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
	)	

MOTION TO SUBSTITUTE COMMENTS OF CFA, *ET AL.*

On January 4, 2001, CFA, *et al.* timely filed comments in the above-captioned proceeding. CFA, *et al.* seek leave to substitute the revised version of those comments as attached hereto to correct several minor typographical errors and to remove reference to the National Association of Telecommunications Officers and Advisors (NATOA) as joining in the comments.

Respectfully submitted,

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January 7, 2002

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

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COMMENTS OF
CONSUMER FEDERATION OF AMERICA,
CONSUMERS UNION, MEDIA ACCESS PROJECT
CENTER FOR DIGITAL DEMOCRACY, THE OFFICE OF COMMUNICATION OF THE UNITED CHURCH OF CHRIST, INC., ASSOCIATION FOR INDEPENDENT VIDEO AND FILMMAKERS, NATIONAL ALLIANCE FOR MEDIA ARTS AND CULTURE, AND THE ALLIANCE FOR COMMUNITY MEDIA

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January 4, 2002

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EXECUTIVE SUMMARY

The importance of the 1992 Cable Act's as yet unfulfilled directive, that the Federal Communications Commission (FCC) impose an effective limit on cable television system ownership, has been demonstrated by the fact that competition for video services has failed to develop over the last ten years:

- If approved, the proposed merger of AT&T Broadband and Comcast would permit that consolidated company to own cable systems serving more than 40% of total U.S. cable subscribers (about 34% of multi-channel video programming distributor, or MVPD, households), giving it the power to determine who "makes it" in the programming market.

- Cable rates continue to skyrocket, exceeding the rate of inflation by leaps and bounds, as cable companies continue to consolidate and increase control over popular programming and Internet content.

- There is no sign that satellite service or the Internet offers meaningful competition to the core cable multichannel video market.

The FCC has the clear power and obligation to adopt a stringent ownership limitation, as demonstrated in **Part I** of these comments. The 1992 Act has been upheld as constitutional, under the authority of the Supreme Court's declaration that the FCC is compelled to promote both competition and diversity. Although a panel of the U.S. Court of Appeals later rejected the FCC's justification for a 30% national ownership cap under that law, there is overwhelming legal and factual support for re-adoption of a similar rule, albeit with a much more thoroughly articulated rationale (**Chapter I**).

The language of the law could not be more explicit. Section 613(f)(2) of the Communications Act requires the Commission, "among other public interest objectives," to:

> ***ensure*** that no cable operator or group of operators can unfairly impede, either because of the size of any individual operator or because of the joint actions by a group of operators of sufficient size, the flow of video programming from the video programmer to the consumer;

> ***ensure*** that cable operators affiliated with video programmers do not favor such programmers in determining carriage on their cable systems and do not unreasonably restrict the flow of video programming of such programmers to other video distributors; [and to]
>
> ***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…

In remanding the cable ownership issue to the FCC for further justification, the *Time Warner II* court did not weaken this Congressional mandate. Rather, it rebuked the FCC for laziness in presenting its facts and analysis, saying that a 30% limit would not stand unless the FCC did its homework.

Antitrust law alone would support imposition of a 30% ownership limit. However, the FCC is charged with going beyond what the antitrust laws would require. Even after the D.C Circuit's *Time Warner II* decision, the Commission can fulfill its Congressional mandate to promulgate a rule that will promote effective competition only by reestablishing a cap that is ***below*** what antitrust law alone would otherwise provide. Unlike antitrust law, which focuses on ***preserving existing competition***, Section 613(f) mandates a limit that will "***enhance effective competition.***"

Moreover, the FCC must also promote First Amendment values by taking such additional steps as are necessary to ***enhance diversity***. Although the court ruled that the Commission could not rely ***solely*** on a diversity rationale to impose its rules, enhancing diversity and competition remain the two primary goals that the Commission must meet in establishing a prophylactic, structural scheme. As described in **Chapter II**, policies to promote the "widest possible dissemination of information from diverse and antagonistic sources" have

the full support of the Supreme Court. Thus what the Commission must do is articulate more persuasively the role of diversity, in conjunction with enhancing competition, and point to the additional evidence in the record presented by CFA *et al. t*o support its conclusions.

CFA *et al.* demonstrate in this analysis that economic theory clearly identifies market conditions in which the abuse of market power is likely (**Part II**). It shows that the widely recognized economic characteristics of the cable industry make it prone to the abuse of market power, which the Congress feared. **Chapters III, IV and V** carefully define and describe the measurement of market power, which are critical steps to understanding the structural problems in the cable industry. **Chapter VI** describes the unique vertical leverage that exists in industries that are based on communications platforms. This vertical dimension must be taken into account to understand the incentive and ability of cable operators to discriminate against potential competitors and to distort competition.

CFA *et al.* demonstrate in this filing that the Commission has previously presented too narrow a view of the dangers to competition and diversity of allowing consolidation above a 30% level. By failing to describe its "open field" analysis more completely in the context of the overall MVPD market and its structure, the Commission presented the Court of Appeals (in *Time Warner II*) with an incomplete picture of the dangers inherent in excessive horizontal consolidation in this industry.

CFA *et al.* present a comprehensive explication of the highly concentrated MVPD market at the transmission, code, and content layers. The analysis demonstrates how the inability of cable's competitors to develop easily substitutable products has made it particularly difficult to develop competition and promote diversity.

The empirical evidence presented in **Part III** demonstrates how horizontal concentration and vertical integration in the cable industry, overlaid on an industry with substantial barriers to entry, render it vulnerable to abuse of market power (**Chapter VII**).

The CFA *et al.* analysis of cable industry behavior presents the Commission with concrete, contemporary examples of cable operators leveraging their market power to discriminate against competing video distribution mechanisms, known as conduit discrimination (**Chapter VIII**). This strategy includes denial of access to vertically integrated programming and muscling independent programmers to withholding content from competing distribution facilities. It also exposes practices that discriminate against unaffiliated programmers by denying access to the public served by cable distribution plants, known as content discrimination. Numerous concrete, contemporary examples of both denial of access and extraction of discriminatory rates, terms, and conditions are provided to illustrate how large cable companies can undermine competition and diversity in the programming/content market.

The performance of the cable industry supports the conclusion that it has and is exercising market power (**Chapter IX**). Prices are rising far faster than inflation. Consumers are denied choice by the industry's strategy of creating ever-larger bundles of services. Not only is the industry becoming more concentrated (as measured by the HHI index) but also it is overcharging consumers (as measured by the Lerner index), and capturing massive monopoly profits (as measured by Tobin's q ratios). Each of these measures indicates that the overall competitive situation has become worse since 1992, when Congress charged the Commission with setting a reasonable limit on ownership.

Because cable operators virtually never compete head-to-head, policy makers and the

public have been forced to rely upon the unkept promise that cross-technology competition will break the cable industry's monopoly hold on the multichannel video market. The clear evidence of the existence, persistence and exercise of market power indicates that these technologies—satellite and the Internet—have failed to live up to their promise. **Part IV** analyzes these two technologies and shows why they have not been, and are not likely to be able to discipline cable's market power in the foreseeable future.

Despite superficial claims that introduction of direct broadcast satellite (DBS) service and the emergence of the Internet have somehow eliminated the need for stringent ownership rules, CFA *et al.* demonstrate that these nascent phenomena have neither changed the overall picture of concentration nor obviated the need for a 30% limit. **Chapter X** presents a broad range of data which show that DBS is not a substitute for cable. DBS remains nothing more than a niche product purchased by people who cannot get cable (40% of DBS subscribers cannot get cable) or viewers who are willing and able to purchase expensive specialty bundles, such as sports channels and foreign language services.

While the Internet is filled with potential and provides revolutionary functionalities that enhance people's daily lives by facilitating communications, it currently plays no measurable role in video markets. **Chapter XI** demonstrates that it cannot possibly discipline cable today, and its promise to do so in the future is still theory, not fact. Because the preferred next-generation broadband Internet connections— which could deliver video-on-demand or similar video products— are owned primarily by large cable multiple systems operators (MSOs) that also have immense leverage over programming and Internet content, the chances that this technology can batter down the walls of the monopoly are slim. Those MSOs have rejected the open model of the first generation Internet by placing limits on us-

ers who wish to stream video. They have turned their networks into "walled gardens" where users are surreptitiously nudged towards affiliated content providers, rather than allowed to roam free on an open Internet. Instead of disciplining cable providers, the Internet is becoming an even more powerful tool for MSOs to extract monopoly profits from consumers.

Finally (**Part V**), CFA *et al.* present a specific quantified defense of the 30 percent limit based on the previous market structural analysis. **Chapter XII** shows that a limit of 20 to 30 percent is necessary to curb the market power of cable operators acting as "monopsonists" (large buyers) in the national market. CFA *et al.* also demonstrate that a 20 to 30 percent limit was justified and remains so based on the "open field" analysis which the Commission formerly applied. In fact, *CFA et al.* demonstrate that an even lower limit would be appropriate in today's market.

In establishing a cable horizontal ownership limit, the Commission previously calculated that a 40% open field was necessary for new programming to succeed. However, given both rising programming costs and increased consolidation within the industry, CFA *et al.* show that the open field necessary for programming to succeed in today's marketplace must be significantly larger. Programmers today need to reach millions more viewers to cover their rising costs than when the FCC initially calculated the "open field." To preserve an "open field" sufficient to provide an incentive for entry of independent programmers, the Commission must re-impose a cap no greater than 30%.

Chapter XIII argues that the Commission must also promote diversity in setting a horizontal limit. *CFA et al.* demonstrate that ownership concentration negatively affects diversity and civic discourse. Where the Commission identifies a zone of reasonableness based on purely economic considerations, diversity concerns should cause it to choose a

number in the lower end of that range.

Based on overwhelming evidence of a highly concentrated market, enormous incentives to undercut competition and diversity in programming, and strong evidence of efforts to exercise this market power, CFA *et al.* urge the FCC to reinstate the 30% rule. The market structure analysis, supported by overwhelming evidence, is more than enough to satisfy the Commission's obligations under *Time Warner II*. Without establishment of a 30% or lower horizontal ownership limit, the FCC will fail to meet Congress's goal of enhancing effective competition, leaving consumers paying inflated prices for programming that fails to meet all their needs.

COMMENTS

COMMENTERS

Consumer Federation of America, Consumers Union, Media Access Project, the Center for Digital Democracy, the United Church of Christ, Office of Communication, Inc., the Association of Independent Video Filmmakers, and the Alliance for Community Media (collectively "CFA, *et al.*"),[1] file the following comments in the above captioned proceedings.

[1] The Consumer Federation of America (CFA) is the nation's largest consumer advocacy group, composed of two hundred and eighty state and local affiliates representing consumer, senior, citizen, low-income, labor, farm, public power and cooperative organizations, with more than fifty million individual members. CFA is online at www.consumerfed.org. Consumers Union (CU), publisher of Consumer Reports, is an independent, nonprofit testing and information organization serving only consumers. CU is online at www.consumersunion.org. Media Access Project (MAP) is a 28 year-old non-profit, public interest telecommunications law firm which represents civil rights, civil liberties, consumer, religious and other citizens groups before the FCC, other federal agencies and the Courts. MAP is online at www.mediaaccess.org. The Center for Digital Democracy (CDD) is committed to preserving the openness and diversity of the Internet in the broadband era, and to realizing the full potential of digital communications through the development and encouragement of

PART ONE:
LEGAL ANALYSIS

I. LEGAL BACKGROUND OF THE 1992 ACT

A. ALTHOUGH *TIME WARNER II* REQUIRES THE COMMISSION TO REST ITS DECISION ON "SUBSTANTIAL EVIDENCE" RATHER THAN A "RATIONAL BASIS," IT DOES NOT EFFECT THE ABILITY OF THE COMMISSION TO MAKE PREDICTIVE JUDGMENTS OR THE REQUIREMENT THAT THE LIMIT ENHANCE COMPETITION AND PROTECT DIVERSITY.

The *FNPRM* seeks comment on how the Commission should formulate the horizontal ownership limit in the wake of *Time Warner II*. *FNPRM* ¶51. In particular, the Commission seeks comment on whether and how to evaluate diversity concerns. *Id.* at ¶59.

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noncommercial, public interest programming. CDD is online at www.democraticmedia.org. The Office of Communication of the United Church of Christ, Inc. (UCC) is a non-profit corporation, charged by the Church's Executive Council to conduct a ministry in media advocacy to ensure that historically marginalized communities (women, people of color, low income groups, and linguistic minorities) have access to the public airwaves. The United Church of Christ has 1.4 million members and nearly 6,000 congregations. It has congregations in every state and in Puerto Rico. UCC maintains a website at www.ucc.org. The Association of Independent Video and Filmmakers (AIVF) is a 25-year-old professional organization serving international film- and videomakers from documentarians and experimental artists to makers of narrative features. AIVF represents a national membership of 5,000, 4,000 of whom are active independent producers. AIVF provides services to the field including: informative seminars and networking events, trade discounts and group insurance plans, advocacy for media arts issues, a public resource library, advice and referral support, and publication of books and directories. AIVF maintains a website at www.aivf.org. The National Alliance for Media Arts and Culture ("NAMAC") is a nonprofit association composed of diverse member organizations who are dedicated to encouraging film, video, audio and online/multimedia arts, and to promoting the cultural contributions of individual media artists. NAMAC's regional and national members collectively provide a wide range of support services for independent media, including media education, production, exhibition, distribution, collection building, preservation, criticism and advocacy. NAMAC's member organizations include media arts centers, production facilities, university-based programs, museums, film festivals, media distributors, film archives, multimedia developers, community access TV stations and individuals working in the field. Combined, the membership of these organizations totals around 400,000 artists and other media professionals. NAMAC maintains a website at www.namac.org. The Alliance for Community Media (ACM), nonprofit, national membership organization founded in 1976, represents over 1,500 Public, Educational and Governmental (PEG) access organizations and community media centers throughout the country. It also represents the interests of millions of people who, through their local

In March 2001, the U.S. Court of Appeals for the District of Columbia Circuit rejected the FCC's explanation justifying the 30% limit and remanded for further proceedings. The *FNPRM* asks what effect the *Time Warner II* decision has on the record it must compile, and on how it should evaluate diversity concerns when formulating the rule.

The *Time Warner II* Court applied an intermediate scrutiny standard of review. *Time Warner II*, 240 F.3d at 1130. It therefore employed a stronger evidentiary showing than would otherwise be required. *Id.* Nevertheless, the court made it clear that the agency is empowered to make predictive judgments:

> substantial evidence does not require a complete factual record -- we must give appropriate deference to predictive judgments that necessarily involve the expertise and experience of the agency. But the FCC has put forth no evidence at all.

Id. at 1133 (citations omitted).

Although the Court speculated that the FCC had justified a 60% limit on the record before it, it did not mandate any particular numeric limit. *Id.* The Court also acknowledged that any limit selected would have a "residue of arbitrariness." *Id.* at 1137. However, it said, the limit chosen must bear a rational relationship to the justification articulated by the Commission, and the evidence supporting it. *Id.*

As to diversity considerations, the Court found that the Commission could not rely ***solely*** on diversity as the rationale for the rule. *Id.* at 1135-36. Diversity remains one of the

---

religious, community and charitable groups, use PEG access to communicate with their memberships and the community as a whole. ACM is online at www.alliancecm.org.

two primary concerns animating the statute, and the dual goals of diversity and competition still require the Commission to act prophylactically. *Id*. at 1130.[2]

In its Opposition to the *Petition for Writ of Certiorari* from the decision in *Time Warner II* filed by CFA, *et al.*, the Commission assured the Supreme Court that:

> The court of appeals' decision does not foreclose the FCC's 30% subscribe limit; ***it simply requires greater record substantiation for the FCC's marketplace assumptions.***

FCC Opposition to Cert. at 7.

The Commission also observed that:

> Indeed, to the extent that the court of appeals opinion may be interpreted as insisting on specific prior evidence of anti-competitive conduct, it would be inconsistent the court's earlier determination that the subscriber limit is a 'structural limitation' that was intended to 'add[] a prophylaxis to the law.' *Time Warner I*¸ 211 F.3d at 1320.

Id. at 9.

