified at 47 U.S.C. § 533(f).

[5] *See Time Warner Entertainment Co., L.P. v. United States*, 211 F.3d 1313 (D.C. Cir. 2000) ("*Time Warner v. United States*").

[6] *See United States v. O'Brien*, 391 U.S. 367, 377 (1968), which established the "intermediate scrutiny" standard of review for content-neutral, but speech-restricting, regulations. Under that standard, a regulation will withstand First Amendment challenge if it advances important or substantial governmental interests and does not burden speech substantially more than necessary.

[7] The D.C. Circuit rejected arguments that the Section 613(f) horizontal and vertical limits are unnecessary in light of the antitrust laws generally and the behavioral restrictions established by the 1992 Act specifically. *Time Warner v. United States*, 211 F.3d at 1320, 1322-23. The D.C. Circuit distinguished Section 613(f) as establishing structural limits, as opposed to behavioral restrictions. *Id.* As structural limits, the D.C. Circuit found that Section 613(f) "adds a prophylaxis to the law and avoids the burden of individual proceedings to remedy particular instances of anticompetitive behavior" and thus is not rendered unnecessary by other laws that impose behavioral restrictions. *Id.*

editorial control over a portion of their channels. The D.C. Circuit held that the Commission did not establish record evidence to support the limits, did not draw the necessary connection between the limits established and the alleged harms of concentration and integration the limits were designed to address, and did not take into account the changing industry market conditions. The D.C. Circuit thus remanded both the horizontal and vertical limits to the Commission for further consideration.[8] The D.C. Circuit also found that, unlike the horizontal and vertical limits, the cable attribution benchmarks do not constrain speech, but rather affect "investments in a particular class of companies."[9] The D.C. Circuit upheld the general attribution benchmarks under administrative standards of review, but vacated several aspects of the rules as "lacking rational justification."[10] By this *Further Notice of Proposed Rulemaking* ("*Further Notice*"), we are seeking comment on the Commission's rules and policies implicated by the *Time Warner* decision.[11]

II. BACKGROUND

3. A principal objective of the 1992 Act was to foster competition in the acquisition and delivery of multi-channel video programming by encouraging the development of alternative and new technologies, including cable and non-cable systems.[12] Congress evidenced a preference for competition over regulation in order to achieve this objective, believing that the presence of alternative cable and non-cable multi-channel video programming distributors ("MVPDs")[13] would constrain cable operators' market power in the acquisition and distribution of multi-channel video programming,[14] as well as improve their service and programming quality and curb their subscription rate increases.[15] As detailed

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[8] *Id.* at 1128, 1130.

[9] *Id.* at 1140.

[10] *Id.*

[11] On January 3, 2000, Consumer Federation of America, Center for Media Education, Association of Independent Video and Film Makers, Office of Communication, Inc., and United Church of Christ (collectively referred to as "CFA") petitioned the Commission to reconsider its ownership and attribution rules. In light of the *Time Warner* decision vacating these rules, we dismiss the petitions as moot. *See* para. 129, *infra.*

[12] *See* S. Rep. No. 92, 102d Cong., 1st Sess. 1, 18 (1991) ("*Senate Report*"); H. Rep. No. 628, 102d Cong., 2d Sess. 27 (1992) ("*House Report*"); *see also* 1992 Act §§ 2(b)(1)-(5).

[13] MVPDs include, but are not limited to, providers of cable, multi-channel multipoint distribution, direct broadcast satellite, and television receive-only program distribution services that make "available for purchase by subscribers or customers, multiple channels of video programming." 47 U.S.C. § 522(13).

[14] *See Senate Report* at 12, 18, 20-24; *House Report* at 30, 44; *see also Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, CS Docket No. 00-132, Seventh Annual Report, 16 FCC Rcd 6005, 6007 n.4 (2001) ("*Seventh Annual Report*") (the 1992 Act "imposed a regulatory scheme on the cable industry designed to serve as a transitional mechanism until competition develops and consumers have adequate multi-channel video programming alternatives"). In fact, experience has shown that competition does result in lower rates, improved service, and increased programming fare. *Id.* at 6092-98.

[15] Various provisions of the 1992 Act reflect congressional concern "about concentration of the media in the hands of a few who may control the dissemination of information" at the local, regional and national levels. *Senate Report* at 32. *See e.g.*, 47 U.S.C. § 543(b)(1) (requiring the Commission to issue rules to protect subscribers of "any cable system that is not subject to effective competition" from excessive rates); 47 U.S.C. § 541(a)(1) (prohibiting local authorities from granting exclusive franchises or unreasonably refusing to award additional franchises); 47 U.S.C. § 533(a)(2) (limiting cable operators from owning MMDS or SMATV systems within their franchise areas); 47 U.S.C. § 533(d) (allowing local authorities to deny transfers of franchises that would reduce or eliminate competition in the

(continued....)

below, however, Congress found that the cable industry, the nation's dominant and increasingly horizontally concentrated medium for the delivery of multi-channel programming, faced virtually no competition at the local level, and only limited competition at the regional and national level.[16] Additionally, Congress found that the increase in vertical integration between cable operators and programmers provided incentives and opportunities for cable operators to favor affiliated over non-affiliated programmers and, likewise, for programmers to favor affiliated over non-affiliated operators in the distribution of video programming.[17] Thus, given the absence of competition at the time,[18] Congress believed that certain structural limits were necessary.[19]

4. To address the consequences of horizontal concentration and vertical integration in the cable industry, Congress adopted subscriber (horizontal) and channel occupancy (vertical) provisions in Section 613(f).[20] These provisions direct the Commission, "in order to enhance effective competition," to establish reasonable limits on the number of cable subscribers that may be reached through commonly owned or attributed cable systems, and to prescribe rules limiting the number of channels that can be occupied by the cable system's owned or affiliated video programming. Specifically, Section 613(f) provides:

> (1) In order to enhance effective competition, the Commission shall, within one year after the date of enactment of the Cable Television Consumer Protection and Competition Act of 1992, conduct a proceeding - -
>
> (A) to prescribe rules and regulations establishing reasonable limits on the number of cable subscribers a person is authorized to reach through cable systems owned by such person, or in which such person has an attributable interest; [and]
>
> (B) to prescribe rules and regulations establishing reasonable limits on the number of channels on a cable system that can be occupied by a video programmer in which a cable operator has an attributable interest.[21]

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delivery of cable services); 47 U.S.C. § 544(b)(2)(C) (requiring the Commission to issue rules that promote the commercial availability of cable consumer equipment); 47 U.S.C. § 547(b) (prohibiting cable operators from engaging in unfair practices *vis-à-vis* video programmers and other MVPDs).

[16] *See* 1992 Act §§ 2(a)(2)-(4), (6); *see also Senate Report* at 12, 13-18, 20, 32-34; *House Report* at 27, 43-47.

[17] *See Senate Report* at 24 ("when cable systems are not subject to effective competition . . . [p]rogrammers either deal with operators of such systems on their terms or face the threat of not being carried in that market. The Committee believes this disrupts the crucial relationship between the content provider and the consumer.... Moreover, these concerns are exacerbated by the increased vertical integration in the cable industry."); *see also* 1992 Act §§ 2(a)(5)-(6); *House Report* at 41.

[18] *See* n.10, *supra.*

[19] *See Senate Report* at 18, 25-26, 33; *House Report* at 26, 30, 40-44.

[20] Section 613 was adopted as Section 11(c) of the Cable Television Consumer Protection and Competition Act of 1992, Pub. L. No. 102-385, 106 Stat. 1460, codified at 47 U.S.C. § 533(f).

[21] Additionally, Section 613(f)(1), 47 U.S.C. § 533(f)(1), requires the Commission to consider whether it is necessary or appropriate to restrict MVPDs' participation in video programming development. Specifically, Section 613(f) directs the Commission:

(continued....)

In prescribing such limits, a principal congressional objective was to prevent the dominant cable medium from stifling the video programming market, and further to encourage the development of, and competition within, the video programming market.[22] This, in turn, would help to make diverse programming available to consumers.[23] Section 613(f) requires the Commission to establish structural limits that are "reasonable"[24] and that serve the "public interest,"[25] and to identify those interests that are deemed "attributable" and thus implicated by the limits.[26] Congress also identified several factors the Commission must take into account, "among other public interest objectives," in setting the structural limits. Specifically, the Commission is directed to:

> (A) ensure that no cable operator or group of cable operators can unfairly impede, either because of the size of any individual operator or because of joint actions by a group of operators of sufficient size, the flow of video programming from the video programmer to the consumer;
>
> (B) ensure that cable operators affiliated with video programmers do not favor such programmers in determining carriage on their cable systems or do not unreasonably restrict the flow of video programming of such programmers to other video distributors;
>
> (C) take particular account of the market structure, ownership patterns, and other relationships of the cable television industry, including the nature and market power of the local franchise, the joint ownership of cable systems and video programmers, and the various types of non-equity controlling interests;
>
> (D) account for any efficiencies and other benefits that might be gained through increased ownership or control;

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> (C) to consider the necessity and appropriateness of imposing limitations on the degree to which multichannel video programming distributors may engage in the creation or production of video programming.

Given the 1992 Act's structural and behavioral restrictions, the Commission found that it was not necessary or appropriate to adopt such restrictions on MVPDs' development of video programming. *See Implementation of Sections 11 and 13 of the Cable Television Consumer Protection and Competition Act of 1992, Horizontal and Vertical Ownership Limits*, MM Docket No. 92-264, Second Report and Order, 8 FCC Rcd 8576 (1993)("*Second Report*"). Specifically, the Commission noted that the horizontal and vertical structural limits are "intended to promote diversity and to encourage competitive dealings between cable programming services and cable operators and between cable programming services and competing radio distributors." *Id.* at 8607. Additionally, the Commission observed that the behavioral restrictions of the 1992 Act prevent cable operators from "requiring either exclusive rights or a financial interest in programming services as a condition of carriage," "discriminating against unaffiliated programmers," and "engaging in 'unfair' and deceptive practices that would hinder competition in cable service and programming or inhibit delivery of programming to consumers." *Id.* at 8608.

[22] *See* 1992 Act §§ 2(a)(4)-(6), (b)(1)-(5); *Senate Report* at 24-27, 32-34; *House Report* at 40-44.

[23] *Id.*

[24] *Senate Report* at 80.

[25] 47 U.S.C. § 533(f)(2). Thus, in setting the subscriber and channel occupancy limits, Congress directed the Commission to consider the potential beneficial and detrimental effects of consolidation and integration in the cable industry in the context of a changing communications marketplace.

[26] *Senate Report* at 80.

(E) make such rules and regulations reflect the dynamic nature of the communications marketplace;

(F) not impose limitations which would bar cable operators from serving previously unserved rural areas; and

(G) not impose limitations which would impair the development of diverse and high quality video programming.

5. As described in *Time Warner v. United States,* which upheld the underlying statute, Congress had two principal objectives in mind in adopting Section 613(f). First, Congress was concerned about concentration of the media in the hands of a few who could control the dissemination of information which would enable cable operators to impose their own biases upon the information they disseminate.[27] Second, Congress was concerned that an increase in concentration and vertical integration in the cable industry could result in anti-competitive behavior by cable operators toward programming suppliers, as well as toward potential new entrants. The court described the concerns of Congress as "... well grounded in the evidence and a bit of economic common sense."[28] The public interest factors set forth in Section 613(f) reflect Congress' concern over the detrimental, anti-competitive effects of ownership patterns developing in the cable industry.[29] Congress believed that concentration and vertical integration would allow such firms to favor their own affiliated programming services and jeopardize the viability of independent programming services, which thereby could reduce programming diversity.[30] However, the delineated public interest factors also reflect congressional recognition of the potential beneficial effects of concentration and integration in the cable industry.[31] Congress recognized that some level of concentration and integration produces efficiencies in the administration, distribution and procurement of programming, and fosters investment in innovative and risky programming fare, which may benefit consumers in terms of lower rates, better service and more diversified programming choices.[32]

6. In considering horizontal and vertical limits for the cable industry, the Commission thus must weigh the public interest objectives, and take into account the beneficial and detrimental effects of cable concentration and integration. Additionally, the Commission must consider the evolving and "dynamic" nature of the communications marketplace,[33] as Congress recognized that alternative services and technologies are being, and will be, introduced.[34] In this regard the *Senate Report* states "[B]ecause

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[27] 211 F. 3d at 1316. However, we note that in the subsequent review of the Commission's implementation of regulations, the D.C. Circuit found that Congress' primary concern behind Section 613(f) was to promote "'fair competition'... sharply confin[ing] the [Commission's] authority to regulate solely in the interest of diversity." *Time Warner,* 240 F.3d at 1135.

[28] *Id.* at 1332.

[29] *See* 47 U.S.C. §§ 533(f)(2)(A), (B), (C).

[30] *See Senate Report* at 24-27, 32-33; *House Report* at 41.

[31] *See* 47 U.S.C. §§ 533(f)(2)(D), (F), (G).

[32] *See Senate Report* at 33-34; *House Report* at 43.

[33] 47 U.S.C. § 533(f)(2)(E).

[34] *See Senate Report* at 12, 80; *House Report* at 27.

these markets are dynamic, the FCC should revisit these limitations at appropriate times to ensure that they accurately reflect the policies of this legislation."[35] As required, the Commission adopted structural limits, as well as attribution benchmarks, and periodically revised its rules through further rulemaking proceedings.[36]

7. In accordance with our statutory mandate, First Amendment principles, and the second *Time Warner* decision, we now seek to reexamine our rules and the state of competition in the MVPD market to ensure that our rules are reasonable and serve the public interest. On remand, we recognize that the subscriber ownership and channel occupancy limits that we implement must reflect the MVPD industry's market conditions. It is primarily within that framework that we are soliciting comment on the horizontal and vertical ownership limits.[37] Specifically, we seek theoretical justification and empirical evidence of alleged harms of concentration. We also seek comment on market conditions and changes that have taken place since the 1992 Act. We believe this input will allow us to draw a closer tie between the possible harms of concentration and the appropriate remedy. The discussion that follows sets forth our tentative assumptions concerning the industry structure in terms of program production, packaging, and distribution markets. We then elaborate on the implications of this structure, of the current state of markets, and of trends within these markets. The market structure and trends provide the basis for our examination of the potential effects of high levels of horizontal concentration within the industry and the means by which they may be addressed, consistent with our statutory mandate. We then examine both the subscriber and channel occupancy limits in greater depth and present alternative approaches for setting these limits. We seek comment on our conceptualization of the market structure and the suggested regulatory approaches described below, as well as alternative regulatory approaches. Finally, the discussion below considers and solicits comment on the Commission's attribution benchmarks, as affected by the *Time Warner* decision.

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[35] *See Senate Report* at 80.