As regard to its ability to consider diversity, the FCC stated:

> The court of appeals found the promotion of diversity to be an insufficient justification for the rule because 'at some point . . . the marginal value of such an increment in diversity would not qualify as an 'important governmental interest'… That concern about *de minimis* enhancements in diversity, however, has no relevance here….The court's ability to imagine hypothetical situations where the incremental increase in diversity might not justify a regulation thus provides no basis for invalidating a regulation whose actual and foreseeable operations substantially enhances the Congressional goal of diversity.

Id. at 10-11.

The FCC concluded that review by the Supreme Court was not warranted because "the court's decision was limited to the record before it" and the FCC could sustain the 30%

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[2] Indeed, it is impossible that the *Time Warner II* Court could have altered the legal findings of the *Time Warner I* Court, since the rules of the Circuit prevent one panel from overruling another. *Insurance Agents' Int'l Union v. NLRB*, 260 F.2d 736 (1958), *aff'd*, 361 U.S. 477 (1960).

limit on the basis of a stronger showing or new theories, and with the benefit of a more recent record. *Id.* at 11-12.

Thus, *Time Warner II* has the following substantive effects:

First, the Commission must take care to clearly articulate the economic and legal rationale supporting its decision, and must point to specific evidence in the record or presumptions of law that support its conclusions.

Second, the FCC may not rely on its traditional policy to promote diversity as the sole justification for the rule. The traditional diversity concerns continue to inform the Commission's analysis, but it must prove that enhancement of diversity under the rule is substantial rather than *de minimus*.

Third, in formulating the rule, the Commission must recognize that Congress's overarching purpose was to "enhance effective competition." Congress was entitled to choose enhancing competition as its vehicle for protecting diversity in the marketplace of ideas and protecting subscribers from abuse by MSOs. *See* H.R. Rep. No. 102-628 (1992) ("House Report") at 43. Accordingly, the Commission must clearly articulate how the rule will enhance competition and protect diversity.

B. THE LEGAL FRAMEWORK FOR FORMULATING THE LIMIT: ENHANCING, NOT MERELY PROTECTING, COMPETITION.

As the *Time Warner II* court observed, the overriding purpose of Section 613(f) is to "enhance effective competition." *Time Warner II*, 240 F.3d at 1136. This fulfills Congress' twin purposes of preventing anticompetitive behavior by cable MSOs and enhancing the availability of diverse programming without fear of corporate control. *Time Warner I*, 211

F.3d at 1319; S.Rep. No. 102-92 (1991) ("Senate Report") at 32-33. As the House Report explained:

> The Committee continues to believe that competition is essential both for ensuring diversity in programming and for protecting consumers from potential abuses by cable operators with market power….The Committee believes that steps must be taken to encourage the further development of robust competition in the video programming marketplace.
>
> House Report at 44.

Congress reached its conclusions on the basis of an extensive record compiled over the course of three years, and distilled its lessons into "unusually detailed legislative findings." *Turner I,* 512 U.S. at 646. At that time, the largest MSO, TCI, controlled only 24% of the market; the top five firms controlled just over half of the market. *Senate Report* 32. The drafters found, however, that despite the antitrust laws, cable operators could exercise market dominance because of their lock on local viewers. *Id.* at 24. Thus, Congress concluded, local monopoly power is the cornerstone of cable market power. 1992 Cable Act §2(a)(2). Congress required the Commission to establish a horizontal ownership limit based on a calculation of cable, not MVPD, subscribers. 1992 Cable Act § 11(C).[3] Cable MSOs then leveraged this power through horizontal expansion and concentration, allowing the largest MSOs to determine which programming services could "make it" by granting or denying carriage. Senate Report at 24, 32-33. This, in turn, allowed cable MSOs to extort equity interests in, and exclusive contracts with, programmers who wanted access, allowing cable MSOs to deny crucial programming to rival MVPDs. *Id.* at 25-26, 29; House Report at 41-42; 138 Cong. Rec. S408–409 (statement of Senator Ford); *Hearings on S. 1880, Before*

[3] *Petition for Reconsideration,* Docket 92-264 (Jan. 3, 2000). See Attachment A.

the Subcomm. on Communications of the Senate Comm. on Commerce, Science, and Trans., S. Hrg. 101-702, at 273, 412-13 (1990); S.Hrg. 101-357, at 345-48.

Not only did individual operators purchase and invest in individual programming services, but multiple operators often simultaneously invested in programmers. Through their investments, major operators that might have otherwise competed in programming acquisition developed a web of alliances with each other, minimizing their rivalries and reducing opportunities for a competing channel to gain carriage from any operator. *Media Ownership: Diversity and Concentration, Hearings Before the Subcomm. on Communications of the Comm. on the Senate Commerce, Science, and Trans.*, S.Hrg. 101-357, at 379-85 (1989) ("S.Hrg. 101-357").[4] In one infamous example, the two largest cable operators -- both with a stake in the Cable News Network -- denied carriage to NBC's proposed news channel, CNBC, unless it agreed to circumscribe its coverage in a manner the FCC concluded was likely "to protect CNN from competition." *Id.* at 301, 609-10; *Competition, Rate Deregulation and the Commission's Policies Relating to the Provision of Cable Television Service, Report*, 5 FCC Rcd 4962, 5028-29 (1990).

Successfully launching a channel was not easy, even without anticompetitive pressures from cable MSOs to "toe the line."[5] Congress therefore concluded that "the cable industry has become highly concentrated. The potential effects of such concentration are barriers to

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[4] For example, TCI jointly invested in various programming services with Time, Storer Cable Communications, Cablevision, and Comcast. Some of those operators also jointly invested in other programmers. *Id.*

[5] For example, the President of Discovery Network explained how, in 1982-83, he conceived of a new documentary channel, mortgaged his house, and sought for 18 months to raise the necessary $20 million in capital to launch a programming service that would not reach the minimum number of subscribers necessary to become self-supporting for one to two years. S. Hrg. 101-357, at 217-19. Only through a last-minute cooperative investment by several cable operators did the channel stave off bankruptcy. *Id.*

new programmers and a reduction in the number of media voices available to consumers." 1992 Cable Act §2(a)(4).

Antitrust law proved inadequate to stop these abuses. Although some programmers did seek recourse from the courts, *see Viacom International, Inc. v. Time, Inc.*, 785 F.Supp. 371 (S.D.N.Y. 1992), this method proved too slow and expensive. Congress therefore enacted a comprehensive web of protections in the 1992 Act, designed to enhance effective competition and protect diversity. The horizontal ownership limit is a central component of this statutory scheme.

C. CURRENT STATE OF THE CABLE INDUSTRY.

In the absence of an enforced horizontal limit, concentration in the industry has continued unabated. Although the other statutory provisions designed to foster competition, such as program access, have helped to ameliorate some abuses, the increased national concentration allows cable MSOs to engage in a variety of anticompetitive behavior. As concentration increases, so does the ability to do harm.

For example, in 1997, the Federal Trade Commission ("FTC") concluded that the cable television programming market is highly concentrated. *Time Warner Inc., Turner Broad. Sys. Inc., Telecommunications Inc., and Liberty Media Corp.*, FTC Docket No. C_3709, Complaint, ¶30, 1997 WL 65377 (Feb. 3, 1997). It further concluded that entry into the programming market is "difficult," taking "more than two years to develop [a service] to a point where it has a substantial subscriber base and competes with ... 'marquee' ... service[s]" *Id.* ¶34.

In 1998, the Department of Justice filed a complaint to prevent the sale of MCI and News Corp.'s U.S. DBS interests to Primestar. Complaint of United States, *United States v.*

Primestar, Docket No. Civil No.: 1:98CV01193 (JLG) (filed May 12, 1998).[6] The complaint details how the cable industry colluded to deny carriage of News Corp.'s cable programming until News Corp agreed to abandon its plans for facilities-based competition against cable via its DBS assets and agreed to sell them to Primestar, a joint venture of cable MSOs.

In 1999, as part of the order now on remand, the Commission found "credible evidence" that cable programmers continued to use their market power to force programmers to deny programming to rivals, in direct violation of Section 613(f)(2)(A)-(2)(B). *Implementation of Section 11(c) of the Cable Television Consumer Protection and Competition Act of 1992 – Horizontal Ownership Limits, Third Report and Order*, 14 FCC 19098, 19122 (1999) ("*1999 Cable Ownership Order*"). The Commission found:

> WCA and Ameritech proffer credible evidence that indicates MSOs have used their market power to cause unaffiliated programmers to refuse to sell their programming to other MVPDs…Ameritech and WCA state that, because of the MSOs' monopsony pressure, unaffiliated cable networks such as Fox News, MSNBC, Game Show Network, Eye on People, Home & Garden Television and TV Land act like vertically integrated programmers and refuse to sell their products to alternative MVPDs.

Id. and n.128.

D. WHEREAS ANTITRUST LAW MERELY SEEKS TO PREVENT LOSS OF COMPETITION, SECTION 613(F) DIRECTS THE COMMISSION TO FORMULATE RULES THAT "ENHANCE COMPETITION."

The purpose of the antimerger laws is to stop increases in concentration that might be anticompetitive or that might make an already anticompetitive market even more anticompetitive. The antimerger provisions of the antitrust law do not empower the enforcement agencies to seek to make a market more competitive or less concentrated. The ulti-

[6] Available at http://www.usdoj.gov/atr/cases/indx41.htm.

mate goal of these laws is to prevent significant decreases in consumer choice, but not to achieve any increases in consumer choice.

The language of the antimerger statute makes this clear. The Clayton Act prohibits mergers the effect of which "may be substantially to lessen competition or to tend to create a monopoly." 15 U.S.C. §18. Nowhere does the law contain a deconcentration objective. The Federal Merger Guidelines also make this clear. Section 0.1, Purpose and Underlying Policy Assumptions of the Guidelines, begins:

> The Guidelines are designed primarily to articulate and analytical framework the Agency applies in determining whether a merger is likely substantially to lessen competition.

U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines (1992, revised 1997) reprinted in 4 Trade Reg. Rep. (CCH) ¶¶ 13, 104, Section 0.1. ("*Merger Guidelines*").

> Nowhere does any antitrust merger decision discuss the desirability of lowering industry concentration, of lowering prices, or of providing more non-price choices for consumers. The antimerger laws are crafted and interpreted to block only mergers that increase industry concentration so significantly that competition and consumer choice will diminish.

E. THE "THRESHOLD" APPROACH PROPOSED IN THE *FNPRM* DOES NOT MEET THE STATUTORY REQUIREMENT THAT THE COMMISSION SET AN ACTUAL LIMIT ON THE NUMBER OF SYSTEMS AN ENTITY MAY OWN.

In the *FNPRM*, the Commission proposes a "threshold" approach as one means of implementing the ownership limit compelled by Section 613(f). *FNPRM* ¶¶64-73. Such an approach violates the clear language and legislative history of Section 613(f), and flies in the face of the public policy animating the statute. The *FNPRM* suggests that rather than trouble the Commission with actually fulfilling its mission and setting a number, as required by

Congress, it will shift the burden to the public to prove that harm is occurring and hope the Commission can correct it after the fact.

The statutory language of §613(f) cannot be clearer. "The Commission ***shall*** …prescribe rules and regulations ***establishing reasonable limits on the number of cable subscribers*** a person is authorized to reach." The word "shall" denotes mandatory language. *Association of Civilian Technicians, Montana Air Chapter No. 29 v. FLRA*, 22 F.3d 1150, 1153 (D.C. Cir. 1994) ("The word 'shall' generally indicates a command that admits of no discretion on the part of the person instructed to carry out the directive"). Congress carefully selected mandatory language because, as the drafters explained, the FCC had failed to take appropriate action to limit concentration despite having the power to do so. Senate Report at 34. Thus, while the drafters left the FCC "discretion in establishing the reasonable limits…the legislation is clear that the FCC must adopt ***some*** limitations." *Id.* at 80 (emphasis added).

The "threshold" approach does not, however, establish any limitation. Rather, as the *FNPRM* explains, it would establish a vague set of criteria and an after the fact complaint proceeding which would only begin only after anticompetitive harms occur. This cannot meet the mandatory language used by Congress deliberately to require a recalcitrant FCC to "adopt some limitation" on national ownership. Senate Report at 34, 80.

A share which permits concentration to take place is not a "limit," even if the agency retains the discretion to address harm retroactively. Nor could any case-by-case standard be considered a "limit." The absence of a clear level at which an acquisition would be prohibited (beyond some upper bound already prohibited by the antitrust laws) would establish a

presumption that any acquisition is permissible. That reversal is wholly inconsistent with any meaning of the word "limit."

Not only does the proposed "threshold approach" violate the plain language of the statute, it violates the statutory purpose. Section 613(f) is designed to "enhance effective competition." As the *FNPRM* itself observes, the reactive "threshold" proposal is incompatible with the prophylactic nature of Section 613(f) and its purpose of ***enhancing*** competition and diversity. The "threshold" approach would, at best, prevent further deterioration in the market place after the fact. It does nothing to ***enhance*** competition, or prohylactically protect the market from harms before they occur.

In addition, the "safe harbor" approach violates the command of the Communications Act that the Commission examine each merger on its merits and render a decision that each merger is in the public interest. 47 U.S.C. §310(d). The burden rests with the ***applicants*** to show not merely that no harm will occur as a result of the merger, but that the merger will yield public benefits and thus serve the public interest. *App'n for Consent to the Transfer of Control of Licenses and Section 214 Authorizations, MediaOne Group, Inc., Transferor, to AT&T Corp., Transferee,* 15 FCC Rcd 9816, 9820-22. In cases where an acquiring MSO can demonstrate that, despite the rule, the merger will serve the public interest, the Commission can (and far too often does) waive the rule based on the specific facts at issue.

The proposed safe harbor approach stands this legal standard on its head. Now the burden will lie not with the applicants to prove their merger benefits the public; it will lie with the members of the public who must prove that the proposed merger would cause competitive harm.

Finally, even if the "threshold" approach could satisfy the statutory requirement that the Commission set "some limit" designed to enhance competition and promote diversity, and did not run afoul of Section 310(d), the approach is unworkable. As the Commission itself observes, to implement such an approach, the Commission would have to solve many complex problems that would require more analysis and justification than setting an actual limit. ¶61. How will the Commission measure abuse? How long will enforcement take?

The recent collapse of the CLEC market provides a cautionary tale against trusting in adjudication rather than prophylaxis. To protect the nascent CLEC industry, Congress spelled out a detailed set of obligations and safeguards. *See, e.g.*, 47 U.S.C. §§251-52. The Commission spent years developing procedures in numerous proceedings to implement these protections. Despite this, ILECs waged a successful war of attrition against a host of well-funded new entrants, stalling and litigating until new competitors finally succumbed and the willingness of investors to put capital into competitors waned.

History suggests the cable industry would follow a similar pattern. The cable industry has proven itself willing to engage in endless obstructions and litigation to wear down rivals or secure better terms. Indeed, it was for this very reason that Congress commanded the Commission to set a definite, prophylactic limit, so that new programmers and rival MVPDs would ***not*** have to endure lengthy delays and costly litigation to protect themselves from abuses.

Finally, the Commission's utter unwillingness to enforce its rules against cable MSOs when anyone actually ***does*** attempt to enforce them would almost certainly engender a sense of futility among those expected to avail themselves of the process. Too often, the Commission has promised to enforce rules designed to protect the public or would-be com-

petitors, only to abandon any actual complainants like a jilted bride at the altar of justice. *See, e.g., Petition for Special Relief of Gemstar International*, Docket No. CSR 5528-Z (released December 6, 2001) (refusal to enforce must carry against Time Warner of Gemstar VBI information for competing electronic programming guide)*; Order, In re Applications for Consent to the Transfer of Control of Licenses and Section 214 Authorizations From MediaOne to AT&T Corp.*, CS Docket 99-251 (released November 13, 2001) (releasing AT&T from merger conditions); *Complaint of Texas.net*, Docket No. CS-30, *Decision of Cable Services Bureau Pursuant to Delegated Authority* (Released October 4, 2001) (*Application for Review by the Commission* pending) (refusal to enforce good faith requirement in AOL/Time Warner merger); *In re AT&T Corp. Notice of Apparent Liability for Forfeiture*, Docket No. NAL/Acct. No. X12000001 (released May 2, 2000) ($3,000 fine for noncompliance with certification requirement, refusal to consider misrepresentations or to consider character issue raised).

If the Commission adopts the proposed "threshold" rule, it would send an unqualified signal to cable MSOs and the public alike that MSOs may do as they will while the Commission turns a blind eye. If the Commission has any intent of complying with Congress' directive to enhance effective competition, it must set an actual—and prophylactic – limit.