[36] *See, e.g., Implementation of Section 11(c) of the Cable Television Consumer Protection and Competition Act of 1992 Horizontal Ownership Limits,* Third Report and Order, MM Docket No. 92-264, 14 FCC Rcd 19098 (1999) ("*1999 Horizontal Order*"); *Implementation of the Cable Television Consumer Protection and Competition Act of 1992 Implementation of Cable Act Reform Provisions of the Telecommunications Act of 1996 Review of the Cable Attribution Rules*, CS Docket Nos. 98-82 and 96-85, Report and Order, 14 FCC Rcd 19014 (1999) ("*1999 Attribution Order*"); *Implementation of Section 11(c) of the Cable Television Consumer Protection and Competition Act of 1992 Horizontal Limits*, MM Docket No. 92-264, Memorandum Opinion and Order on Reconsideration and Further Notice of Proposed Rulemaking, 13 FCC Rcd 14462 (1998)("*Order on Reconsideration and Further Notice*"); *Implementation of the Cable Television Consumer Protection and Competition Act of 1992 Review of the Cable Attribution Rules*, CS Docket No. 98-82, Notice of Proposed Rulemaking, 12 FCC Rcd 12990 (1998); *Further Notice of Proposed Rulemaking, Regulations Governing Attribution of Broadcast and Cable/MDS Interests, Regulation and Policies Affecting Investment in the Broadcast Industry and Reexamination of the Commission's Cross-Interest Policy*, MM Docket Nos. 94-150, 92-51 and 87-154, 11 FCC Rcd 19895 (1996); *Implementation of Section 11(c) of the Cable Television Consumer Protection and Competition Act of 1992, Vertical Ownership Limits,* Memorandum Opinion and Order on Reconsideration of the Second Report and Order, 10 FCC Rcd 7364 ("1995 Reconsideration Order"); *Second Report,* 8 FCC Rcd 8565 (1993): *Implementation of Sections 11 and 13 of the Cable Television Consumer Protection and Competition Act of 1992 Horizontal and Vertical Ownership Limits, Cross-Ownership Limitations and Anti-trafficking Provisions,* MM Docket No. 92-264, Notice of Proposed Rulemaking, 8 FCC Rcd 210 (1992) ("*Initial Notice*").

[37] *See* 47 U.S.C. § 533(f)(2)(C); *see also Time Warner*, 240 F.3d at 1133, 1139.

III. MARKET DESCRIPTION AND IMPLICATIONS

A. Markets for Programming Networks and Distribution

8. One way to describe the markets involved in creating programming and delivering it to consumers is to recognize three separate but interrelated markets: (1) the production of programming, (2) the packaging of that programming, and (3) the distribution of that programming to consumers, either by free over-the-air broadcast or by subscription via cable, wireless, or satellite, for example.[38] We believe that producers and purchasers in each market operate separately to some extent, but there also is some degree of vertical integration between these markets, which may or may not affect production and purchase decisions.

9. **Market for Program Production:** We understand that producers of programming, using specialized inputs and "talent," and non-specialized inputs,[39] create programs for sale and/or distribution. Programming may be classified into two broad categories: (a) general entertainment, and (b) niche programming. The relevant geographic market for general entertainment programming is at least national, and, to some extent, international. The geographic market for certain types of niche programming may also be national or international in scope. An example would be programming that appeals to a narrowly defined interest group across a broad geographic area such as golf fans (e.g., the Golf Channel). Other types of niche programming, such as regional sports programming, for example, have a much narrower geographic market. We believe that the market for program production is vertically integrated to some degree with the market for program packaging (*e.g.*, USA Networks owns USA Studios and Disney owns the Disney Channel as well as extensive film production facilities). We seek comment on our conceptualization of the market structure, as well as comment on additional categories of programming that might impact our analysis.

10. **Market for Program Packaging:** We assume that the market for the packaging of video programming consists of entities of various size, from unaffiliated packagers that own one programming network to large corporations, such as Time Warner and Discovery, which own many 24-hour networks. Companies that own programming networks produce their own programming and/or acquire programming produced by others. These companies then package and sell this programming as a network or group of networks to MVPDs for distribution to consumers. Networks are therefore aggregators of the product of program producers, and, through their selection of programming and payments to producers, assume part of the risk and fixed costs of program producers.[40] Over-the-air broadcast networks are also

[38] Although cable, wireless, and satellite currently are the only technologies in use for distribution of subscription video services, other technologies may become commercially viable. Streaming video over the public Internet or over private, non-cable, fiber-optic networks are examples of such technologies.

[39] More specifically, program producers use both labor and non-labor inputs in program production. Labor inputs may be divided into two groups. The first group consists of stagehands, cameramen, film editors, and similar craftsmen. This group is characterized by relatively homogeneous resources that are readily available to the industry. The second group of labor inputs includes specialized or "talent" inputs, which may consist of actors, directors, writers, and producers. These resources are heterogeneous with respect to the salaries they can command in the marketplace, their ability to produce output which appeals to large audiences, and their ability to earn in their best alternative occupation, i.e., their opportunity cost. As a result, they are higher cost and have fewer available substitutes. *See New Television Networks: Entry, Jurisdiction, Ownership and Regulation,* Network Inquiry Special Staff, FCC, Oct. 1990.

[40] For purposes of this *Further Notice,* we simplify the discussion below by referring to MVPDs only as distributors of programming content.

purchasers of programming content. They package programming *and* distribute it to consumers through network-owned stations, affiliates, and independent stations. All broadcast networks also own some production facilities and so are vertically integrated with program production, but tend to broadcast both independently produced and affiliated programming. Over-the-air broadcast networks have an interesting role in relation to the MVPD industry: they compete with MVPDs for advertising revenue but are also carried as content on MVPD systems. Because of must carry regulations, in fact, content that is carried on over-the-air broadcast networks is generally guaranteed carriage on cable systems. We seek comment on the extent to which the must carry rules limit the barriers that a cable system can place between programmers and consumers.

11. We understand that video programming networks sell programming to MVPDs based on contracts generally lasting several years or more. Video programmers[41] are compensated through license fees that are calculated per subscriber per month. These license fees are negotiated based on "rate cards" that specify a top fee, but substantial discounts are negotiated based on the number of subscribers to which the MVPD will transmit the network and on other factors, such as placement on a particular tier. Video programmers also derive revenue by selling advertising. Advertising time on programming networks is generally split between the programmer and the MVPD.

12. We believe that the relevant geographic market for video program packaging can be regional, national, or even global in scope depending on the nature of the programming under consideration. For instance, some programming networks offer programming of broad interest, similar to that of the over-the-air broadcast networks, and depend on a large, nationwide audience for profitability.[42] Other programming networks also seek large nationwide audiences, but offer content that is more focused in subject.[43] These networks purchase highly desired programming within their areas of interest at considerable cost, and appear to strive for dominance within their niches to support the cost of providing such programming. Another subtype of network is that which still seeks nationwide distribution, but offers narrowly tailored programming, focusing on a "niche within a niche."[44] A fourth type of programming network does not seek a national audience, but is regional or even local in scope, including regional sports and news networks. Other categories include premium movie networks (such as HBO and Showtime), home shopping channels (such as QVC), and pay-per-view movie channels. Some channels, such as MTV, CNN, and The Discovery Channel, even seek worldwide distribution.[45]

13. Our brief description above does not provide a rigorous method of classifying types of programming networks, for many distinctions are possible. Instead, it merely highlights the fact that different types of networks seek out, or can be supported by, different sizes of audiences. Some programming networks likely can survive with distribution to a few million subscribers within a certain

[41] The terms "video programming networks" and "video programmers" are used inter-changeably hereafter to describe companies that package programming into networks for transmission over MVPD distribution systems. We are simply using common terminology, not collapsing the program production and program packaging markets, as the term "video programmer" might imply.

[42] Examples include TNT and USA.

[43] Examples of the second type include ESPN for sports and CNN for news.

[44] Examples of this third type of programming include Discovery Health, the Golf Network, and Home and Garden.

[45] MTV, including regional versions of the service, is said to reach 340 million households in 140 countries. *See* www.viacom.com. The Discovery Channel and its affiliated services are said to reach 425 million viewers in 152 countries. *See* www.discovery.com.

region; others may need nationwide distribution to a large percentage of MVPD homes in order to remain viable.[46]

14. We believe that program packagers seek to reach the widest range of subscribers for their type of programming on a regional or national basis to increase the value of their programming to advertisers, and to build brand recognition that will in turn spur other MVPDs to carry their programming. MVPDs as buyers of programming from video programming networks attempt to negotiate favorable license fees based, in part, on their total number of subscribers. In addition, MVPDs often receive a portion of the advertising time on the networks they carry.[47] Although some program packagers are vertically integrated with MVPDs, many program packagers are unaffiliated with any MVPD.[48] We seek comment on our description of the market for program packaging.

15. *Characteristics of Programming Networks.* We believe that video programming networks are similar in at least one respect to the over-the-air broadcast networks that we examined in the *Dual Network NPRM.*[49] Consumption of the programming of a video programming network, whether broadcast or cable, by one viewer does not reduce the amount of the good available for another viewer. This implies that most if not all of the costs of transmission are fixed since the marginal cost of showing the program to one additional viewer is near zero.[50] This in turn implies that, assuming everything else remains constant, video program packagers will always prefer to transmit to larger audiences, measured either through audience ratings or number of subscribers to whom the programmer is carried, because larger audiences bring in greater license fees and advertising revenues, but add little or no additional cost. However, some MVPDs (e.g., cable overbuild and DBS) compete with incumbent cable operators to varying degrees. This competitive effect may induce some program packagers to delay signing a licensing agreement with a new entrant for fear of being dropped by the incumbent MVPD. Alternatively, this fear may encourage the program packager to request that the new entrant accept an unreasonably high licensee fee. We seek comment on whether new entrants have experienced these effects when attempting to complete a licensing agreement with program packagers, and the extent to which these effects vary with the size of the subscriber base of the incumbent MVPD. Finally, the high fixed cost associated with developing a program indicates that a program packager needs to have access to a critical number of viewers in order to avoid a financial loss. We seek comment on the extent to which this financial risk places some program packagers at a substantial negotiating disadvantage vis-à-vis MVPDs. We also seek comment on the extent to which bargaining power differs across program packagers, i.e., between so-called marquee and non-marquee program packagers.

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[46] The fact that different types of programming networks can be supported by different sizes of audiences might be relevant in the context of the "open field" regulatory approach, discussed in ¶¶ 53-59, *infra.*

[47] Most large MSOs (Cablevision in the New York market is a notable exception) have a presence in many markets across the country, not just within one locality or region. Networks and MVPDs that have national distribution tend to be more attractive to national advertisers while those with a strong regional presence (e.g., with large regional clusters), tend to appeal to local advertisers.

[48] For a discussion regarding the status and trend in vertical integration, *see* ¶¶ 77-80, *infra.*

[49] *See Amendment of Section 73.368(g) of the Commission's Rules -- The Dual Network Rules*, MM Docket No. 00-108, Notice of Proposed Rule Making, 15 FCC Rcd 11253, 11257-61 (2000) ("*Dual Network NPRM*").

[50] In this discussion, we are referring to the marginal costs of transmission to additional consumers *once it is created or purchased.* This is distinct from the marginal cost of *producing and acquiring content*, which will not be zero. *See*, *infra* for a further discussion of this relationship.

16. Further, we understand that many of these fixed costs are sunk, or, in other words, deployed in uses that are specialized and therefore cannot be re-deployed to other uses if the demand for the original use declines or disappears. Specifically, once a programming network produces or acquires programming, there is no use for it other than to sell it to MVPDs for transmission to consumers. When production costs are largely sunk, the risk associated with production increases. Allocation of this risk is likely a major issue in negotiation of carriage contracts, and may explain in part the equity stakes (a form of risk sharing) that some MVPDs have in such program packagers.[51]

17. It appears that innovation is an important factor in entry and competition. In such a market, incumbency can confer large advantages. We seek comments on the value of incumbency in the programming market. It also appears that such value may be magnified by two factors. First, MVPDs may be averse to carrying latecomers in a programming niche, particularly those that are only slightly differentiated from existing programming since MVPDs have an incentive to avoid carrying programming that is a close substitute for programming already carried. Such close substitute programming may reduce the ratings of the already carried programming. At a minimum, this characteristic will disadvantage latecomers in carriage contract negotiations, leading to lower license fees and unfavorable advertising splits. Second, the brand name of pre-eminent networks has been extended through the launch of additional affiliated networks.[52] Networks with powerful brand names may be able to make carriage of their newer networks a requirement of carriage contracts, further increasing their dominance of a programming niche, and limiting channel space available for, or interest in, rival networks in the same niche. In sum, although individual packagers in the network market may differ in terms of the nature of the packager and the audience reach, generally the market may be characterized as favoring early entrants and as having large fixed or sunk costs, which packagers seek to recover through increased access to consumers.

18. **Market for the Distribution of Video Programming:** MVPDs bundle programming networks into groups of channels or "tiers" and sell this programming to consumers, deriving revenues from subscription fees and the sale of advertising time that they receive through their carriage agreements. MVPDs range in size from single-system cable operators with only a few dozen subscribers, to MSOs that own many systems and serve millions of subscribers.

19. The relevant geographic scope of the third market, the distribution of multi-channel video programming by MVPDs, previously has been defined by the Commission as local.[53] Cable services are

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[51] In the video program packaging market, the critical inputs appear to include rights to valued programming, early entry into a programming niche, and network brand name. A prime example of this is the market position of ESPN, the pre-eminent 24-hour sports programming network. ESPN was the first national programming network to enter this market, combining live sports events with sports news programming. As the first, and, for many years, only 24-hour sports network, ESPN built a highly regarded brand name (i.e., valued by many customers) that allowed it to acquire valuable sports programming. ESPN's brand name also appears to give it a powerful advantage over rivals in negotiations for new contracts. Often, first movers in the video program packaging market enjoy lasting advantages. Latecomers can enter and survive by emulating the incumbent or by providing a differentiated product. *See generally* Daniel L. Rubinfeld and John Hoven, Antitrust Division, U.S. Department of Justice, *Innovation and Antitrust Enforcement*, presented at the Conference on Dynamic Competition and Public Policy in Washington, D.C. on Dec. 16, 1998.

[52] For instance, ESPN launched ESPN2 and ESPNews, and Discovery launched Animal Planet and Discovery Health.

[53] *In the Matter of Application for Consent to the Transfer of Licenses and Section 214 Authorizations from Tele-Communications, Inc., Transferor, to AT&T Corp., Transferee,* 14 FCC Rcd at 3172-73. *See Sixth Annual Report*
(continued....)

furnished in local franchise areas by one or more MVPDs, and consumers cannot switch to another MVPD that does not offer service within that area. Most franchise areas are served by only one cable operator. In a limited, but growing, number of franchise areas, a second cable operator ("overbuilder") or multi-channel multipoint distribution services ("MMDS" or "wireless cable") operator also offers service. Satellite master antenna television ("SMATV") providers[54] do not provide competition throughout a local franchise area because they generally offer service only where they may do so without crossing public rights-of-way. SMATVs offer services largely to institutions, such as universities and hospitals, and to multiple dwelling units ("MDUs"), such as apartment buildings and cooperatives. Direct broadcast satellite ("DBS") providers also distribute MVPD services and are available nationwide to consumers who have an unobstructed view of the southern sky from their homes or place of residence. While there are some differences among these distribution technologies and each has its own limitations and advantages, they offer consumers similar services.

20. *Recent Trends in Multi-Channel Video Programming Distribution Market.* The current MVPD market differs from that which existed when Congress enacted the subscriber and channel occupancy provisions of the 1992 Act. These differences must inform our examination of our rules. In 1992, competition was limited to a small percentage of local markets. Specifically, Congress found that cable was the "dominant nationwide video medium," with "over 60% of the households with television" subscribing to cable, a percentage "almost certain to increase."[55] In contrast, home satellite delivery (HSDs) served only an estimated two-to-three million subscribers;[56] MMDS served only an estimated 350,000 subscribers;[57] DBS, although authorized, was not yet operational;[58] and telephone companies were barred from providing video programming within their service areas.[59] Further, there was minimal local competition between cable systems: out "of over 11,000 cable systems nationwide . . . only 53 . . . have some overbuild."[60]

21. By June 2000, cable operators served 67.7 million subscribers (an increase of 22.6 percent since 1992); DBS served over 10 million subscribers (from zero in 1992); HSD served 1.5 million subscribers (a reduction of 24 percent from 1992); MMDS served 700,000 subscribers (an increase of 133 percent over 1992); and SMATV served 1.5 million subscribers.[61] Additionally, overbuild activity has

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on Competition in Video Markets, 14 FCC Rcd at 987-1070, for details on the cable industry and its competitors. It should be noted, however, that the Commission has determined that for purposes of assessing the impact of horizontal concentration, it is appropriate to examine "both the national programming market and the local distribution market," because cable operators generally acquire programming on the national level and distribute it on the local level through their locally franchised systems. *See Order on Reconsideration and Further Notice*, 13 FCC Rcd at 14477.