F. BECAUSE PURE ANTITRUST SUPPORTS A 30% LIMIT THE STATUTE'S COMMAND THAT THE RULE ENHANCE COMPETITION AND PROTECT DIVERSITY REQUIRES A LIMIT NO HIGHER THAN 30%

As the *Time Warner II* Court observed, the "substantial evidence" requirement does not prevent the Commission from using its expertise to make predictive judgments regarding

the future. *Time Warner II*, 240 F.3d at 1133. Indeed, the antitrust laws, which are reviewed under a less deferential standard than that applied to FCC rulemaking, do not require proof with certainty; it is enough even under antitrust law that the government show that a level of concentration or industry structure will ***probably*** lessen competition. *H.J. Heinz*, 246 F.3d at 719 (the antitrust laws are concerned with "probabilities" not "certainties" or "ephemeral possibilities"). The government need not prove a dominant market share to show the potential for anticompetitive harm, but may rely on any direct or indirect evidence that shows the potential for anticompetitive effects. *Toys "R" Us, Inc. v. FTC*, 221 F.3d 928, 937 (2000)("*TRU*").

In *United States v. Philadelphia National Bank*, 374 U.S. 270 (1966), the Supreme Court created a presumption that a merger which leads to a firm possessing 30% or more of a relevant market would be anticompetitive:

> The merger of appellees will result in a single bank's controlling at least 30% of the commercial banking business in the four-county Philadelphia metropolitan area. Without attempting to specify the smallest market share which would still be considered to threaten undue concentration, we are clear that 30% presents that threat.

Id. at 364.

The Court explained how it arrived at the crucial 30% number in what has become known as the "*Philadelphia National Bank* presumption":

> Our conclusion that these percentages raise an inference that the effect of the contemplated merger of appellees may be substantially to lessen competition is not an arbitrary one, although neither the terms of 7 nor the legislative history suggests that any particular percentage share was deemed critical.

Id. at 365.

The Court then cited a number of cases and scholarly articles, none of which explicitly contained the 30% figure, but all of which, when analyzed by the Court in the aggregate, together supported its conclusion. *Id.*

The Supreme Court was worried that undue concentration would lead to any of several types of anticompetitive outcomes. The Court expresses a concern with possible adverse effects of the merger on "price, variety of credit arrangements, convenience of location, attractiveness of physical surroundings, credit information, investment advice, service charges, personal accommodations, advertising, miscellaneous special and extra services...." *Id.* at 368. The Court thus explained its fear of undue concentration in terms of reduction in either price or non-price competition that might harm consumers. *Id.* at 364. The Court wanted consumers to be able to choose freely on the basis of any price or non-price issue important to them, and the Court feared that a merger might lead to a reduction of some aspect of consumer choice. While a defendant may rebut the *Philadelphia National Bank* presumption in a variety of ways, s*ee, e.g., United States v. Baker Hughes, Inc.*, 908 F.2d 981 (D.C. Cir. 1990), the core principle remains. When concentration rises to 30% or more, the government may presume that the industry structure supports either overt collusion or implicit understanding between firms that create anticompetitive effects in violation of the antitrust laws.

Applying the *Philadelphia National Bank* presumption here, antitrust law alone allows the Commission to presume that 30% is the proper limit. It then falls to those seeking a higher limit to rebut the presumption. Because Section 613(f) is designed to "enhance effective competition" and protect diversity, the burden on those seeking a higher limit is considerably higher than under the antitrust law. Furthermore, as discussed

elsewhere in these comments at length, because of the critical importance of enhancing competition in the mass media to ensure a diversity of views from mutually antagonistic sources, the Commission must set a limit that "***ensures***" that cable operators cannot act singly or collusively in the manner presumed under *Philadelphia National Bank*. 47 U.S.C. §§613(f)(2)(A)-(B).

Unfortunately, because the Commission previously relied on its market foreclosure theory without a proper industry analysis or discussion of the *Philadelphia National Bank* presumption and other antitrust tools at its disposal, the *Time Warner II* court had the benefit of none of this analysis. Thus, despite strong antitrust law to the contrary, the *Time Warner II* Court opined that the Commission had not proved the likelihood of collusion for a limit above 30%. *Time Warner II*, F.3d at 1132. The Court, however, recognized other theories could support the 30% limit. *Id.* at 1133. Had the Court had the benefit of a Commission analysis that explicitly relied on the *Philadelphia National Bank* presumption and an analysis of the cable industry structure rather than focusing exclusively on the foreclosure or "open field" analysis, the Court would no doubt have decided otherwise.

The continued vitality of the *Philadelphia National Bank* presumption was recently demonstrated in *FTC v. H.J. Heinz Co.*, 246 F. 3d 708, 715 (D.C. Cir. 2001) (citing and relying on presumption). The court carefully examined the rationale underlying this presumption – that collusion is more likely as concentration increases – and found it sound. As the Court explained:

> Merger law rests upon the theory that, where rivals are few, firms will be able to coordinate their behavior, either by overt collusion or implicit understanding, in order to restrict output and achieve profits above competitive levels.... Increases in concentration above certain levels are thought to raise a likelihood of interdependent anticompetitive conduct.

Id. at 715-16 (citations and footnotes omitted).

Accordingly, the FCC should begin with a presumption that 30% is the appropriate limit, and that nothing in *Time Warner II* suggests otherwise.[7]

[7] To the extent a firm wishing to merge can rebut the presumption and furthermore, demonstrate that a merger is in the public interest, the Commission can waive the rule.

II. THE IMPORTANCE OF DIVERSITY TO CIVIC DISCOURSE

Even pure antitrust law recognizes the value of diversity in the marketplace of ideas. The Supreme Court has rejected the argument that the First Amendment prohibits application of the antitrust laws to members of the press; to the contrary, application of the antitrust law serves the First Amendment by guaranteeing "the widest possible dissemination of information from diverse and antagonistic sources." *Associated Press v. United States*, 326 U.S. 1, 20 (1945). Thus, even under a pure antitrust analysis, recognition of the importance of competition in the marketplace of ideas would require the Commission to set the lowest limit justified by the evidence. *See* Maurice E. Stucke & Allen P. Grunes, "Antitrust and the Marketplace of Ideas," 69 Antitrust L.J. 249 (2001).

Neither the Supreme Court nor Congress has been willing to reduce civic discourse to simple economics. A narrow, economically-driven view of civic discourse misreads the aspiration of the First Amendment as interpreted by the Supreme Court for more than half a century. The Constitutional and legislative basis of media ownership rules was never rooted solely in an economic argument or principle. Relaxing cross-ownership rules designed to promote diverse and antagonistic sources of information will not only forego the opportunity to make a substantial advance in the quality of public debate, but it risks diminishing the quality of civic discourse. Failing to strengthen civic discourse in the face of powerful new technologies could dramatically reduce the capacity for the enlightened debate that the Supreme Court has determined is essential to American democracy.

A. CIVIC DISCOURSE CANNOT BE REDUCED TO COMMERCIALLY DRIVEN ENTERTAINMENT VARIETY

Civic discourse is more than economic efficiency. Justice Frankfurter, concurring in *Associated Press*, made this much clear:

> A free press is indispensable to the workings of our democratic society. The business of the press, and therefore the business of the Associated Press, is the promotion of truth regarding public matter by furnishing the basis for an understanding of them. Truth and understanding are not wares like peanuts and potatoes. And so, the incidence of restraints upon the promotion of truth through denial of access to the basis for understanding calls into play considerations very different from comparable restraints in a cooperative enterprise having merely a commercial aspect.[8]

Congress has repeatedly declared, and the Supreme Court repeatedly upheld, principles for communications media that go far beyond simple economics. Economic efficiency is but one consideration among many and is not more effective in achieving a multiplicity of viewpoints than other public policy tools. Moreover, it is clear that reliance on commercial market forces alone will not assure the opportunity for diverse points of view to be heard through the video marketplace.

Even if the economic media marketplaces were composed of significant numbers of small firms competing aggressively with one another, an unfettered commercial video market might not lead to a vibrant marketplace of ideas that our Constitution attempts to promote; diverse sources of information are not the object of commercial competition. Profit maximization in increasingly centralized media conglomerates promotes standardized, lowest common denominator products that systematically exclude minority audiences and unpopular points of view, eschew controversy, and avoid culturally uplifting but less commercially attractive content. It favors entertainment at the expense of information. We

[8] *Associated Press*, 326, U.S. at 17.

believe that the Federal Communications Commission cannot reduce its obligation to promote diversity and the public interest to simple economic considerations, even where the economic marketplace is working.

Owen Fiss articulates this point well:

> … the market brings to bear on editorial and programming decisions factors that might have a great deal to do with profitability or allocative efficiency (to look at matters from a societal point of view) but little to do with the democratic needs of the electorate. For a businessman, the costs of production and the revenue likely to be generated are highly pertinent factors in determining what shows to run and when, or what to feature in a newspaper; a perfectly competitive market will produce shows or publications whose marginal cost equals marginal revenue. Reruns of *I Love Lucy* are profitable and an efficient use of resources. So is MTV. But there is no necessary, or even probabilistic, relationship between making a profit (or allocating resources efficiently) and supplying the electorate with the information they need to make free and intelligent choices about government policy, the structure of government, or the nature of society. This point was well understood when we freed our educational systems and our universities from the grasp of the market, and it applies with equal force to the media.

None of this is meant to denigrate the market. It is only to recognize its limitations. The issue is not market failure but market reach. The market might be splendid for some purposes but not for others. It might be an effective institution for producing cheap and varied consumer goods and for providing essential services (including entertainment) but not for producing the kind of debate that constantly renews the capacity of a people for self-determination.[9]

To the extent that economics is a consideration, economic competition in commercial mass media markets cannot assure diversity and antagonism. It has long been recognized that the technologies and cost structure of commercial mass media production are not conducive to vigorous, atomistic, competition. Like print and broadcast media, cable

and satellite have unique economic characteristics. On the supply side they require substantial fixed costs, and on the demand side they involve very strong consumer preferences (inelasticity), and very little substitutability to meet consumers' tastes. The development of media markets allowed by recent relaxation of rules restricting the accumulation of economic market power reveals that they are anything but atomistically competitive – rather, they are evolving toward tight, differentiated oligopolies. Each time a structural rule is lifted, and increase in concentration and reduction in the number of independent voices takes place.

Prof. Baker elucidates this point:

> Monopolistic competition theory applies to media goods. They, like utilities, characteristically manifest the "public good" attribute of having declining average costs over the relevant range of their supply curves due to a significant portion of the product's cost being its "first copy cost," with additional copies having a low to zero cost. There are a number of important attributes of monopolistic competition that are relevant for policy analysis and that distinguish it from the standard model of so-called pure competition, the standard model that underwrites the belief that a properly working market leads inexorably to the best result (given the market's givens of existing market expressed preferences and the existing distribution of wealth). The first feature to note here is that in monopolistic competition often products prevail that do not have close, certainly not identical, substitutes. Second, this non-substitutability of the prevailing monopolistic product will allow reaping of potentially significant monopoly profits. . . . . .within this type of competition, products' uniqueness or monopoly status often permits considerable margin for variation while still remaining profitable. The "potential" profit of the profit maximizing strategy can be realized and taken out as profit—which is what the corporate newspaper chains are accused of doing. However, the market itself does not require the profit maximizing response as it does in a model of pure competition. Rather the potential profit can instead be spent on indulging (or "subsidizing") the owners' choices about content or price.[10]

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[9] Fiss, Owen. *"Essays Commemorating the One Hundredth Anniversary of the Harvard Law Review: Why the State?"*

[10] C. Edwin Baker, *"Giving Up on Democracy: The Legal Regulation of Media Ownership."*

We believe that civic discourse is not primarily about entertainment and not primarily about variety or the number of outlets. Civic discourse is about information from diverse sources, particularly taking ownership into account. Multiple outlets with single owners are only one voice. Entertainment is only one consideration among many and carries little importance in promoting democracy.

The Federal Communications Commission cannot reduce its obligation to promote diversity and the public interest to a count of entertainment programs available.

B. THE NEED FOR MORE ROBUST CIVIC DISCOURSE INCREASES WITH THE GROWTH OF MORE POWERFUL COMMUNICATIONS TECHNOLOGIES

The simplistic economic approach to diversity that counts variety of entertainment outlets and variety of channels takes a unidimensional view of output that fails to consider whether there is a need for more effective means of public debate. If citizen participation in civic discourse is to continue to be or become more effective, a substantial improvement in the means of communications at the disposal of the public—far beyond commercial video influences—must be promoted through public policy.

While it is certainly true that there is a great deal more information available to more educated citizens, it is also true that they need more information. The same changes in the information environment that have made the development of more complex and rapid communications possible also make it more difficult for citizens to comprehend and respond effectively to new conditions. As the world becomes a more complex place, the need for diverse sources of information becomes more important. Globalization of the economy and communication networks, mobility and social fragmentation place greater demands on the

communications network to enable citizens to be informed about increasingly complex issues and express their opinions more effectively in civic discourse.

The power of digital communication will be greatly enhanced by improved video images with impact heightened by real-time interactivity and personalized ubiquity. Dramatic increases in the ability to control media messages could result in a greater ability to manipulate and mislead rather than a greater ability to educate and enlist citizens in a more intelligent debate. The Commission must not become so mesmerized by the new technology that it loses sight of the Supreme Court's directive to ensure that diverse and antagonistic sources of information can use such technology to preserve the democratic process.

Associated Press certainly expressed a concern about the sheer size of media organizations and the influence that could result.[11] The size of media organizations presents a growing mismatch between those who control media and average citizens.[12]

The new distribution technologies are still controlled by the giants of the commercial mass media. The technologies of commercial mass media are extremely capital intensive and therefore restrictive of who has access to them. A small number of giant corporations

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[11] Stucke and Grunes

> Nor did the majority of the justices jump through the typical hoops of defining a relevant market, determining market share and the restraints' impact on price and examining issue of entry or expansion by the other news wire services. Rather the majority was satisfied that AP was sufficiently large to impact the marketplace of ideas, in that it was "a vast, intricately reticulated, organization, the largest of its kind, gathering news from all over the world, the chief single source of news for the American press, universally agreed to be of prime consequence."

[12] Sullivan, Lawrence, "Economics and More Humanistics Disciplines: What are the Sources of Wisdom for Antitrust, 125,

> Americans continue to value institutions the scale and workings of which they can comprehend. Many continue to value the decentralization of decision making power and responsibility. Many favor structures in which power in own locus may be checked by power in another.

interconnected by ownership, joint ventures and preferential deals now straddle broadcast, cable and the Internet. Access to the means of communications is controlled by a small number of entities in each community and distribution proprietors determine what information the public receives. Individual members of society need new communications skills and access to technology to express themselves and evaluate the information presented by more powerful messengers.

C. THE GROWTH OF DIGITAL COMMUNICATIONS HAS NOT TRANSFORMED THE DOMINANT MEANS OF CIVIC DISCOURSE

At this point in time, the hope that new technologies will strengthen civic discourse is just that—a hope. Claims that dramatic changes have already rendered policies to promote diversity obsolete are premature. There has been far less fundamental change in the marketplace of ideas than meets the eye.

We find very clear evidence that different types of media—in this case, cable and satellite—represent distinct product and geographic markets. While the advocates of convergence equate all media, the reality is that different media serve different needs, have different content, and differ widely in their impact and effect. People use different media in different ways, spend vastly different amounts of time in different media environments, consume services under different circumstances and pay for them in different ways. In economic terms, these are separate markets with weak substitution effects. As a result, competition between the media is muted in the marketplace and, in some respects, the specialization of each is worth preserving because of the unique functions provided in the marketplace of ideas.

D. THE COMMISSION MUST CONSIDER THE NEGATIVE EFFECT OF CONSOLIDATION ON THE LOCAL FRANCHISE

The drafters of the 1992 Cable Act intended PEG channels and leased access channels to provide innovative cable programming and to facilitate civic discourse. Senate Report at 79. The legislative history of the 1992 Cable Act also reflects a concern that local franchising authorities negotiated at a disadvantage with MSOs, and that Congress sought through the 1992 Cable Act to restore authority to local franchising authorities to negotiate on behalf of their citizens. House Report at 35-37.