[54] SMATV providers are also known as private cable operators.

[55] 1992 Act § 2(a)(3).

[56] *See Senate Report* at 15; *House Report* at 45.

[57] *See Senate Report* at 14; *House Report* at 44.

[58] *See Senate Report* at 16; *House Report* at 46.

[59] *See Senate Report* at 17-18.

[60] *Id.* at 13.

[61] *See Seventh Annual Report*, 16 FCC Rcd at 6010-13. It should be noted that neither the *Senate Report* nor the *House Report* cited SMATV figures for 1992. However, in 1994, SMATV was reported to serve one million
(continued....)

increased: second franchises have been awarded in 369 communities."[62] Based on the figures above, in 1992, cable and non-cable multi-channel programming providers served 95.5 percent and 4.5 percent of the MVPD subscribers, respectively. In contrast, cable's current share of MVPD subscribership has decreased to 80 percent, and non-cable's share has increased to 20 percent, of which 15 percent is attributable to DBS.[63] Thus, although cable continues to be the dominant player in the MVPD market, its market share has diminished somewhat with the emergence and continued growth of competing MVPD providers.

22. Perhaps the most important difference between the industry in 1992 and today is that in 1992 there was no clear nationwide substitute for cable.[64] Today, on the other hand, DBS has a national footprint and, although there are questions concerning DBS' ability to constrain cable prices,[65] it appears that DBS currently offers an effective alternative path through which program networks can reach subscribers. DirecTV now is the third largest MVPD operator, after AT&T and Time Warner, and EchoStar is the eighth largest.[66] In addition, it appears that the competitive presence of DBS reduces cable operators' incentive to choose programming for reasons other than quality because a cable operator that selects programming on some other basis risks loss of subscribers if high quality programming is available via DBS.[67] We seek comment on the impact of DBS' presence on cable operators' market power generally and on their ability to select programming for reasons other than quality and/or viewer interest. We also seek comment on the extent to which advertisers view DBS as an effective substitute for cable in reaching viewers.

23. Not only has the MVPD market become somewhat more competitive, the cable industry has become more dynamic. For instance, two MSOs that now are among the ten largest cable MSOs, Charter and MediaCom, recently were created either through acquisitions or combinations of smaller MSOs. In addition, RCN, a relatively new MVPD, has grown to one of the 20 largest MSOs through a

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subscribers. *See Implementation of Section 19 of the 1992 Cable Act (Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming)*, CS Docket No, 94-48, First Report, at Table 5.1 ("*1994 Annual Report*"). Thus, between 1994 and 2000, SMATV realized a 50 percent increase in subscribership.

[62] *See Seventh Annual* Report, 16 FCC Rcd at 6024-25.

[63] *Id.* at Appendix C, Table C-1.

[64] C-Band satellite was available nationally, but the size and cost of the equipment required to access the service, among other things, rendered C-Band service an ineffective competitor to cable in most settings.

[65] *See Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992, Statistical Report on Averages Rates for Basic Service, Cable Programming Services, and Equipment,* MM Docket No. 92-266, Report on Cable Industry Prices, 16 FCC Rcd 4346 (2001) ("*2000 Price Survey*"). Results from an econometric model presented in this report suggest that DBS is a substitute for cable services. This result is different from earlier findings that showed DBS exerting only a modest influence on the demand for cable services. *See, e.g.*, 15 FCC Rcd at 10946 (2000).

[66] *See Seventh Annual* Report, 16 FCC Rcd at Appendix C, Table C-3.

[67] By "quality," generally we mean programming that consumers value and are willing to pay for. The ability of cable operators to choose programming for reasons other than consumer demand, e.g., based on affiliation, would indicate that cable operators have a degree of market power.

combination of incumbent cable systems, overbuild cable systems, and open video systems.[68] We believe that the growth of non-cable MVPD competitors, in combination with the creation and success of new mid-sized MSOs, provides new outlets for programmers. We seek comment on this assumption.

24. This is not to suggest that consumers necessarily enjoy the effects of strong competition in the MVPD market. Rather, it simply points to the fact that there are alternatives to cable available to consumers and programmers today that were not available in 1992. We examine the nature of this competition below, with particular attention to the level at which competition can be deemed effective for purposes of both the subscriber and the channel occupancy limits. Effective competition, in this context, seems to mean competition sufficient to provide alternative means for programmers viably to reach consumers, thus protecting consumer choice and welfare. Below we seek comment supported by empirical evidence on the appropriate measure for determining when effective competition is reached in this context.

25. Additionally, as discussed in Section V on vertical limits, another important difference between today's competitive landscape and that of 1992 is the increase in the number of channels available on MVPDs. In 1992, a majority of cable systems had a channel capacity of between 30 and 53 analog channels.[69] Today, cable systems, on average, offer 80 analog channels, and cable operators continue to expand capacity through upgrades of cable plant.[70] Digital cable increases capacity even further, allowing transmission of six or more digital channels through the capacity formerly required by one analog channel. Indeed, DBS operators already offer hundreds of digital channels.

26. A principal objective of the subscriber limit provisions of Section 613(f) was to encourage development, innovation, and competition in the market for video programming by limiting concentration among cable operators, and the associated bargaining power of cable operators. Excessive bargaining power could enable cable operators to reduce unduly the economic returns of programmers, causing them to curtail their activities and thereby limit the quality and diversity of programming fare.[71] The task we face is to determine how to implement that congressional intent in today's dynamic MVPD marketplace. Below we describe the potential effects of high levels of concentration followed by a discussion of the implications of current market conditions.

B. Potential Effects of High Levels of Cable Concentration

27. To examine the effects of high levels of ownership concentration in the cable industry, we consider a hypothetical setting in which the absence of government restrictions enables substantial MVPD concentration. This exercise allows us to consider the potential harms and benefits of high levels of concentration.

28. **Potential Harms Resulting from Concentration:** There are several potential negative effects of high levels of concentration. First, as the Commission articulated in the *1999 Horizontal*

[68] The 1996 Act established open video systems ("OVS"), which is a regulatory category that can apply to any type of MVPD facility and generally is characterized by reduced regulatory burdens. *See* 47 U.S.C. § 573; *see also* 47 C.F.R. §§ 76.1500-14.

[69] *See House Report* at 31.

[70] *See Seventh Annual Report*, 16 FCC Rcd at 6017-18.

[71] *See* ¶ 3, *supra*.

Order, in a highly concentrated market, one or several MSOs could unfairly impede programming flow, either individually or through joint action. With such action, a single MSO or multiple MSOs might be able to determine the success or failure of a programming network, an outcome Congress sought to prevent.[72] We seek comment on the possibility of such action, including evidence that such action may have occurred in the past.

29. Second, large MSOs might gain power to affect vertical relationships and horizontal concentration within the industry. With regard to vertical relationships, MSOs with large programming interests may unfairly favor affiliated programming over unaffiliated programming. Another possibility is that a vertically integrated MSO may use its ties to affiliated networks to strategically create barriers to entry or otherwise disadvantage competing MVPDs by making access to affiliated programming more difficult.[73] Moreover, as discussed above, large MSOs have the ability to command large discounts on license fees from video programming networks, forcing prices toward marginal cost.[74] Networks may not have an incentive to enter the market or to be innovative in their programming if they do not anticipate being able to recover the fixed/sunk costs of network program development. This would impede "...the flow of video programming from the video programmer to the consumer" contrary to congressional intent.[75] We seek comment and empirical evidence on whether this problem has occurred in the past or is likely to occur if MSOs are not constrained by a subscribership limit. We also seek comment and empirical evidence regarding possible market solutions to this problem.

30. With regard to horizontal concentration, we have received comment in previous proceedings concerning the ability of large MSOs to disadvantage overbuild entrants due to the large programming license fee discounts the incumbents receive and by gaining exclusive contracts for nonaffiliated or terrestrially delivered programming.[76] At sufficiently high levels of concentration among

[72] Such a result is directly contrary to 47 U.S.C. § 533(f)(2)(A), which directs the Commission to "ensure that no cable operator or group of cable operators can unfairly impede, either because of the size of any individual operator or because of joint actions by a group of operators of sufficient size, the flow of video programming from the video programmer to the consumer."

[73] It should be noted that the Commission's Program Access rules ensure that competing MVPDs have nondiscriminatory access to satellite delivered affiliated programming. The rules, however, do not cover terrestrially delivered programming or non-affiliated programming. For a discussion of the effect of vertical integration on the supply of programming, see, *e.g.*, Waterman, David and Andrew A. Weiss, *Vertical Integration in Cable Television*, The MIT Press and The AEI Press, 1997 at 55-86 ("*Waterman and Weiss*"). For a more general discussion of the effects of vertical integration, see Riordan, Michael H. and Steven C. Salop, "Evaluating Vertical Mergers: A Post-Chicago Approach, *Antitrust Law Journal*, Vol 63, 1995.

[74] For an alternative view, see, *e.g.*, Chipty, Tasneem and Christopher M. Snyder, "The Role of Firm Size in Bilateral Bargaining: A Study of the Cable Television Industry," *Review of Economics and Statistics*, Vol 81, May 1999, at 338. Chipty and Snyder analyze the effects of mergers in terms of upstream and downstream efficiency gains and the bargaining process that takes place between cable operators and programming networks using 1993 data. Results of their study indicate that, in the absence of efficiency gains, mergers tend to reduce rather than enhance cable operators' bargaining position vis-à-vis programming suppliers because mergers generally reduce the amount of surplus revenue (advertising revenue minus the cost of producing programming) available for operators to appropriate from programming networks during negotiations. Within the framework of the Chipty and Snyder model, however, the primary explanation for mergers is upstream and downstream efficiency gains rather than increased bargaining power.

[75] 47 U.S.C. § 533(f)(2)(A).

[76] *See Seventh Annual Report*, 16 FCC Rcd at 6075.

cable MSOs, overbuild entrants and even DBS operators may be forced to pay programming license fees that are so high that continued operation is unprofitable. Cable MSOs with a disproportionately large number of subscribers may also be able to convince video programming networks not covered by program access rules to grant them exclusive rights at the expense of smaller competitors.[77] Since exclusive contracts would deny some programming to subscribers of alternative MVPDs, this would be contrary to congressional intent.[78] Such a situation could also harm consumers through a lessening or elimination of competition. Since competition can create incentives to offer a wider variety of programming and new services, it would appear that the lessening of competition may also impede the flow of programming to the consumer. We seek comment and empirical evidence on whether this problem has occurred in the past, or is likely to occur if MSOs are not constrained by an ownership limit. Empirical studies that examine the viability of DBS and overbuild competitors at various levels of cable concentration would be particularly helpful. A convincing showing that effective competition would be curtailed at a certain level of horizontal concentration in the cable industry might indicate an appropriate limit. We also seek comment on and empirical evidence regarding the ability of an independent DBS industry to provide a profitable outlet for programming networks, and we seek comment on how many subscribers DBS must serve in order to serve this function.

31. A third potential problem with MSO concentration relates to innovation and long-term performance in the MVPD market. If one or two MSOs came to dominate the cable industry, they might experience diminished incentive to innovate, either through upgrades and improvements in their plant and their customer service, or their program offerings? Some economists argue that monopolists are insufficiently motivated to minimize costs and to innovate, and therefore incur "X-inefficiencies."[79] We seek comment on, and empirical evidence to support the idea that larger MSOs are less innovative and more subject to X-inefficiencies. We also seek comment on whether horizontal ownership limits encourage entry into MVPD markets, and whether such increased entry would reduce the likelihood of X-inefficiencies.

32. A fourth potential problem relates to the competition *for* markets, not competition within markets. All cable systems in the United States are locally franchised, and local franchising authorities ("LFAs") review franchisee performance at renewal time. It is possible that the existence of multiple MSOs provide LFAs with alternatives at least as a means to compare the performance of the incumbent against other operators, referred to in the literature as "benchmarking."[80] If so, then the existence of

[77] *See Waterman and Weiss* at 148 for a discussion of possible modifications to the Commission's program access rules that would cover such circumstances.

[78] *Id.*

[79] X-inefficiency arises in a situation where the lack of competitive pressure leads management and employees to use their inputs less effectively than they could. As a result, costs are higher in monopoly markets than in competitive markets. More formally, according to Leibenstein, who coined the term, X-inefficiency is "... the extent to which a given set of inputs do not get to be combined in such a way so as to lead to maximum output." *See* Harvey Leibenstein, "Competition and X-Efficiency," *Journal of Political Economy*, May 1973, at 766. *See also* Harvey Leibenstein, "Allocative Efficiency vs. 'X-Efficiency,'" *American Economic Review*, Vol. LVI 1966, at 392-414 and William S. Comanor and Harvey Leibenstein, "Allocative Efficiency and the Measurement of Welfare Losses," *Economica*, Vol. XXXVI, Aug. 1969, at 304-09.

[80] *See, e.g., In the Applications of NYNEX Corporation Transferor, and Bell Atlantic Corporation Transferee, for Consent to Transfer Control of NYNEX Corporation and its Subsidiaries, Memorandum Opinion and Order*, File No. NSD-L-96-10, 12 FCC Rcd at 20058-60 (1997), for a discussion of regulatory benchmarking.

multiple MSOs could provide a helpful check on MSO practices in their franchise areas.[81] Further, under some circumstances, it may be helpful for LFAs to refer to franchise agreements negotiated in other franchise areas with different MSOs, particularly as evidence that elements of those franchise agreements are not financially ruinous.

33. We recognize that LFAs' ability to review incumbent cable systems' offerings is limited. The 1992 Cable Act bars LFAs from considering incumbents' "mix or quality" of specific programming at renewal.[82] This limitation does not, however, prevent LFAs from considering generally whether incumbents' renewal proposals are reasonable in terms of community needs and interests.[83] Therefore, we believe that there is some potential for using other cable operators' offerings and performance to influence the behavior of an incumbent cable operator.

34. We seek comment and empirical evidence on whether LFAs actually use the performance of other MSOs in order to discipline the behavior of their franchisees, and on how extensive this disciplining effect is. Do LFAs rely on the ability to refer to franchise agreements negotiated in other franchise areas? Would small LFAs be greatly disadvantaged in franchise renewal negotiations if the market consisted of only a few extremely large MSOs? We also seek comment regarding the ability of a start-up cable firm to take over an under-performing franchise at renewal time. Again, we are interested in the relevance of deep programming discounts that an extremely large MSO might command. At what point would such discounts make competition economically infeasible, and thus eliminate the helpful effects of potential entry?

35. A fifth potential problem with MSO concentration stems from the effects of high levels of concentration on programming choices offered by MVPDs to their subscribers. Some economists have argued that a monopoly MVPD would provide fewer choices among similar types of programming and charge higher prices for that programming than competitive MVPDs.[84] This is because a monopolist will not offer new programming that significantly reduces the demand for existing programming and thereby reduce the revenues generated by the existing programming. This consideration, coupled with a monopolist's pricing power, could result in higher prices and a more limited selection of programming. Competitive MVPDs, on the other hand, are likely to offer programming networks that include substitutes as long as that programming generates sufficient revenues to cover program production costs.[85] We seek comment on the possible effects of the level of concentration on programming choice. In particular, we seek comment and empirical evidence on whether very large MSOs would carry less programming content or less diverse content than consumers would desire.

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[81] Overbuilders might be able to fulfill this role if they were able to be competitive in a world with only a single MSO, or several very large MSOs.

[82] *See* 47 U.S.C. § 546(c)(1)(B).