As cable MSOs consolidate, however, the balance of power established in the 1992 Act again shifts significantly to the cable MSOs. The responsiveness of cable system operators to local communities is diminished as ownership of cable systems is consolidated at fewer and fewer corporate offices, outside of the local jurisdictions where they operate. In addition, the growing disparity of resources between small communities and mammoth MSOs (which can threaten costly litigation) increasingly causes communities to acquiesce to cable demands. Further consolidation of cable system ownership, beyond the current limit of thirty percent of the market, will further damage the public interest by eroding the ability of local governments to represent the desires and needs of their citizens in the franchising process.

Certainly smaller systems can also fail in their responsibilities to local programmers, and can attempt to bully local franchises or lobby state authorities for better terms. But, based on the experiences of NATOA and ACM members, this situation appears to grow worse as systems consolidate.

The Commission must consider this information under Section 613(f)(2)(A) and (f)(2)(C). The Commission must set the limit low enough that cable MSOs cannot unfairly interfere with the flow of local programming to subscribers. While Commenters cannot correlate this effect to a precise limit, it provides yet one more reason why, when specifying the limit, the Commission should chose the lowest number supported by the evidence, rather than the highest.

III. ATTRIBUTION

As the Commission explained in the *FNPRM*, in *Time Warner II*, the D.C. Circuit affirmed the Commission's reasoning as regard to the attribution rules generally; the attribution rules properly address ***influence***, not ***control.*** *Time Warner II*, 240 F.3d at 1140-41. Significantly, the court found that the attribution rules do not raise First Amendment issues. *Id.* As the *FNPRM* notes, the court also explicitly affirmed, the five percent voting and 33 percent equity plus debt benchmarks. *FNPRM* ¶87. The *FNPRM* therefore seeks comment on two—and only two—issues: the insulation criteria governing limited partnerships and the single majority shareholder rule. *Id.*[13]

CFA, *et al.* previously warned the Commission that the insulation criteria adopted in the 1999 *Order* were irrational and subject to reversal. *See Attachment B, Petition for Reconsideration of CFA, et al.* in FCC No. 99-288, CS Docket No. 98-82. In light of the *Time Warner II* decision, the Commission dismissed this *Petition* as moot without considering the merits. *FNPRM* ¶134. CFA, *et al.* renew the legal and factual arguments presented in that *Petition* here. A copy of the *Petition* is provided as Attachment B.

Regarding the Single Majority Shareholder exemption, the Commission should abolish this exemption in all services. All collaborative ventures, regardless of the degree of ownership, create opportunities for influence and information exchange that facilitate coordinated action. *See* Federal Trade Commission and U.S. Department of Justice, *Antitrust Guidelines for Collaborations Among Competitors* (2000) §3.31(b) ("*Collaboration Guidelines*").

A. THE COMMISSION SHOULD ABOLISH THE PARTNERSHIP INSULATION CRITERIA AND RETURN TO THE PREVIOUS RULE OF FULLY ATTRIBUTING PARTNERSHIP INTERESTS.

In 1993, the Commission established attribution rules for cable paralleling those established for broadcasting. *In re Horizontal and Vertical Ownership Limits*, 8 FCC Rcd 8565, 8579-81 (1993) ("*1993 Cable Ownership Order*"). This conformed with both the FCC's traditional approach to attribution, which seeks to prevent entities from exercising influence over a purportedly independent source of ideas and information. *Id.* Since the ownership rules seek to preserve diversity and enhance competition, *see generally FCC v. National Citizens Committee for Broadcasting*, 436 U.S. 775, 795 (1978), attribution acts as a necessary safeguard; attribution reveals influence on purportedly independent sources and enhances competition by preventing coordination.

As part of these rules the Commission considered all partnerships fully attributable unless the limited partner had "no material involvement" in the partnership's "media interests." Similarly, corporate officers and directors held attributable interests unless their duties were "wholly unrelated" to the "primary business" of the enterprise. *1993 Cable Ownership Order* at 8581.

Congress understood and approved of the Commission's attribution rules. When mandating that the Commission establish reasonable limits on cable ownership, it instructed the Commission to create attribution rules and limits on the number of systems an entity may own or have an attributable interest. 47 U.S.C. § 613(f)(1)(A). The legislative history makes clear that the drafters intended the FCC to use the approach developed in broadcasting and adopt attribution rules identical to those governing broadcast licensees:

> In determining what is an attributable interest, it s the intent of the Committee hat the FCC use the attribution criteria set forth in 47 CFR Section 73.3555 (notes) or other criteria the FCC may deem appropriate.

Senate Report at 80. *See also 1993 Cable Ownership Order* at 8581 n.49.

In 1999, the Commission departed from this reasoning. Lured by the chimera of cable telephony, the Commission altered its traditional approach. It sought to create insulation criteria that would permit "good" collaborations (such as those designed to facilitate cable telephony and broadband) while prohibiting "bad" collaborations.

As CFA, *et al.* observed in the *Petition for Reconsideration* filed in that proceeding, the Commission's naïve belief that it can somehow control what goes on in partnerships via a case-by-case certification flies in the face of its past practice and reality.

More significantly, it flies in the face of the 1992 Act. The Commission premised its change to the attribution rules by pronouncing the sole purpose of Section 613(f) as preventing the flow of programming from programmers to subscribers. But, as CFA, *et al.* stated in their *Petition for Reconsideration*, this is but one of seven listed criteria the Commission must consider when formulating the ownership limits and accompanying attribution rules. Indeed, to the extent Section 613(f)(1) has an overarching purpose, it is "to enhance effective competition." *Time Warner II*, 240 F.3d at 1136.

Furthermore, Section 613(f)(2)(C) requires the Commission to:

> Take particular account of the market structure, ownership patterns, and other relationships of the cable marketing 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.

The legislative history makes clear that the drafters of the statute knew the variety of ways in which cable system owners acted or could act to the detriment of the public and

competitors. They therefore instructed the Commission to "take particular account" of these broad methods of control and capture them in the ownership limitations.

No basis exists within this statutory scheme for carving out exceptions to the attribution rules, particularly on grounds the Commission has rejected elsewhere. In the *1999 Attribution Order*, the Commission stated that "the cable operators have not presented a valid basis for a radical departure from our attribution rules framework." *Review of the Commission's Cable Attribution Rules*, 14 FCC Rcd 19014, 19029 (1999) ("*1999 Attribution Order*"). It further observed that the stringent insulation criteria in place before the *1999 Attribution Order* "identify situations in which it is safe to presume that a limited partner will not be materially involved in the media management and operations of the partnership." *Id.* at 19039-40. Small wonder that the *Time Warner II* court found the modified insulation criteria irrational.

Although the *Petition for Reconsideration* was pending for over 18 months prior to this proceeding, the Commission failed to consider the merits. Instead the Commission dismissed it as moot in light of this new proceeding. Accordingly, the Commission must now consider these arguments for the first time in the context of this proceeding. Nothing in *Time Warner II* detracts from the reasoning of the *Petition*; rather, the reverse is true. As the *Petition* predicted, the attempt to jigger the attribution rules in 1999 was arbitrary and capricious and unsupported by any logical reasoning or evidence. Rather than continue to try to support modification of the rule, the Commission should leave the 1993 Attribution Rule intact, and reaffirm that the 1993 language remains in force.

B. THE COMMISSION SHOULD ABOLISH THE SINGLE MAJORITY SHAREHOLDER EXEMPTION IN ALL SERVICES.

The *Time Warner II* court found that the Commission had failed to provide adequate justification for abolishing the single majority shareholder exemption in the cable attribution rules. While the Commission's statement abolishing the exemption was unfortunately terse, its action in abolishing the exemption was correct. Conversely, its subsequent action in unilaterally reinstating the exemption for broadcast and MDS has no rational basis. The Commission should abolish the exemption immediately in all services.

The Commission initially adopted the single majority shareholder exemption in the belief that, where a single majority shareholder existed, a minority shareholder could not hope to influence the licensee. *Corporate Ownership Reporting and Disclosure By Broadcasting Licensees*, 97 FCC.2d 997, 1008-09 (1984). Since then, however, the Commission has come to understand the fallacy of this assumption. Parties with joint interests have the potential to influence one another's behavior and better coordinate their behavior (either through outright collusion or conscious parallelism) to the detriment of competition and diversity.

As the Department of Justice and FTC have explained:

> Competitor collaborations may provide an opportunity for participants to discuss and agree on anticompetitive terms, or otherwise to collude anticompetitively, as well as a greater ability to detect and punish deviations that would undermine collusion.

Competition Guidelines §3.31(b).[14] *See also Broadcast Ownership Recon*, 16 FCC 1097, 1116 (2001).

[14] While the DOJ guidelines permit collaborating companies to overcome these concerns with a showing of pro-competitive benefits, certification on a case-by-case basis would defeat the Commission's desire for a bright line rule. In any event, the Guidelines are not offered here to urge adoption of a similar rule. Rather, they are offered for the basic principle that, even absent a

In view of the Commission's stated preference for a bright line rule (a preference endorsed by the *Time Warner II* Court as an appropriate basis for the rule, *Time Warner II*, 240 F.3d at 1141), and the increased concerns for diversity and competition beyond those considered in antitrust law, the Commission should abolish the single majority shareholder exemption.

Furthermore, a minority shareholder can influence the licensee in a variety of ways, even with a single majority shareholder. A substantial minority equity holder will have rights of access and inspection and other means to make its desires in managing the licensee known. While a single majority shareholder might have the power to act unilaterally regardless of the minority shareholder's desires, this does not address the question of ***influence***, as opposed to the question of control. As the Commission and the *Time Warner II* court have stated, attribution captures influence, not merely control.

This is particularly telling in the cable attribution rules, where Congress directed the Commission "take particular account" of the many and varied ways in which cable MSOs exercise influence over one another and coordinate to the detriment of the public, rival MVPDs, and programmers. 47 U.S.C. § 613(f)(2)(C). Congress had before it a wealth of testimony pertaining to the highly complex structures and interests used by cable MSOs to exercise influence over the industry and the drafters clearly expressed their concern that the FCC issue rules that would curtail these practices. Elimination of the single majority shareholder, while warranted in all services, is therefore particularly warranted in the cable attribution rules.

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controlling interest, joint ventures create the ability for market rivals to influence each other's behavior and coordinate behavior in an anti-competitive fashion.

C. THE COMMISSION SHOULD REQUIRE MVPDS TO REPORT SUBSCRIBER INFORMATION RATHER THAN RELY ON "ANY GENERALLY ACCEPTED" COMMERCIAL REPORT, SHOULD COUNT OVERBUILDERS TOWARD THE LIMIT, AND SHOULD RELY ON CABLE HOMES PASSED RATHER THAN TOTAL MVPD SUBSCRIBERS.

CFA, *et al.* present to the Commission once again the arguments made in the *Petition for Reconsideration* in the *1999 Cable Ownership Order*, dismissed as moot by the Commission in the *FNPRM.*

In particular, CFA, *et al.* strongly protest allowing MSOs to submit any "generally accepted" data as proof that a transaction complies with the ownership limit. It is arbitrary and capricious to use such imprecise, flawed and unreliable data. The practice shirks the Commission's responsibility and opens the door to gamesmanship, manipulation, and outright trickery.

The Commission, and only the Commission, has the power to compel accurate subscriber numbers from MVPDs. The situation is markedly different from broadcasting, where independent services such as Nielsen's designate market areas on the basis of understood economic criteria. In the case of MVPD subscriber numbers, ***only the MVPDs themselves have accurate information on subscriber numbers.*** The commercial services that publish such data gather this information from the MVPDs, with no guarantee of accuracy. Worse, because these commercial services rely on the MVPDs as their exclusive sources of information ***and*** as their primary customers for industry analysis, the commercial services are particularly susceptible to manipulation by large MVPDs close to the ownership limit.

Because the total number of MVPD subscribers cannot be determined with certainty from any publicly available source, citizens or organizations wishing to challenge cable

transactions close to the limit will be unable to produce sufficient evidence. Worse, any subscriber numbers that can be produced will be countered by more favorable numbers the MSOs involved in the transaction will find produce.

Furthermore, the cost of purchasing multiple reports to compare industry numbers is prohibitively expensive. For example, the most recent copy of *Kagan's Economics of Cable Networks 2002 Handbook*, costs $1,195.[15] Multiplying this across the many reports, updates, and industry newsletters a member of the public or a non-profit organization must obtain to monitor the industry, the cost runs into the tens of thousands of dollars per year. While trivial to a large MSO, such a recurring cost is a significant burden to any citizen or non-profit that wants to see the rules enforced.

The Commission need not engage in such evidentiary dramas, and should not put members of the public at a disadvantage when they seek to have the Commission enforce the law. Rather, the Commission should rely on cable homes passed, a number ascertainable by the simple expedient of consulting records in each franchise area.

Alternatively, if the Commission insists on retaining the total MVPD measure, the Commission ***must*** keep accurate records of the total number of MVPD subscribers and publish them regularly. While this adds to the administrative burden on the MSOs and the Commission, it is the only way to have trustworthy numbers for total MVPD subscribers. Anything less shirks the Commission's responsibility and unfairly places the burden on the public to do the Commission's job.

Indeed, it delegates an intrinsically government function to the private reporting services and the public. This is wholly different from the market determinations made

pursuant to Section 614(h)(1)(C)(i), where Congress explicitly directed the Commission to delineate markets for purposes of must-carry. No such statute directs the Commission to rely on private commercial services here. To the contrary, the statute directs the Commission to set a limit.

Finally, because commercial services designating market areas rely on many factors, the ability of the broadcasters to manipulate the data – while contrary to the public interest – is at least somewhat limited. Here, no such limit exists. The MVPDs entirely control the flow of information upon which private reporting services base their subscriber counts. This puts the MSOs in an unprecedented position to manipulate data. For MVPDs close to the limit, the incentive to "low ball" their subscribers during a transaction could easily outweigh the desire to impress Wall St. with higher subscriber numbers.

In short, the Commission's decision to allow cable MSOs to chose any "generally accepted" industry number violates the law by delegating an intrinsic government function and fails to set an exact limit as required by Congress. Furthermore, it is arbitrary and capricious, in that it maximizes the ability of those with the most incentive to manipulate the data to do so at their will.

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[15] http://www.inside.com/product/Product.asp?pf_id={E6D22C9C-5D51-4380-A860-12952C9211A5}.

PART TWO:
ECONOMIC THEORY AND ITS APPLICATION TO THE CABLE INDUSTRY

As described in the previous section, the Appeals Court remanded the horizontal limit on cable ownership to the Commission under a very narrow economic interpretation. The Court concluded that, in light of the Commission's reliance on its "open field"/foreclosure argument, the Commission could consider unilateral actions of individual cable companies in a broadly defined national programming market.[16] Applying this argument, it concluded that the FCC might set the limit on ownership at 60 percent of the market, twice the level it had chosen. Alternatively, the FCC could justify a lower limit either under a different economic theory or if presented with evidence that cable companies will collude to foreclose more than 60 percent of the market place absent the 30 percent limit.[17] Indeed, as the FCC reported to the Supreme Court in its *Opposition to Petitioners Petition for Review of Time Warner II:*

> the court of appeals' decision does not foreclose the FCC's 30% subscriber limit; it simply requires greater record substantiation for the FCC's marketplace assumptions.
>
> The court's decision was limited to "the record before it." The decision thus leaves open the possibility that the same or similar regulatory limits will be sustained if the FCC creates a stronger record of an actuality or probability of collusion or other anti-competitive conduct, or offers a more extensive explanation for its assumptions about marketplace behavior. Relatedly, the court of appeals did not foreclose the possibility that there are theories of anti-competitive behavior other than collusion on which the FCC may be able to rely on remand.[18]

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[16] *Time Warner II*, 240 F.3d at 1131.
[17] *Id.* at 1132.
[18] *Federal Opposition to Writ of Certiorari in Consumer Federation of America v. FCC*, No. 01-223 (filed November 1, 2001) at 7, 11-12 (citations omitted).

The FCC is therefore not bound by the Court's *dicta* concerning economic theories formed on an incomplete record. This is fortunate, for in reaching its economic conclusions on the record before it, the Court seemed to reject the fundamental principles of contemporary economic analysis as articulated by the Congress, applied by federal agencies, and accepted by previous panels of the court and the Supreme Court across a wide range of policy areas, including media ownership issues.[19]

As described below, horizontal ownership limits and triggers for scrutiny on concentration are based on the simple premise, common throughout economic policymaking, that some market structures are so conducive to anticompetitive or antisocial conduct that they result in unacceptable outcomes that require prophylactic measures before the fact to prevent harm to the public.