[83] *See* 47 U.S.C. §§ 546(c)(1)(C), (D); *see also Senate Report* at 47.

[84] *See, e.g.,* Owen, Bruce M., and Steven Wildman, *Video Economics,* Harvard University Press, 1992 at 116 ("*Owen and Wildman*"). Also, *see* Spence, A. Michael, and Bruce Owen, "Television Programming, Monopolistic Competition, and Welfare," *Quarterly Journal of Economics*, 1977 at 112.

[85] Alternatively, to the extent that a monopolist MVPD may tend to offer a programming line-up that does not include many highly similar programming networks, it tends to reduce program duplication and thereby may provide a greater variety of programming. This outcome has been simulated in economic models that demonstrate that a monopolist has an incentive, other things being equal, to offer a greater variety of programming than do firms that compete with each other. *See Waterman and Weiss* at 63 and *Owen and Wildman* at 100.

36. **Potential Benefits of Concentration:** There are also potential positive effects of MSO concentration. Some economists, most notably Schumpeter, suggest that monopoly can be more conducive to innovation than competition, since monopolists can more readily capture the benefits of innovation.[86] Moreover, a concentrated market may enjoy efficiencies as a result of economies of size and scale. In addition, the operator with increased bargaining power may pass some of its savings on to consumers in the form of lower rates (or smaller rate increases).

37. Another potential benefit of concentration stems from the characteristics of video programming. As noted above, the viewing of video programming by one person does not lower the amount of programming available for consumption by others. Programming also involves low marginal cost for additional distribution, and high sunk and fixed costs.[87] Theoretically, a high level of concentration among MVPD providers might mitigate some of the problems associated with such characteristics. As an example, an MVPD market having a single provider would not experience the problem that could result when programmers try to recover revenues lost to discounts granted to large MSOs by charging higher fees to smaller MSOs.[88] This problem might be avoided in a single MVPD scenario since the program distributor (i.e., the MVPD) would absorb a greater amount of the sunk costs incurred in the production of new programming (analogous to the "first copy" costs in publishing) in order to ensure the economic viability of essential programmers, and thus the continued supply of high quality programming.[89] This potentially could increase the supply of high quality and diverse programming to consumers by reducing the risks associated with the production and acquisition of programming.

38. We seek comment on the empirical evidence of whether small MSOs absorb most of the first copy costs associated with program production. This issue seems likely to be most pressing when there is a single large cable MSO and several smaller cable and non-cable MVPDs. By contrast, in a highly fragmented market in which no MVPD could command significant programming discounts, this type of problem tends to dissipate. We seek comment on the effect of a heavily concentrated cable sector on the ability of programmers to recover all relevant operating costs and on non-cable competitors' ability to acquire programming at competitive rates.

39. This potential benefit associated with high levels of concentration, however, depends upon several factors that are not likely to occur in practice. In a highly concentrated industry, operators may demand excessive discounts from programmers because of the market power they enjoy. Because MVPDs depend upon programmers for content, even a monopoly MVPD would not *knowingly* harm

[86] *See, e.g.*, Schumpeter, Joseph, *The Theory of Economic Development*, Oxford University Press (1961).

[87] *See* ¶ 14, *supra*.

[88] Generally, this problem can arise in a setting with large fixed costs of production and near-zero costs for distributing the product to additional buyers. This can cause a failure to recover completely the high sunk costs involved in production, including program production costs. In the current market, large MSOs may have sufficient bargaining power to be able to command programming license fee discounts that are so large that they enable video programming networks to recover only their variable costs and not their sunk costs of programming production. Video program networks that provide such discounts may be compelled to recoup costs by charging smaller MVPDs, which have less bargaining power, higher license fees to offset the discounts demanded by the larger MSOs. In principle, this problem may be reduced by vertical integration or other forms of investment alliances. *See Waterman and Weiss* at 74.

[89] Theoretically, another possible solution to this type of problem is a highly fragmented market in which no single entity has the bargaining power required to command discounts.

programming networks by demanding excessive discounts. In order to avoid harming programmers, however, the operator would have to have an intimate knowledge of the programmers' cost structure, which is unlikely in practice.[90] As a result, the operator might unwittingly force video programmers to accept compensation that does not cover all of their relevant costs, thus reducing programmers' ability to provide high quality programming or, possibly, forcing some out of business. In addition, in the absence of meaningful competitive alternatives, customers may continue to purchase the product of the dominant MVPD operator even if the quality of that product declines. This would enable the operator to choose programming for reasons other than quality, such as the desire to ensure the profitability of an affiliated programmer.

40. In view of the potential benefits and harms of concentration, on balance, it appears likely that high levels of concentration have the potential to harm both consumers in downstream markets and programming suppliers in the upstream market. Moreover, Congress has expressed a concern that concentration in downstream markets would be detrimental to MVPD consumers generally and to the health of the video program packaging industry specifically. In meeting congressional intent and fulfilling our mandate under Section 613(f), we believe it is incumbent upon us to fashion regulations that would preclude a single MSO from serving all cable subscribers nationwide. We seek comment on this conclusion.

C. Implications of Current Market Conditions

41. As discussed in our description of the programming markets, we have observed two trends in the MVPD marketplace - - increased competition from DBS and expanded channel capacity through system upgrades and the use of advanced digital technologies. These two trends may reduce the potential harm to video program networks that could flow from increased concentration in the cable industry. Indeed, even if a single MSO owned or controlled all cable systems, a programmer denied access to its cable subscribers now might be able to reach millions of consumers through DBS.[91] Still, it is possible that substantial concentration could create an environment in which a single large MSO could determine independently the success or failure of video programming networks, an outcome Congress sought to prevent.[92]

42. As discussed above, economic studies dealing with both horizontal concentration and vertical integration in the cable industry show that there may be potential benefits as well as costs associated with such concentration and integration at levels similar to those found in the industry today.[93]

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[90] For instance, it is unlikely that Cox, which owns no programming networks, has any detailed information regarding the cost structure of ESPN, a programmer with no MSO affiliation.

[91] For example, NFL Direct Ticket reaches consumers exclusively through DirecTV, and Echostar carries certain ethnic programming exclusively. These programmers were not denied access to cable subscribers, but their carriage on DBS demonstrates that it is possible to reach consumers through means other than cable systems.

[92] We also recognize that cable concentration may have implications for services that are new or under development, such as interactive programming services. Although it is impossible to measure the effect of cable concentration on services that are as yet undefined, our rules should be designed to promote a fertile environment in which such services may grow and develop.

[93] *See generally* Chipty, Tasneem, "Horizontal Integration for Bargaining Power: Evidence From the Cable Television Industry," *Journal of Economics & Management Strategy*, Vol. 4, Summer 1995, at 375-97; Ford, George S. and John D. Jackson, "Horizontal Concentration and Vertical Integration in the Cable Television Industry, *Review of Industrial Organization*, Vol. 12, 1997, at 501-18; *Waterman and Weiss* at Chapter 7; Shooshan, Harry (continued....)

As competition increases and the number of distribution outlets grows, the buying power of each entity typically decreases, as do the opportunities for vertical foreclosure. It also appears that there is increasing diversity within the video programming market as a result of large increases in channel capacity over the past several years (*e.g.*, MSNBC and FoxNews have been able to emerge as competitors to CNN despite CNN's first mover advantage in that market). In addition, because video programming is critical to program packagers and programming networks are critical to MVPDs, each level in the programming distribution chain has an interest in the economic health of the other levels. While these facts do not eliminate the possibility of vertical foreclosure, it appears that cable MSOs, especially in the face of DBS' nationwide reach, have an interest in offering the most competitive programming possible, regardless of its source.[94]

43. On the other hand, at much higher levels of concentration, if a cable operator had significant bargaining power, it might use that power to pay a lower price for programming than competing buyers pay, and may perceive a reduced need to secure innovative, high quality programming. The result may be that viewers receive less high quality programming. If the purchasing firm is also vertically integrated, it may find it profitable to engage in anti-competitive behavior by raising the cost of entry to rival firms in the distribution or the programming markets.[95] Moreover, as discussed above, a large firm with significant bargaining power might command price discounts for programming large enough to preclude competition from other potential entrants in the MVPD market or may be able to gain exclusive contracts for programming that damage competitors. More specifically, the costs of such a large MSO potentially could be so low that it could render overbuild startups economically infeasible, or it could force the prices that other MVPD providers pay for programming to be so high that they could no longer compete profitably with cable.[96] We seek comment on how higher levels of concentration affect program acquisition costs and also on the prevalence of exclusive distribution contracts.