The remainder of these comments demonstrates that within the framework of contemporary economic theory and analysis, more than enough evidence supports the 30 percent limit. Given the competition and diversity policies that are clearly articulated in the statute,[20] immediate implementation of the 30 percent rule is imperative. As the Commission itself maintained to the Supreme Court, the Court's erroneous economic *dicta* and analysis have their root in the failure of the Commission to properly articulate the economic concepts underlying its rule.

In its previous *Order*, modifying and articulating the rationale for the 30 percent limit, the FCC relied primarily on a market foreclosure argument. The Commission stated that the rule existed to keep a sufficient field open for unaffiliated programmers to have a

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[19] *See FCC Opposition to Cert.* at 9, *citing FTC v. Heinz Co.*, 246 F.3d 708, 715 (D.C. Cir. 2001).
[20] *Time Warner I*, 211 F.3d at 1319-20.

chance to get their product to market.[21] While this argument has merit, it should have been presented in the context of a market structure analysis. Once such an analysis is undertaken, other equally important grounds for the rule will emerge as well.

Had the FCC presented the *Time Warner II* court with the proper analytic framework, it would not have had any difficulty in identifying a wealth of evidence to support the 30 percent rule. This proceeding gives the Commission the opportunity to set the record straight from both an analytic and an evidentiary point of view. Public interest commenters establish the analytic framework and empirical basis on which the FCC should set its limit, and set it at or below 30 percent.

[21] *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).

IV. MARKET STRUCTURE ANALYSIS CONCLUDES THAT THE CABLE INDUSTRY HAS MARKET POWER THAT MUST BE CHECKED BY A HORIZONTAL LIMIT

A. SUMMARY

Recognizing the failure of the Commission to lay a proper analytic framework to sustain its rule, the Commission early in its Notice requests "theoretical justification and empirical evidence of alleged harms of concentration."[22] Later in the Notice, it cites theories that claim "a concentrated market may enjoy efficiencies as a result of economies of size and scale."[23] The Notice is quick to point out that "this potential benefit of concentration, however, depends upon several factors that are not likely to occur in practice."[24] These factors do not apply to the cable industry.

This chapter presents the conceptual framework on which the horizontal limit ought to be based, and indeed on which most communications public policy is based. It first describes the characteristics of economic markets with which public policy is concerned – the structure of markets, which dictates the conduct of producers and determines industry performance.

This section then discusses unique characteristics of information, communications, and video markets. It shows that these characteristics tend to produce monopolistic and oligopolistic markets, which lead to troubling public policy outcomes.

Finally, the chapter discusses and rejects the claims that monopolies or highly-concentrated markets should be embraced as a superior form of organization in the multichannel video industry. It reviews the strong theoretical case that monopoly in this

[22] ¶ 7.
[23] ¶36

industry is likely to lead to abuses of market power and harm to consumers and is not likely to be innovative or consumer-friendly.

B. ECONOMIC THEORY USED TO ANALYZE MARKET STRUCTURE

1. Elements of Market Structure Analysis

Economic public policy is primarily concerned with market performance (see Exhibit IV-1).[25] The concept of performance is multifaceted, including both efficiency and fairness.[26] The measures of performance to which we traditionally look are pricing, quality, and profits. They are the most direct measure of how society's wealth is being allocated and distributed.

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[24] ¶39

[25] Scherer, F. M. and David Ross, Industrial *Market Structure and Economic Performance* (Boston, Houghton Mifflin: 1990), p. 4.

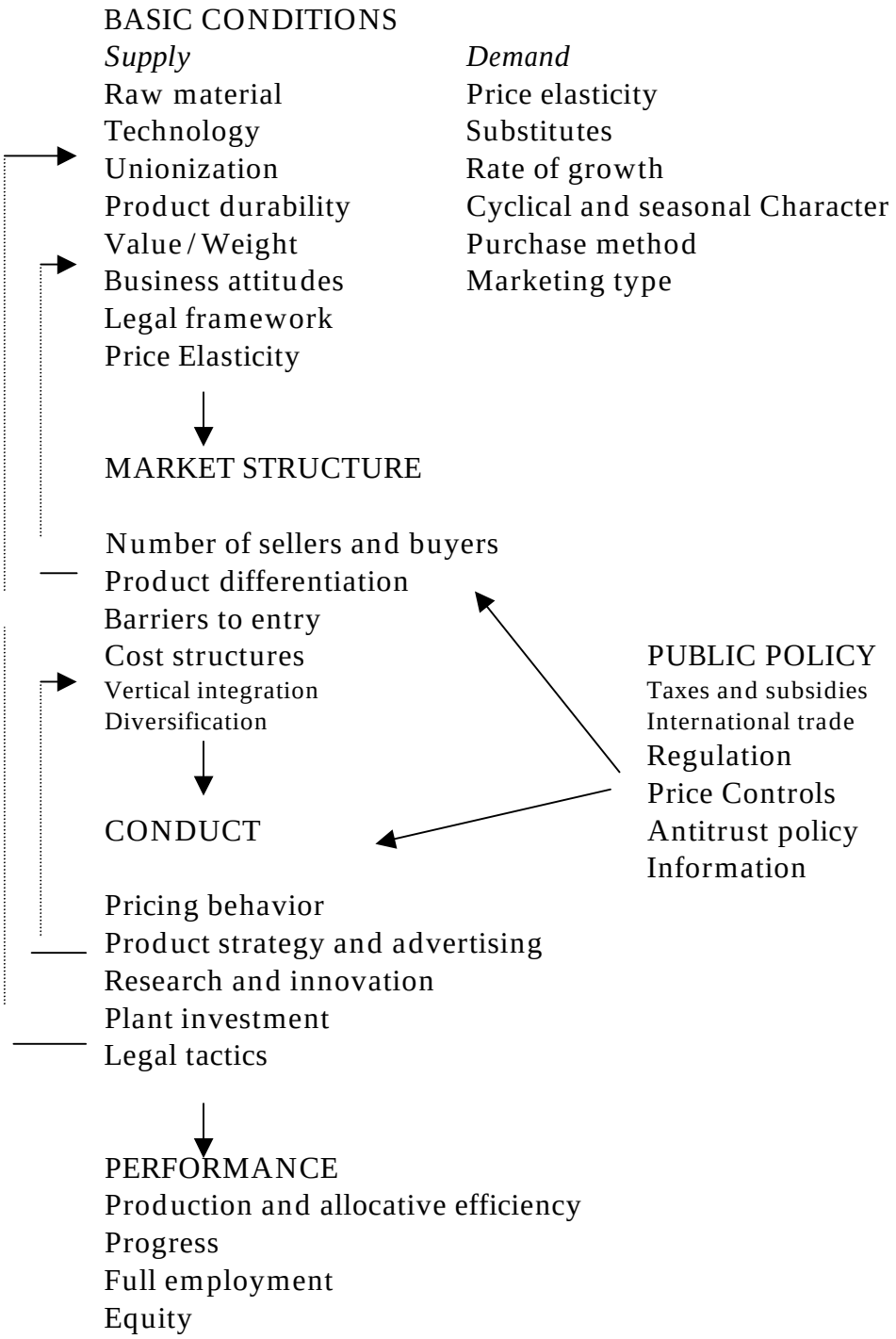
> We seek to identify sets of attributes or variables that influence economic performance and to build theories detailing the nature of the links between these attributes and end performance. The broad descriptive model of these relationships used in most industrial organization studies was conceived by Edward S. Mason at Harvard during the 1930s and extended by numerous scholars.

Shepherd, William, G., *The Economics of Industrial Organization* (Prentice Hall, Engelwood Cliffs, N.J., 1985), p. 5, presents a similar view.

[26] Scherer and Ross, p. 4.

> We begin with the fundamental proposition that what society wants from producers of goods and services is good performance. Good performance is multidimensional… Decisions as to what, how much and how to produce should be efficient in two respects: Scarce resources should not be wasted, and production decisions should be responsive qualitatively and quantitatively to consumer demands.
>
> The operations of producers should be progressive, taking advantage of opportunities opened up by science and technology to increase output per unit of input and to provide consumers with superior new products, in both ways contributing to the long-run growth of real income per person. The operation of producers should facilitate stable full employment of resources… The distribution of income should be equitable. Equity is notoriously difficult to define, but it implies at least that producers do not secure rewards in excess of what is needed to call forth the amount of services supplied.

EXHIBIT IV-1:
THE STRUCTURE-CONDUCT-PERFORMANCE PARADIGM



SOURCE: Scherer and Ross, F. M., and David Ross, *Industrial Market Structure and Economic Performance* (Houghton Mifflin Company: Boston, 1990), p. 5.

The performance of industries is determined by a number of factors, most directly the conduct of market participants. Do they compete? What legal tactics do they employ? How do they advertise and price their products?[27] That conduct is only part of the overall analytic paradigm and is influenced by other factors is central to the fabric of this analysis.

Conduct is affected and circumscribed by market structure. Market structure includes an analysis of the number and size of the firms in the industry, their cost characteristics and barriers to entry, and the basic conditions of supply and demand.[28]

Market structure is also influenced by basic conditions, such as the elasticities of supply and demand as well as the constraints of available technologies.[29]

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[27] Scherer and Ross, p. 4.

> Performance in particular industries or markets is said to depend upon the conduct of sellers and buyers in such matters as pricing policies and practices, overt and taciturn interfirm cooperation, product line and advertising strategies, research and development commitments, investment in production facilities, legal tactics (e. g. enforcing patent rights), and so on.

[28] Scherer and Ross, p. 5.

> Conduct depends in turn upon the structure of the relevant market, embracing such features as the number and size distribution of buyers and sellers, the degree of physical or subjective differentiation prevailing among competing seller's products, the presence or absence of barriers to entry of new firms, the ratio of fixed to total costs in the short run for a typical firm, the degree to which firms are vertically integrated from raw material production to retail distribution and the amount of diversity or conglomerateness characterizing individual firms' product lines.

[29] Scherer and Ross, p. 5.

> Market structure and conduct are also influenced by various basic conditions. For example, on the supply side, basic conditions include the location and ownership of essential raw materials; the characteristics of the available technology (e.g. batch versus continuous process productions or high versus low elasticity of input substitution); the degree of work force unionization; the durability of the product; the time pattern of production (e.g. whether goods are produced to order or delivered from inventory); the value/weight characteristics of the product an so on. A list of significant basic conditions on the demand side must include at least the price elasticity of demand at various prices; the availability of (and cross elasticity of demand for) substitute products; the rate of growth and variability over time of demand; the method employed by buyers in purchasing (e.g. acceptance of list prices as given versus solicitation of sealed bids versus haggling); and the marketing characteristics of the product sold (e.g. specialty versus convenience shopping method).

2. Competition vs. Market Power

Market structures that support competition are the primary object of public policy because "[c]ompetition has long been viewed as a force that leads to an ideal solution of the economic performance problem, and monopoly has been condemned."[30] The predominant reason for the preference for competitive markets reflects the economic performance they generate, although there are political reasons to prefer such markets as well.[31] In particular, competition fosters an efficient allocation of resources, the absence of profit, the lowest cost production, and a strong incentive to innovate.[32] Where competition breaks down, firms are said to have market power[33] and the market falls short of these results.[34]

Market structure analysis identifies situations in which a small number of firms control a sufficiently large part of the market to make coordinated or reinforcing activities feasible. Through various implicit and explicit mechanisms, a small number of firms can

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[30] Scherer and Ross, p. 15.

[31] Scherer and Ross, p. 18.

[32] Scherer and Ross, p. 20.

> The cost of producing the last unit of output – the marginal cost – is equal to the price paid by consumers for that unit… It implies efficiency of resource allocation…
> With price equal to average total cost for the representative firm, economic (that is, supra normal) profits are absent…
> In long-run equilibrium, each firm is producing its output at the minimum point on its average total cost curve…
> One further benefit is sometimes attributed to the working of competition, although with less logical compulsion. Because of the pressure of prices on costs, entrepreneurs may have especially strong incentives to seek and adopt cost-saving technological innovation. Indeed, if industry capacity is correctly geared to demand at all times, the *only* way competitive firms can earn positive economic profits is through innovative superiority.

[33] Scherer and Ross, pp. 17…18.

> Pure monopolists, oligopolists, and monopolistic competitors share a common characteristic: each recognizes that its output decisions have a perceptible influence on price… All three types possess some degree of power over price, and so we say that they possess monopoly power or market power…
> The power over price possessed by a monopolist or oligopolist depends upon the firm's size *relative to* the market in which it is operating.

reinforce each other's behavior rather than compete. Identification of when a small number of firms can exercise this power is not a precise science. Generally, however, when the number of significant firms falls into the single digits, there is cause for concern, as the following suggests.

> Where is the line to be drawn between oligopoly and competition? At what number do we draw the line between few and many? In principle, competition applies when the number of competing firms is infinite; at the same time, the textbooks usually say that a market is competitive if the cross effects between firms are negligible. Up to six firms one has oligopoly, and with fifty firms or more of roughly equal size one has competition; however, for sizes in between it may be difficult to say. The answer is not a matter of principle but rather an empirical matter.[35]

Pure and perfect competition is rare, but the competitive goal is important.[36] Therefore, public policy pays a great deal of attention to the relative competitiveness of markets as well as the conditions that make markets more competitive or workably competitive. Summarizing the literature, Scherer and Ross develop a useful list of these characteristics as follows:

> Structural Criteria
>
> - The number of traders should be at least as large as scale economies permit.
> - There should be no artificial inhibitions on mobility and entry.

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[34] Scherer and Ross, Chapter 18.

[35] J. W. Friedman, Oligopoly Theory (Cambridge: Cambridge University Press, 1983), pp. 8-9.

[36] Scherer and Ross, p. 16…17

> In modern economic theory, a market is said to be competitive (or more precisely, purely competitive) when the number of firms selling a homogeneous commodity is so large, and each individual firm's share of the market is so small, that no individual firm finds itself able to influence appreciably the commodity's price by varying the quantity of output it sells…
>
> Homogeneity of the produce and insignificant size of individual sellers and buyers relative to their market (that is, *atomistic* market structure) are sufficient conditions for the existence of pure competition, under which seller possess no monopoly power. Several additional structural conditions are added to make competition in economic theory not only "pure" but "perfect." The most important is the absence of barriers to entry of new firms, combined with mobility of resources employed.

- There should be moderate and price-sensitive quality differentials in products offered.

Conduct Criteria

- Some uncertainty should exist in minds of rivals as to whether price initiatives will be followed.
- Firms should strive to attain their goals independently, without collusion.
- There should be no unfair, exclusionary, predatory, or coercive tactics.
- Inefficient suppliers and customers should not be shielded permanently.
- Sales promotions should be informative, or at least not misleading.
- There should be no persistent, harmful price discrimination.

Performance Criteria

- Firms' production and distribution operations should be efficient and not wasteful or resources.
- Output levels and product quality (that is variety, durability, safety, reliability, and so forth) should be responsive to consumer demands.
- Profits should be at levels just sufficient to reward investment, efficiency, and innovation.
- Prices should encourage rational choice, guide markets toward equilibrium, and not intensify cyclical instability.
- Opportunities for introducing technically superior new products and processes should be exploited.
- Promotional expenses should not be excessive.
- Success should accrue to sellers who best serve consumer wants.[37]

In its Notice, the FCC appears to reject any elements of what is essential to promote competition and instead proposes a narrow notion of effective competition which is inadequate. It states that:

> 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.[38]

If this definition is suggests that the existence of the mere possibility of alternatives for program delivery is sufficient "to protect consumer choice and welfare," then it is simply wrong. Competition must be sufficiently developed within a market to produce a reasonable

[37] Scherer and Ross, pp. 53-54.

approximation of the performance results generally associated with competition for that market to be workably competitive.[39] The Commission's desire for simplicity is laudable, but it cannot be achieved at the cost of undermining the essence of generally accepted elements of competition policy and the public policy goals that Congress set for the Commission.

C. THE INDUSTRY IS NOT COMPETITIVE AND SERVES AS A PUBLIC GOOD

It has long been recognized that information production, communications networks, and video programming exhibit unique economic characteristics. It is useful to think of multichannel video as a communications platform that provides an environment in which information is produced. It is defined by three layers – the physical layer, the logical or code layer, and the content layer.[40] The physical layer has two primary assets: devices and transmission media.[41] The logical layer involves the codes and standards with which appliances interconnect, interoperate, and communicate. The content layer involves

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[38] ¶ 24.

[39] See also Peter Asch, *Industrial Organization and Antitrust Policy* (New York: John Wiley and Sons, 1983), pp. 100-104,

[40] Yochai Benkler, "From Consumers to Users: Shifting the Deeper Structure of Regulation Toward Sustainable Commons and User Access," *Federal Communications Law Journal*, 56 (2000) (hereafter Consumers to Users), see "Intellectual Property and the Organization of Information Production," forthcoming in *International Journal of Law and Economics*, (hereafter, Intellectual Property); "Coase's Penguin, or Linux and the Nature of the Firm," *Conference on the Public Domain"* Duke University Law School, (November 9-11, 2001) (hereafter, Coase's Penguin); "The Battle Over the Institutional Ecosystem in the Digital Environment," *Communications of the ACM*, 44:2 (February, 2001); Lawrence Lessig, *The Future of Ideas* (New York: Random House, 2001), p. 23. Lessig notes that Tim Berners-Lee (*Weaving the Web: The Original Design and Ultimate Destiny of the World Wide Web by Its Inventor* (San Francisco: Harper SanFranciso, 1999), identifies four layers, transmission, computer, software and content.

[41] ¶18.

information products, both outputs and inputs.[42] It is a platform because there are strong complementarities between the layers.[43]

It has long been recognized that information production exhibits characteristics of public goods, with positive externalities and high first-copy costs.[44] Information is non-excludable and non-rivalrous.[45] Once it is produced, it is difficult to prevent it from being shared. The consumption of information (by reading or viewing) by one person does not detract from the ability of others to derive value from consuming it.

Information frequently has positive direct and indirect externalities (and occasional negative externalities) associated with its production. It produces benefits to bystanders that cannot be easily captured in the transactions between the private parties.

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[42] The Notice (9, 10) divides the content layer into two functions, program production and program packaging.

[43] Carl Shapiro and Hal R. Varian, *Information Rules* (Cambridge: Harvard Business School Press, 1999), pp. 9 – 15; Richard N. Langlois, "Technology Standards, Innovation, and Essential Facilities: Toward a Schumpeterian Post-Chicago Approach," in Jerry Ellig (Ed.), *Dynamic Competition and Public Policy: Technology, Innovations, and Antitrust Issues* (Cambridge: Cambridge University Press, 2001), p. 207, calls them system products – "Most cumulative technologies are in the nature of systems products, that is products that permit or require simultaneous functioning of a number of complementary components." Complementarities exist where standards knit the layers of the platform together. In this proceeding, they do not play a large role, although the transition to a new standard has proven to be a major challenge for the agency and the industry.

[44] C. Edwin Baker, *Media, Markets and Democracy* (Cambridge: Cambridge University Press, 2002), pp. 297-307 (hereafter Media, Markets). pp. 8-14, see also "Giving Up on Democracy: The Legal Regulation of Media Ownership," Attachment C, *Comments of Consumers Union, Consumer Federation of America, Civil Rights Forum, Center for Digital Democracy, Leadership Conference on Civil Rights and Media Access Project,* (before the Federal Communications Commission, In the Matter of Cross Ownership of Broadcast Station and Newspaper/Radio Cross-Ownership Waiver Policy, MM Docket No. 01-235, 96-197; December 3, 2001); Benkler, Intellectual Property, p.5; as well as "Siren Songs and Amish Children: Autonomy, Information, and Law," *New York University Law Review*," 76 (April 2001);). "Through the Looking Glass: Alice and the Constitutional Foundations of the Public Domain," *Conference on the Public Domain"* Duke University Law School, (November 9-11, 2001) (hereafter, Through the Looking Glass); "Property Commons, and the First Amendment: Towards a Core Common Infrastructure," *Brennan Center for Justice, New York University Law School*, March 2000 (hereafter Core Common Infrastructure); "Free As Air to Common Use: First Amendment Constraints on Enclosure of the Public Domain," *New York University Law Review*,74 (May 1999) (hereafter Free as Air).

[45] The NPRM, 15-16 launches its analysis based on several of these characteristics.

In some respects it is also subject to network effects. Its production and distribution become more valuable as more people have access to it. Information is also a major input to its own output. Where these externalities are direct and strong, it exhibits positive feedback loops. Putting it into the world enables subsequent production at lower cost by its original producers or other producers.

To the extent that information and communication are extremely important inputs into the production process for other goods and services, they have a special economic role. They are often viewed as infrastructure.

Over the past century-and-a-half, information production has exhibited economies of scale typical of the industrial age. Capital intensive technologies and high first-copy costs have created substantial economies that dictate very large scale production. This was not always the case, nor need it be in the future, as discussed below, but it has been the fact of life for information production in the industrial age.

Modern information products also exhibit significant nonsubstitutability and strong preferences.[46] Different types of information products and institutions have evolved to fill different needs and to provide different functions. The result is little ability for individual to substitute between media products or institutions.

It has long been recognized that these characteristics of information render it highly likely that its markets will not be made up of numerous companies competing vigorously

[46] Comments of Consumers Union, Consumer Federation of America, Civil Rights Forum, Center for Digital Democracy, Leadership Conference on Civil Rights and Media Access Project, (before the Federal Communications Commission, In the Matter of Cross Ownership of Broadcast Station and Newspaper/Radio Cross-Ownership Waiver Policy, MM Docket No. 01-235, 96-197; December 3, 2001) (hereafter Consumers Union, et al, Newspaper Broadcast Crossownership).

(atomistically competitive).[47] Rather, they tend to be tight, differentiated oligopolies or monopolistically competitive.

> Monopolistic competition theory applies to media goods. They, like utilities, characteristically manifest the "public good" attribute of having declining average costs over the relevant range of their supply curves due to a significant portion of the product's cost being its "first copy cost," with additional copies having a low to zero cost. There are a number of important attributes of monopolistic competition that are relevant for policy analysis and that distinguish it from the standard model of so-called pure competition, the standard model that underwrites the belief that a properly working market leads inexorably to the best result (given the market's givens of existing market expressed preferences and the existing distribution of wealth). The first feature to note here is that in monopolistic competition often products prevail that do not have close, certainly not identical, substitutes. Second, this non-substitutability of the prevailing monopolistic product will allow reaping of potentially significant monopoly profits.[48]

Public policy has been centrally concerned with preventing the abuse of this market power and with promoting competition at all layers of the communications platform through a wide range of mechanisms. At various times and in different layers, this policy has included structural regulation of ownership, setting standards, requiring carriage of programming, public interest obligations in programming, regulation of rates, and the like.

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[47] Shapiro and Varian, pp. 22-23.

> Information is costly to produce but cheap to reproduce.
> Once the first copy of an information good has been produced, most costs are sunk and cannot be recovered.
> Multiple copies can be produced at roughly constant per-unit costs.
> There are no natural capacity limits for additional copies.
> These cost characteristics of information foods have significant implications for competitive pricing strategy.
> The first and most important point is that markets for information will not, and *cannot,* look like text-book perfect competitive markets in which there are many suppliers offering similar products, each lacking the ability to influence prices.

[48] *Study of Who Benefits Whom in Differentiated Product Markets*, 2000; with Peter Siegelman *Race and Radio: Preference Externalities, Minority Ownership and the Provision of* Shapiro and Varian, pp. 28, 54, 87-89,Joel Waldfogel, *Who Benefits Whom in Local Television Markets?,* November 2001, Roundtable On FCC Ownership Policies October 29, 2001. Other papers in this series entered in the record of the above hearing include, *Preference Externalities: An Empirical Programming to*

D. DEBUNKING THE ARGUMENT THAT A MONOPOLY IS PREFERABLE TO COMPETITION

1. Overview of the "Monopoly is Better for Consumers" Argument

The Commission notes that there are those who see this struggle against monopoly power as folly. They offer an alternative theory which argues that monopoly is to be preferred over competition since "[s]ome 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." Here it is argued that competition between facility owners exercising their property rights to exclude and dictate uses of the network will produce a more dynamic environment; the rent-seeking behavior of innovators will stimulate more investment.

This argument is conceptually linked to longstanding claims that "firms need protection from competition before they will bear the risks and costs of invention and innovation, and a monopoly affords an ideal platform for shooting at the rapidly and jerkily moving targets of new technology."[49] It has been extended lately to claims that in the new economy "winner take all" industries exhibit competition for the entire market, not competition within the market. As long as monopolists are booted out on a regular basis, or believe they can be, monopoly is in the public interest.[50]

Minorities, 2001 with Lisa George, *Who Benefits Whom in Daily Newspaper Markets?*, (2000); as well as the statement *Comments on Consolidation and Localism* (2001).

[49] Scherer and Ross, p. 31 (emphasis added).

[50] Stan J. Liebowitz and Stephanie E. Marigolds, *Winners, Losers & Microsoft* (Oakland: The Independent Institute, 2001), uses the term serial monopoly, as do a bevy of other Microsoft supported experts. Mark Cooper, "Antitrust as Consumer Protection: Lessons from the Microsoft Case," 52 *Hastings Law Journal* (2001), points out that there is no serial in Microsoft's monopolies. Rather, Microsoft conquers market after market using leverage and anticompetitive tactics, never relinquishing any of its previous monopolies.

An even more extreme version of this theory exists, one in which the mere threat of competition (rather than the occasional existence of it) is mentioned by the Commission.[51] This theory of contestability has been thoroughly rejected across a number of industries and, given the clearly-documented existence of sunk costs in the industry that the Notice recognizes,[52] contestability is a non-starter for this industry, even if it had any validity.[53]

2. The "Monopoly is Better for Consumers" Argument is Untenable

The subject of considerable dispute, the "winner take all" argument, has recently been rejected in the Microsoft case.[54] The claim for Schumpeterian rents has long been contested.

> Viewed in their entirety, the theory and evidence suggest a threshold concept of the most favorable climate for rapid technological change. A bit of monopoly power in the form structural concentration is conducive to

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[51] ¶ 69.

[52] ¶ ¶ 15-16.

[53] Mark Cooper and Gene Kimmelman, "Comments of the Consumer Federation of America," *In the Matter of Policy and Rules Concerning Rates for Dominant Carriers,"* CC Docket No. 87-313, October 19, 1987, p. 66 pointed out that

> Many economists have criticized the theory loudly because of the unrealistic assumption on which it rested. Immediate reactions came from M. Schwartz and R.J. Reynolds, "Contestable Markets: An Uprising in the Theory of Industrial Organizations: Comment," *American Economic Review* 73 (1983), *On the Limited Relevance of Contestability Theory* (U.S. Department of Justice, Antitrust Division, Economic Policy Office, Discussion Paper No. EPO 84-10, 1984); M L. Weidman, "Contestable Markets: An Uprining in the Theory of Industry Structure: Comments," *American Economic Review* 73 (1983). Extensive critiques can be found in M. A. Spence, "Contestable Markets and the Theory of Industry Structure: A review Article," *Journal of Economic Literature*, 21 (1983); W.G. Shepherd, "Contestability v. Competition," *American Economic Review*, 74 (1984), "Illogic and Unreality: The Odd Case of Ultra-Free Entry and Inert Markets, in R.E. Grieson (Ed.) *Antitrust and Regulation* (Lexington: Lexington Books, 1986)…
>
> When sunk costs are introduced into experimental simulations of contestability theory, market performance appears to be no better than a duopoly situation, hardly acceptable as an example of vigorous competition (see D. Coursey, et al., "Market Contestability in the Presence of Sunk (Entry) Costs," *Rand Journal of Economics*, 15 (1984), Natural Monopoly and Contested Markets: Some Experimental Evidence, *Journal of Law and Economics*, 27 (1984).

[54] Mark Cooper, "Antitrust as Consumer Protection: Lessons from the Microsoft Case," 52 *Hastings Law Journal* (2001).

> innovation, particularly when advances in the relevant knowledge base occur slowly. But very high concentration has a positive effect only in rare cases, and more often it is apt to retard progress by restricting the number of independent courses of initiative and by dampening firms' incentive to gain market position through accelerated R&D. Likewise, given the important role that technically audacious newcomers play in making radical innovations, it seems important that barriers to new entry be kept at modest level. Schumpeter was right in asserting that perfect competition has no title to being established as the model of dynamic efficiency. But his less cautious followers were wrong when they implied that powerful monopolies and tightly knit cartels had any strong claim to that title. What is needed for rapid technical progress is a subtle blend of competition and monopoly, with more emphasis in general on the former than the latter, and with the role of monopolistic elements diminishing when rich technological opportunities exist.[55]

In fact, the Schumpeterian theory of monopoly also appears to have little relevance to the facility portion (the physical layer) of this industry. Since the subject of this proceeding is a limitation on the ownership of physical facilities, the theory should not influence the policy. The empirical literature on innovation suggests the opposite of allowing a small number of large firms to dominate communications networks by exercising monopoly power over facilities.

> One policy implication for antitrust is the need to preserve a larger number of firms in industries where the best innovation strategy is unpredictable…
> Another implication is … that "technical progress thrives best in an environment that nurtures a diversity of sizes and, perhaps especially, that keeps barriers to entry by technologically innovative newcomers low…
> A third implication is the awareness that dominant firms may have an incentive to act so as to deter innovative activities that threaten the dominant position.[56]

The theoretical literature provides ample basis for concern that the physical layer of communications platforms will not perform well if market power is not checked. In this layer, barriers to entry are substantial and go far beyond simple entrepreneurial skill. At the

[55] Scherer and Ross, p. 660.
[56] Daniel Rubinfeld and John Hoven, "Innovation and Antitrust," pp. 75-76.

structural level, new entry into these physical markets is difficult. Most of these markets have at most two or three competitors, which is not sufficient to sustain a competitive outcome.[57]

The physical facilities do not invite vibrant competition. Too few competitors slow the innovation process.[58] Controlling access to the platform confers a great deal of market power on the owner of the physical facility because it dominates a large part of the platform with easily implemented manipulation.[59] Denial of access to the physical layer transforms innovation that should be located in the code and content layers (a relatively malleable software problem), into a hardware problem.[60] Facilities markets are much more prone to monopolistic, duopolistic, or, at best, oligopolistic structures, while the applications and content markets are much better able to sustain an atomistically competitive structure.

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[57] Richard N. Langlois, "Technology Standards, Innovation, and Essential Facilities: Toward a Schumpeterian Post-Chicago Approach," in Jerry Ellig (Ed.), *Dynamic Competition and Public Policy: Technology, Innovations, and Antitrust Issues* (Cambridge: Cambridge University Press, 2001), p. 222,

> But in the case of a broad patent – or a broad standard – the remuneration that monopoly rights confer far outstrip the risk-discounted ex ante costs of innovation. Moreover, in the case of a broad patent or standard, the ability of the patent holder to block future innovation will do more to diminish the incentive for technological progress than will any weakening of intellectual property rights…
>
> Clearly, the narrower the scope of a technical standard, the more temporary – the more "Schumpeterian" – the rents are likely to be.

[58] Langlois, pp. 217-218 notes that it is possible for system competition to have beneficial effects, but there must be many competing systems.

> Another way to see this issue is to note that, when there is vibrant intersystem competition, there are more possible entry points for innovation. Multiple competing systems provide a way not only of providing variety but also of experimenting with organizational and design alternatives.

[59] Langlois, p. 221, call this scope and sees this as a fundamental issue.

> Here the idea of the "scope of the standard becomes important. The owner of a standard that control the compatibility of a large fraction of the components of a system is in a much better position to close off avenues of innovation that threaten the rent-earning potential of the standard. The owner of a standard with relatively small scope is always in danger of being "invented around" or made obsolete if it closes off access or otherwise exercises market power unduly.

[60] Langlois, p. 216,

Inadequate competition at the physical layer harms the public by slowing competition in the layers of code and content.

3. Ways in Which Market Power Manifests Itself in the Industry

The model that has emerged in this industry is one in which only the facility owner with a dominant technology that is a critical input for service delivery can leverage control of transmission facilities to achieve domination of content services. With proprietary control over the network for which there is a lack of adequate alternatives, such an owner can lock in consumers and squeeze competitors out of the broader market. Whether we call them essential facilities,[61] choke points,[62] or anchor points,[63] the key leverage point is controlling access facilities.

It is hard to imagine private entities that possess this market power would refrain from using it to their advantage. Theoretical claims that monopolists have little motivation to engage in anticompetitive activity across layers of the platform or product markets have been refuted. There is ample evidence that these anti-competitive behaviors may be attractive to a new economy monopolist for static and dynamic reasons.[64]

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[61] Langlois, p. 194.