44. We seek to adopt regulations that are appropriate given the market power of cable operator in today's dynamic and changing MVPD marketplace.[97] We ask commenters to address the relevance of the developments that have occurred since 1992 and those that are likely to occur in the

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M., "Cable Television: Promoting a Competitive Industry Structure," in *New Directions in Telecommunications Policy: Volume 1, Regulatory Policy: Telephony and Mass Media*, Paula R. Newberg, ed., Duke University Press, 1989, at 222-46; and TCI Comments in Docket 92-264 at App. A, Besen, Stanley and John Woodbury, *An Economic Analysis of the FCC's Cable Ownership Restrictions*, August 1998, ("*Besen and Woodbury*").

[94] There is also some question concerning the level of editorial control that MVPDs exercise over programming networks, whether the networks are vertically integrated or not. Given our three level description of the market above, it appears that most editorial decisions concerning selection of content occur when video program packagers select video program content from producers, not when MVPDs select video programming networks. This is driven by the fact that cable operators purchase video programming networks as a package, i.e., as one or more 24-hour networks. Of course, the MVPD remains the ultimate gatekeeper since it makes the final decision on the networks it will carry, and those decisions ultimately determine what programming is actually seen and heard by subscribers.

[95] An example of such behavior might include the denial by a vertically integrated MSO of terrestrially delivered affiliated programming to a rival MVPD, a situation which would not be covered under present program access rules. *See Waterman and Weiss* at 56-86 for a further discussion of anti-competitive strategic behavior.

[96] On average, programming costs account for one third of a cable system's expenses. *See e.g.*, U.S. Bureau of Census, *Annual Survey of Communication Services*, at 20 (1998).

[97] *See* 47 U.S.C. § 533(f)(2)(E); *see also* ¶¶ 21-25, *supra*.

MVPD marketplace in the future. We also ask commenters to address our conceptualization of the market structure and the ownership patterns that exist, to provide empirical or theoretical analyses that support or contradict our assessments, and to discuss the bearing such information has on the suggested regulatory approaches. Additionally, we ask commenters to discuss whether the suggested regulatory approaches adequately account for competition and market power in the industry, and whether they properly account for the elasticities of supply and demand, both in the acquisition and the distribution of multi-channel programming. In particular, we seek comment on whether increased bargaining power by programming networks renders additional concentration among MVPDs less harmful to viewers. Mindful of the Section 613(f)(2) public interest factors, we ask commenters to consider the potential beneficial and detrimental effects of the regulatory approaches suggested below.[98] We seek comment on the possible efficiencies and other service benefits, such as innovation in the distribution of programming, that potentially might be gained through less restrictive ownership limits. We also seek comment on the impact of relaxed ownership limits, which potentially could lead to fewer -- but more powerful -- gatekeepers, on the opportunities for new programming networks to successfully enter the market, on innovation in programming, and on consumer choice. With respect to each identified harm or benefit of increased concentration in cable ownership, we seek comment on: (1) the theoretical basis for the existence of such harm or benefit; (2) the empirical evidence that such harm or benefit is or is not occurring at present levels of concentration; and (3) the specific limits on concentration required to address a particular harm or the degree of concentration necessary to achieve a particular benefit. Finally, consistent with Section 613(f)(2), we seek comment on other public interest objectives the Commission should consider in reexamining the horizontal limit.

45. In light of the structural changes in the industry since the adoption of the 1992 Act, we examine the foregoing issues in more detail below with the goal of developing a regulatory approach that is consistent both with congressional intent and with the D.C. Circuit's decision in *Time Warner*.

IV. HORIZONTAL LIMIT

A. The Commission's Horizontal Ownership Rule

46. The Commission's horizontal ownership limit bars a cable operator from owning or having an attributable interest in cable systems that in the aggregate reach more than 30 percent of MVPD subscribers nationwide.[99] In setting the horizontal limit at 30 percent, the Commission sought to address

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[98] *See* 47 U.S.C. § 533(f)(2)(G); *see also* ¶ 4, *supra*.

[99] 47 C.F.R. § 76.503. Section 76.503 provides, in pertinent part:

> (a) Subject to paragraph (b) of this section, no cable operator shall serve more than 30% of all multi-channel-video programming subscribers nationwide through multi-channel video programming distributors owned by such operator or in which such cable operator holds an attributable interest.
>
> (b) Cable subscribers that a cable operator does not serve through incumbent cable franchises shall be excluded from the cable operator's limit.
>
> (c) For purposes of this section, "incumbent cable franchise" means a cable franchise in existence as of October 20, 1999, and all successors in interest to these franchises.
>
> (d) Subscribers that a cable operator serves through incumbent cable franchises shall include all subscribers served by those incumbent cable franchises, regardless of when the subscribers were added to the incumbent cable franchise.

(continued....)

congressional "concerns regarding the development of the video-programming market" on a national scale,[100] by preventing a single large cable operator or a group of operators from "collectively deny[ing] carriage to a new programmer, either by unilateral, independent decisions or by tacit collusion."[101] Analyzing industry data, the Commission estimated that a new programming cable network would need access to 40 percent of the MVPD subscribers nationwide to be viable.[102] The 30 percent limit, the Commission reasoned, would allow new programming networks access to a 40 percent "open field" by ensuring the presence of at least four cable operators in the market, and by preventing the two largest cable operators from garnering more than 60 percent of the market.[103] In this regard, the Commission explained, "... even if two operators, covering 60% of the market, individually or collusively deny carriage to a programming network, the network would still have access to 40% of the market, giving it a reasonable chance of financial viability."[104] Additionally, the Commission believed that the more MSOs there were purchasing programming, the greater the likelihood that different programming choices would be made and that diverse voices would be carried.[105]

47. The Commission recently reformulated the methodology used for calculating the 30 percent horizontal limit in an effort to better gauge MSOs' market power in the national video-programming market.[106] The current limit is based on the aggregate number of subscribers served, rather than the number of cable homes passed by an MSO's cable systems. The Commission determined that a subscriber-based calculation represented a more accurate measurement of "market power," given that cable operators deal with and purchase programming from cable networks based on the actual number of

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(e) "Multi-channel video-programming subscribers" means subscribers who receive multi-channel video-programming from cable systems, direct broadcast satellite services, direct-to-home satellite services, multi-channel multipoint distribution services, local multipoint distribution services, satellite master antenna television services (as defined in § 76.5(a)(2)), and open video systems.

(f) "Cable operator" means any person or entity that owns or has an attributable interest in an incumbent cable franchise.

(g) Prior to acquiring additional multi-channel video-programming providers, any cable operator that serves 20% or more of multi-channel video-programming subscribers nationwide shall certify to the Commission, concurrent with its applications to the Commission for transfer of licenses at issue in the acquisition, that no violation of the national subscriber limits prescribed in this section will occur as a result of such acquisition.

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[100] *1999 Horizontal Order*, 14 FCC Rcd at 19105.

[101] *Id.* at 19116.

[102] The 40 percent "open field" was based on the Commission's findings that in order to be viable, a new programming network needs to access approximately 15-20 million subscribers (20 percent of the market), and that, even with such access, it has only a 50 percent chance of actually reaching subscribers given tier packaging and consumer preferences. *See 1999 Horizontal Order*, 14 FCC Rcd at 19115-18.

[103] *Id.*

[104] *Id.* at 19119.

[105] *Id.*

[106] *Id.* at 19098.