[62] Mark Cooper, "Open Access to the Broadband Internet: Technical and Economic Discrimination in Closed Proprietary Networks," *University of Colorado Law Review*, Fall 2000).

[63] Sanford C. Bernstein and McKinsey and Company, *Broadband!*, January, 2000 (hereafter Bernstein), pp. 18…21,

> Broadband access platforms are the anchor points for much of the value at stake and vehicles for accessing new revenue streams.
>
> However, the current set of alternatives for reaching customers with broadband connections is inadequate. At least for the time being, cable is closed, meaning that much of the value is, in effect, ceded to the platform rather than captured by the content/applications providers…
>
> Furthermore, access is currently a bottleneck, and access winners have the potential to leverage their privilege positioned to ensure long-term value creation.

[64] Langlois, pp. 195 –202; Michael Katz & Carl Shapiro, "Antitrust and Software Markets", in *Competition, Innovation And The Microsoft Monopoly: Antitrust And The Digital Marketplace* (Jeffrey A. Eisenbach & Thomas M. Leonard eds., 1999), pp. 70-80; Lansuz A. Ordover and Robert

Companies can exercise market power in the core product by conquering neighboring markets, erecting cross-platform incompatibilities, raising rivals' costs, and preventing rivals from achieving economies of scale. Companies can increase profits by enhancing their ability to engage in price discrimination. By driving competitors out of neighboring markets, new monopolies may be created, and the ability to preserve market power across generations of a product may be enhanced by diminishing the pool of potential competitors.

The dominant players in the physical layer can readily distort the architecture of the platform to protect their market power.[65] They have a variety of tools to create barriers to entry [66] such as exclusive deals,[67] retaliation,[68] manipulation of standards,[69] and strategies that

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D. Willig, Access and Bundling in High Technology Markets, in *Competition, Innovation And The Microsoft Monopoly: Antitrust And The Digital Marketplace* (Jeffrey A. Eisenbach & Thomas M. Lenard eds., 1999) ; Rubinfeld, *supra* note, in *Competition, Innovation And The Microsoft Monopoly: Antitrust And The Digital Marketplace* (Jeffrey A. Eisenbach & Thomas M. Lenard eds., 1999)at 877-81; Steven C. Salop, *Using Leverage to Preserve Monopoly*, in *Competition, Innovation And The Microsoft Monopoly: Antitrust And The Digital Marketplace* (Jeffrey A. Eisenbach & Thomas M. Lenard eds., 1999).

[65]Langlois, Franklin M. Fisher, Innovation and Monopoly Leveraging, ," in Jerry Ellig (Ed.), *Dynamic Competition and Public Policy: Technology, Innovations, and Antitrust Issues* (Cambridge: Cambridge University Press, 2001).

66. Joseph Farrell & Garth Saloner, Installed Base and Compatibility: Innovation, Product Preannouncements and Predation, 76 AM. ECON. REV. 940, 948-51 (1986) Michael Katz & Carl Shapiro, Product Innovation with Network Externalities, 40 J.INDUS. ECON. 55, 73 (1992)..Richard Makadok, Can First-Mover and Early Mover Advantages Be Sustained in an Industry with Low Barriers to Entry/Imitation?, 19 STRATEGIC MGMT. J. 683, 685 (1996).; Ulrich Witt, "Lock-in" vs. "Critical Masses"–Industrial Change Under Network Externalities, 15 INT'L J. INDUS. ORG., 753, 768-69 (1997). Robin Mansell, Strategies for Maintaining Market Power in the Face of Rapidly Changing Technologies, 31 J. ECON. ISSUES 969, 970 (1997).

67. Melissa A. Schilling, Technological Lockout: An Integrative Model of the Economic and Strategic Factors Driving Technology Success and Failure, 23 ACAD. MGMT. REV. 267, 270 (1998), at 276.

68. Willow A. Sheremata, New Issues in Competition Policy Raised by Information Technology Industries, 43 ANTITRUST BULL. 547, 573-74 (1998) Robert A. Woroch et al., Exclusionary Behavior in the Market for Operating System Software: The Case of Microsoft, in OPENING NETWORKS TO COMPETITION: THE REGULATION OF PRICE AND ACCESS (David Gabel & David Weiman eds., 1997).

freeze customers.[70] Firms can leverage their access to customers to reinforce their market dominance[71] by creating ever larger bundles of complementary assets.[72] As the elasticity of demand declines over the course of the product life cycle, market power lodged in the physical layer results in excessive bundling[73] and overpricing of products under a variety of market conditions.[74] Control over the product cycle can impose immense costs by creating incompatibilities,[75] forcing upgrades,[76] and by spreading the cost increases across layers of the platform[77] to extract consumer surplus.[78] In information markets, creating incompatibilities or blocking the flow of information undermines consumer value.[79]

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69. *See* Sheremata, *New Issues in Competition*, , at 560; *see also* CHARLES H. FERGUSON, HIGH STAKES NO PRISONERS: A WINNER'S TALE OF GREED AND GLORY IN THE INTERNET WARS 309 (Three Rivers Press ed., 1999), p. 307; Mark A. Lemley & David McGowan, *Could Java Change Everything? The Competitive Propriety of a Proprietary Standard*, 43 ANTITRUST BULL. 715 (1998), p. 732.

70 Joseph Farrell & Michael L. Katz, The Effect of Antitrust and Intellectual Property Law on Compatibility and Innovation, 43 ANTITRUST BULL., 645, 650 (1998), pp. 643-45; Sheremata, New Issues in Competition,

71.Makadok, at 693.

72. David B. Office, "CHESS and Competing in the Age of Digital Convergence," *in Competing in the Age of Digital Convergence* 27 (Harvard Business School ed., 1997), p. 26; *see also* Robert E. Daisy & Cecilia Conrad, *Commodity Bundling*, 74 AM. ECON. REV. 377 (1984).

73. Carmen Mattes and Pierre Regime, *Compatibility and Bundling of Complementary Goods in a Duopoly*, 50 J. INDUS. ECON. 46 (1992);

74 Joseph P. Guilt Nan, The Price Bundling of Services: A Normative Framework, 51 J. MKTG. 74 (1987); Carmen Mattes and Pierre Regime, Compatibility and Bundling of Complementary Goods in a Duopoly, 50 J. Indus. Econ. 46 (1992). Lester Teller, A Theory of Monopoly of Complementary Goods, 52 J. BUS. 211-30 (1979); Richard Schmalensee, Gaussian Demand and Commodity Bundling, 57 J. BUS. 211-30.

75.Jay Pil Choi, *Network Externalities, Compatibility Choice and Planned Obsolescence*, 42 J. Indus. Econ. 167 (1994), pp 171-73.

76.*See* Glenn Ellison & Drew Fudenberg, "The Neo-Luddite's Lament: Excessive Upgrades in the Software Industry," 30 RAND J. ECON. 253, 272 (2000); Drew Fudenberg & Jean Tirole, *Upgrades, Trade-ins, and Buybacks*, 28 *Rand J. Econ*. 235, 236 (1998).

77.*See* FERGUSON, 309-10.

78*Id.* at 176-77. K. Sridhar Moorthy, "Market Segmentation, Self Selection, and Product Lines Design," 3 *Mktg. Sci.* 303 (1984); Marcel Thum, "Network Externalities, Technological Progress, and the Competition of Market Contracts," 94 *Int. J. Indus. Org.* 280, 285-86 (1997).

[79] Langlois, p. 221,

E. CONCLUSION: THE NEED TO CREATE A MORE COMPETITIVE MARKET

This chapter has established the broad outlines of the analytic framework that must be used to establish a limit on horizontal ownership. Consistent with Congressional intent expressed about a decade ago, the theoretical literature continues to support the conclusion that competition is the proper goal for public policy. The basic characteristics of the video industry dictate that atomistic competition is not likely to be achieved in the industry; nevertheless, this fact does not imply that we should abandon policies that strive to make it effectively competitive.

The owner of a dominant standard may thus want to manipulate the standard in ways that close off the possibilities for a competitor to achieve compatibility. This has a tendency to retard the generational advance of the system.

V. THE ECONOMIC UNDERPINNINGS OF MARKET POWER

A. SUMMARY

The public policy goal we have outlined in theory and that Congress has clearly articulated in its directives is to prevent the abuse of market power. This chapter develops the concept of market power.

The primary measure of that harm is in the impact it has on prices and efficiency, although increasing attention is paid to quality and innovation. Price analysis focuses on the firm's ability to set price above cost to achieve above normal profits. Starting from this observation helps to focus the discussion of factors that result in the abuse of market power.

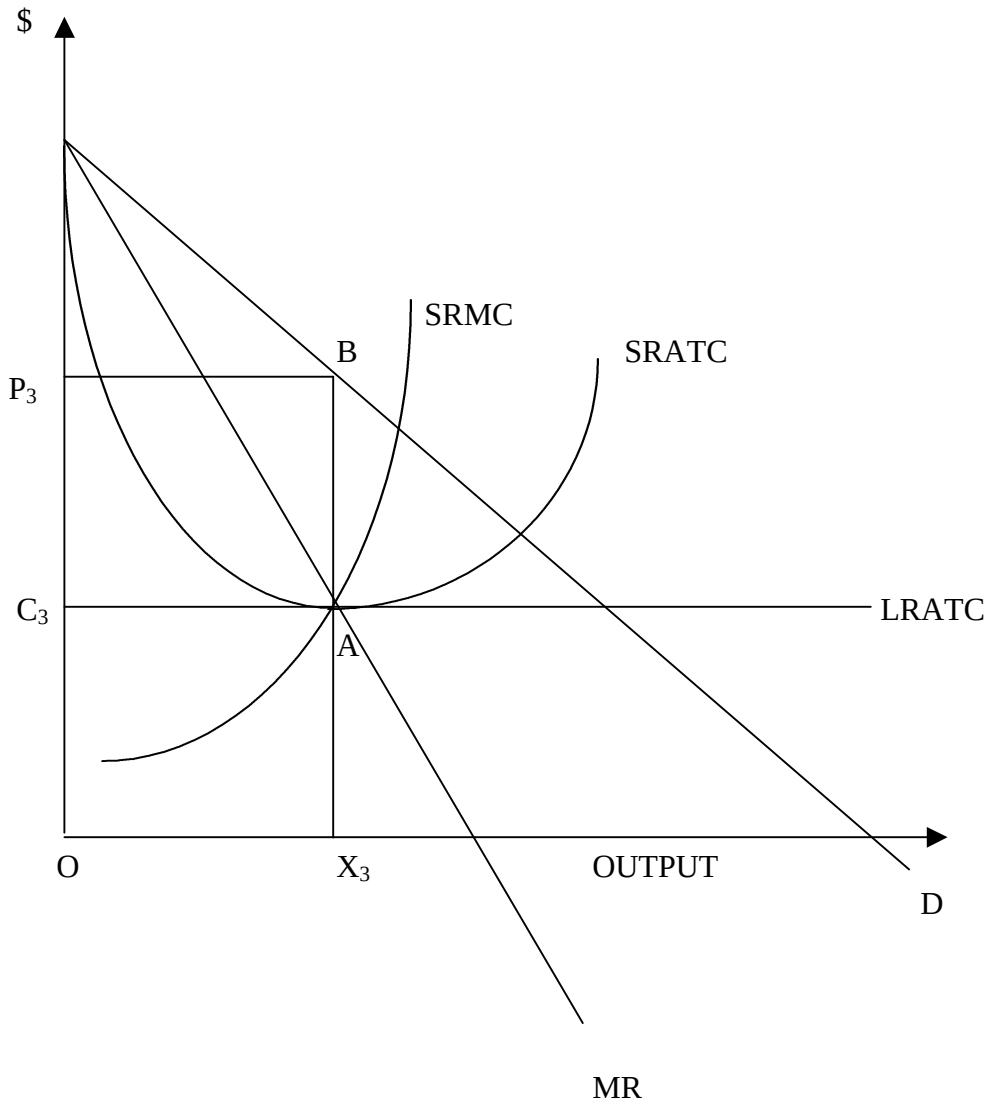
The analytic framework is established with primary reference to the work of two prominent "liberal" economists – Scherer and Ross – and two prominent "conservative" economists – Landes and Posner. We present the Lerner index, to which the Notice refers,[80] as the central measure of market power. The decomposition of that index into the key market structure characteristics – market shares, elasticities of supply and demand – elucidates the fabric of the concept of market power.

B. CONCEPTUALIZING MARKET POWER

The conceptual depiction of the exercise of market power is presented in its simplest form in Exhibit V-1 and Exhibit V-2. Exercising market power allows suppliers to set prices above their costs to achieve above normal profits. Scherer and Ross describe this concept as follows, in the terms identified in Exhibit V-1.

[80] ¶ 63

EXHIBIT V-1:
SCHERER AND ROSS ON MONOPOLIST PRICING



> The profit-maximizing firm with monopoly power will expand its output only as long as the net addition to revenue from selling an additional unit (the marginal revenue) exceeds the addition to cost from producing that unit (the marginal cost). At the monopolist's profit-maximizing output, marginal revenue equals marginal cost. But with positive output, marginal revenue is less than price, and so the monopolist's price exceeds marginal cost. This equilibrium condition for firms with monopoly power differs from that of the competitive firm. For the competitor, price equals marginal cost; for the monopolist, price exceeds marginal cost.…
> [The] Figure .. illustrates one of the many possible cases in which positive monopoly profits are realized; specifically, the per-unit profit margin P_3C_3 times the number of units OX_3 sold. As long as entry into the monopolist's market is barred, there is no reason why this profitable equilibrium cannot continue indefinitely.[81]

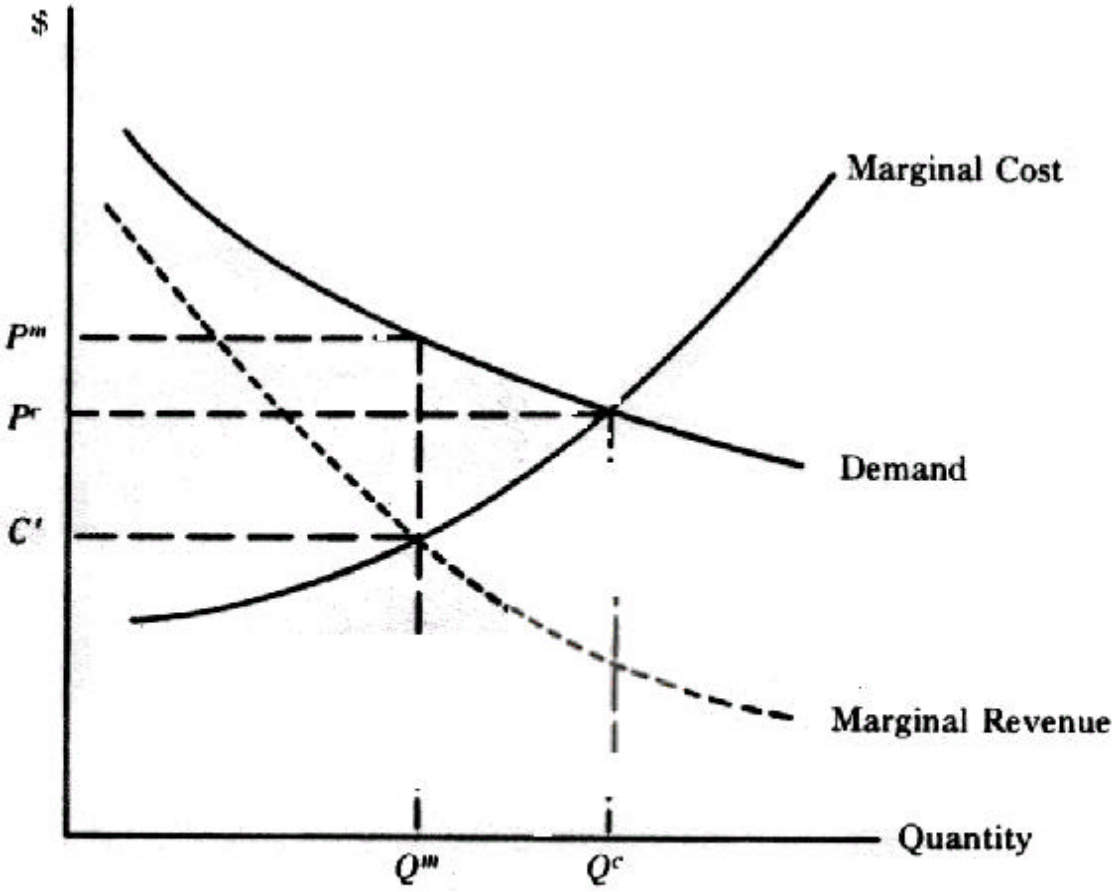
Landes and Posner – two prominent conservative economic thinkers -- offer a similar concept, described as follows with reference to Exhibit V-2. [82]

> Our concept of market power is illustrated in [Exhibit 3] on the next page, where a monopolist is shown setting price at the point on his demand curve where marginal cost equals marginal revenue rather than, as under competition, taking the market price as given. At the profit-maximizing monopoly price, pm, price exceeds marginal cost, C', by the vertical distance between the demand and marginal cost curves at the monopolist's output, Qm; that is, by pm -C'.

[81] Scherer, F. M. and David Ross, Industrial *Market Structure and Economic Performance* (Boston, Houghton Mifflin: 1990, Third edition), pp. 21…22; Shepherd, William, G., *The Economics of Industrial Organization* (Prentice Hall, Engelwood Cliffs, N.J., 1997, Fourth edition), presents a similar view.

[82] Landes, W. M. and R. A. Posner, "Market Power in Anti-trust Cases," *Harvard Law Review*, 19: 1981. Interestingly, the first economic text cited by Landes and Posner (at note 6) was the 1980 edition of Scherer and Ross.

EXHIBIT V-2
LANDES AND POSNER ON LERNER INDEX



Monopoly vs. Competitive Pricing

FIGURE 1

C. MEASURING HORIZONTAL MARKET POWER AND ITS IMPACT: THE LERNER INDEX

The most frequent starting point for a discussion of the empirical measurement of the price impact of monopoly power is the *Lerner Index.* The *Lerner Index* is defined as

M= (Price – Marginal Cost)/ Price.[83]

> Its merit is that it directly reflects the allocatively inefficient departure of price from marginal cost associated with monopoly. Under pure competition, M=0. The more a firm's pricing departs from the competitive norm, the higher is the associated Lerner Index value. A related performance-oriented approach focuses on some measure of the net profits realized by firms or industries.[84]

Scherer and Ross describe a series of profitability measures. The measures of profitability include profit margins, return on equity, and return on investment.

> As a surrogate, researchers have chosen diverse profitability measures that can be used, with varying degrees of reliability, as proxies for the evaluation of price above marginal cost.
>
> A good long-run approximation to the Lerner index is the ratio of supra-normal profits to normal cost. This is approximated by the ratio:

$$\frac{\pi}{S} = \frac{\text{Supra-normal profit}}{\text{Sales revenue}}$$

> where supra-normal profit = sales revenue – noncapital costs – depreciation – (total capital x competitive cost per unit of capital).
>
> second-best surrogates falling into three categories.

P_3). The total value of the overcharge is derived by multiplying the per-unit overcharge times the total number of units sold (OX_3). This is equal to the area of the rectangle P_3 BA C_3. This is the index of market power used by the CAL-ISO in documenting abuses in the California market.

[83] Scherer and Ross, at 70… 71.[83] Returning to Exhibit III-1, the Lerner Index represents the ratio of the monopoly overcharge (P_3 - C_3) divided by the total price (P_3). The total value of the overcharge is derived by multiplying the per-unit overcharge times the total number of units sold (OX_3). This is equal to the area of the rectangle P_3 BA C_3. This is the index of market power used by the CAL-ISO in documenting abuses in the California market.

[84] Scherer and Ross, at 70… 71.

One is the accounting rate of return on stockholders' equity:

$$\pi_E = \frac{\text{Accounting profits to stockholders}}{\text{Book value of stockholders equity}}$$

Or on capital:

$$\pi_E = \frac{\text{Accounting profits + interest payments}}{\text{Total Assets}}$$ [85]

Scherer and Ross identify a second measure of profitability, Tobin's q, which "captures the deviation between the market value of a firm and the replacement cost of its assets."[86]

$$q = \frac{M_C + M_P + M_D}{A_R}$$

The numerator is the sum of all common and preferred stock plus outstanding debt. The denominator is the costs replacing total assets. The logic is straightforward since "in an industry that meets all the conditions of pure competition, the q ratio should be one." Supranormal profits would attract entry. This means that if entrepreneurs could simply enter the market and put up competing systems, they could do so at a much lower cost. Needless to say, if competitors could actually enter the market, incumbent firms could not command such a premium price for their systems. Scherer and Ross note that all of the profitability measures present problems, but they are all highly correlated.

The Commission asks specifically about Tobin's q as a measure of market power distinct from the Lerner index discussed above. Tobin's q is a summary measure of

[85] Scherer and Ross, at 415... 416.
[86] Scherer and Ross, p. 416.

performance in a market that has a conceptual underpinning to the concept of market structure and market power, but it does not allow a direct representation in terms of market structure elements. If there is market power, we would expect Tobin's q to be high, but we do not calculate or estimate it based on the structural characteristics of market shares or elasticities.

Landes and Posner took the discussion in a different direction. First, the price/cost margin is converted to the reciprocal of the elasticity of demand. The lower the elasticity of demand, the greater the market power.

$$L = \frac{P - MC}{P} = \frac{1}{E}$$

They then transformed the index into an expression that used the market share of the dominant firm and decomposed the elasticity of demand into two components.

> We point out that the Lerner index provides a precise economic definition of market power, and we demonstrate the functional relationship between market power on the one hand and market share, market elasticity of demand, and supply elasticity of fringe competitors on the other.

$$L = \frac{(P - C)}{P} = \frac{1}{E_d} \qquad \frac{S}{e_m^d + e_j^s (1 - s_i)}$$

where:

S = the market share of the dominant firm

e_m^d = elasticity of demand in the market

e_j^s = elasticity of supply of the competitive fringe

s_i = market share of the fringe.

In words this formula says that the markup of price over cost will be directly related to the market share of the firm and inversely related to the ability of consumers to reduce consumption (the elasticity of demand) and to the ability of other firms (the competitive fringe) to increase output (the elasticity of this supply).

Interestingly, the point of the Landes and Posner article was to argue against the rote use of market shares in market power analysis. The elasticities of supply and demand were of particular concern.

> Market Share Alone Is Misleading. -Although the formulation of the Lerner index in equation (3) provides an economic rationale for inferring market power from market share, it also suggests pitfalls in mechanically using market share data to measure market power. Since market share is only one of three factors in equation (2) that determine market power, inferences of power from share alone can be misleading. In fact, if market share alone is used to infer power, the market share measure in equation (2), which is determined without regard to market demand or supply elasticity (separate factors in the equation), will be the wrong measure. The proper measure will attempt to capture the influence of market demand and supply elasticity on market power.[87]

Once one brings these elasticities into play in an industry like cable TV, the analysis become extremely troubling. Landes and Posner point out that when demand elasticities are low, market power becomes a substantial problem – the formula "comes apart."

> [T]he formula "comes apart" when the elasticity of demand is 1 or less. The intuitive reason is that a profit-maximizing firm would not sell in the inelastic region of its demand curve, because it could increase its revenues by raising price and reducing quantity. Suppose, for example, that the elasticity of demand were .5. This would mean that if the firm raised its price by one percent, the quantity demanded of its product would fall by only one-half of one percent. Thus its total revenues would be higher, but its total costs would be lower because it would be making fewer units of its product.

[87] Landes and Posner, at 947.

> Raising price in these circumstances necessarily increases the firm's profits, and this is true as long as the firm is in the inelastic region of its demand curve, where the elasticity of demand is less than 1.
>
> If the formula comes apart when the elasticity of demand facing the firm is l or less, it yields surprising results when the elasticity of demand is just a little greater than 1. For example, if the elasticity of demand is 1.01, equation (la) implies that the firm's price will be 101 times its marginal cost. There is a simple explanation: a firm will produce where its demand elasticity is close to one only if its marginal cost is close to zero, and hence a relatively low price will generate a large proportional deviation of price from marginal cost.[88]

This reminds us in simple terms that when we talk about market forces we mean the ability of consumers to cut back or shift their demand and the ability of producers to increase their output in response to price increases, i.e., the elasticities of supply and demand. If these elasticities are too close to zero, market forces are weak and the exercise of market power will take place.

An improvement in the formula was suggested.[89] It can be adjusted to take into account the key factor of strategic interactions.[90] A term can be included which adjusts for the special impact of the market shares of other firms.

$$L = \frac{(P - C)}{P} = \frac{S\,(1 + k)}{e^{d}_{m} + e^{s}_{j}\,(1 - s_{i})}$$

where:

S = the market share of the dominant firm

e^{d}_{m} = elasticity of demand in the market

e^{s}_{j} = elasticity of supply of the competitive fringe

s_{i} = market share of the fringe.

---

[88] Landes and Posner, at 942.

[89] Ordover, J.A. and R. D. Willig, "Herfindahl Concentration, Rivalry, and Mergers," *Harvard Law Review*, 95: 1982.

[90] Scherer and Ross (p. 412) introduce this idea as well, referring to it as "the firms conjectural variation – its assumptions about how rivals will respond to changes in its production levels."

where k = the effect of strategic interaction

The modified Lerner index can be described as follows: If the likelihood of strategic interaction will reinforce the efforts of the dominant firm to raise prices, then k can be set positive. If there is likely to be a uniquely vigorous competitive response, then k can be set negative. When k equals zero, there is no strategic interaction effect. Estimating the value of k is a subjective process, but it does add an important element to relating market structure to performance through conduct.

D. CONCLUSION

This chapter has used the Lerner index, one of the measures of market power identified by the Commission to explain the concept of market power. Market forces are expressed in economic parlance as elasticities of supply and demand. Market power can be directly related to these market fundamentals by recognizing the dynamic that market share creates. It enables the power-holder to raise prices based on the inability of consumers to cut back demand and competitors' inability to increase supply.

Although the analysis is typically conducted in terms of price increases, the logic applies to quality as well. Firms exercising market power seek to increase profits by either raising price or cutting back on quality (to pocket cost savings). In either case, it is the lack of "disciplinary" market forces that affords them the ability to exercise that market power.

VI. ECONOMIC THEORY OF MARKET POWER

A. SUMMARY

We now turn to the central question: "Under what circumstances is market power a problem?" In this chapter we discuss the third of the indices of market power on which the Notice seeks comment – the Herfindahl-Hirschman Index – because it has been widely used to set thresholds for concern and scrutiny of market power.

In this discussion, market shares, and therefore market concentration, are the starting point for measuring market power. Measuring concentration for purposes of market structure analysis has received a great deal of attention. We describe the Department of Justice (DOJ) Merger Guidelines which are based on the HHI and relate these to the four-firm concentration ratio. More importantly, we describe a number of market structures that have played a role in the discussion of the horizontal limits – monopoly, duopoly, oligopoly, etc.

This chapter also discusses the concept of monopsony power – the power of a large purchaser – which is the focal point of this proceeding. We demonstrate that increased consolidation in cable leads to tremendous monopsony power, one of the main concerns of Congress in directing the Commission to enact the horizontal ownership cap. Based on a theory of monopsony power, we show that the rule is properly set at 30 percent.

B. DOJ'S MERGER GUIDELINES

The DOJ defines market levels of concentration to determine the extent of review of mergers. [91] These guidelines were defined in terms of the Herfindahl-Hirschman Index (HHI). This measure takes the market share of each firm, squares it, sums the result, and

multiplies by 10,000.[92] A second method to quantify market concentration is to calculate the market share of the largest 4 firms (4 firm concentration ratio or CR4).

Under its Merger Guidelines, the DOJ considers a market with an HHI of 1000 or less to be unconcentrated. Such a market would have the equivalent of ten equal sized competitors. In such a market, the 4-firm concentration ratio would be 40 percent (see Exhibit VI-1). Any market with a concentration above this level is deemed to be a source of concern.

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[91]U.S. Department of Justice, Merger Guideline, revised, 1997.

[92] Shepherd, William, G., *The Economics of Industrial Organization* (Prentice Hall, Engelwood Cliffs, N.J., 1997, Fourth edition), p. 389, gives the following formulas for the Herfindahl-Hirschman Index (HHI) and the Concentration Ratio (CR):

$$H = \sum_{i=1}^{n} S_i^2$$

$$CR = \sum_{i=1}^{m} S_i$$

m i = 1

where
n = the number of firms
m= the market share of the largest firms (4 for the 4 firm concentration ratio)
S_i = the share of the ith firm.

EXHIBIT VI-1:

DESCRIBING MARKET CONCENTRATION FOR PURPOSES OF PUBLIC POLICY

DEPARTMENT OF JUSTICE MERGER GUIDELINES	TYPE OF MARKET	EQUIVALENTS IN TERMS OF EQUAL SIZED FIRMS	HHI	4-FIRM SHARE
	Monopoly	1 Firm with 65% or more	4250<	100
	Duopoly	2	5000<	100
↑		5	2000	80
HIGHLY CONCENTRATED	Tight Oligopoly		1800 OR MORE	
		6	1667	67
UNCONCENTRATED	Loose Oligopoly	10	1000	40
↓				
	Atomistic Competition	50	200	8

Sources: U.S. Department of Justice, *Horizontal Merger* Guidelines, revised April 8, 1997, for a discussion of the HHI thresholds; Shepherd, William, G., *The Economics of Industrial Organization* (Prentice Hall, Englewood Cliffs, N.J., 1985), for a discussion of 4 firm concentration ratios.

The DOJ considers an HHI of 1800 as the point at which a market is considered highly concentrated. This level falls between five and six equal-sized competitors.

Shepherd describes these thresholds in terms of four-firm concentration ratios as follows:[93]

> Tight Oligopoly: The leading four firms combined have 60-100 percent of the market; collusion among them is relatively easy.
>
> Loose Oligopoly: The leading four firms, combined, have 40 percent or less of the market; collusion among them to fix prices is virtually impossible.

There are three other types of markets that should be identified. Although ten firms constitutes an unconcentrated market, under certain circumstances even that number does not ensure vigorous competition. Generally, a much higher number, perhaps fifty, is associated with the concept of vigorous or atomistic competition.

On the other hand, there are two types of markets that are even more concentrated and therefore a source of additional concern. A duopoly is composed of two firms. Although the expression 'monopoly' technically refers to one firm, antitrust practice refers to monopoly power when the market share of a firm rises to the level of 60 to 70 percent.

C. THE LINK BETWEEN MARKET STRUCTURE, COLLUSION, AND MARKET POWER

It is critical to keep in mind that merger policy is probabilistic and predictive. The DOJ Guidelines are oriented toward conditions under which certain types of anticompetitive behaviors are sufficiently likely to occur to require regulatory action.

> The rule of thumb reflected in all iterations of the Merger Guidelines is that the more concentrated an industry, the more likely is oligopolistic behavior by that industry.... Still, the inference that higher concentration increases the risks of oligopolistic conduct seems well grounded. As the number of industry participants becomes smaller, the task of coordinating industry behavior becomes easier. For example, a ten-firm industry is more likely to

[93] Shepherd, p. 4.

> require some sort of coordination to maintain prices at an oligopoly level, whereas the three-firm industry might more easily maintain prices through parallel behavior without express coordination.

Shepherd refers to collusion in his discussion, but that is not the only concern of market power analysis or the Merger Guidelines. The Merger Guidelines recognize that market power can be exercised with coordinated, or parallel, activities and even unilateral actions.

> Market power to a seller is the ability profitably to maintain prices above competitive levels for a significant period of time.*/ In some circumstances, a sole seller (a "monopolist") of a product with no good substitutes can maintain a selling price that is above the level that would prevail if the market were competitive. Similarly, in some circumstances, where only a few firms account for most of the sales of a product, those firms can exercise market power, perhaps even approximating the performance of a monopolist, by either explicitly or implicitly coordinating their actions. Circumstances also may permit a single firm, not a monopolist, to exercise market power through unilateral or non-coordinated conduct --conduct the success of which does not rely on the concurrence of other firms in the market or on coordinated responses by those firms. In any case, the result of the exercise of market power is a transfer of wealth from buyers to sellers or a misallocation of resources.
>
> */ Sellers with market power also may lessen competition on dimensions other than price, such as product quality, service or innovation.[94]

Lawrence Sullivan and Warren S. Grimes, describe the DOJ approach as follows:

> The coordination that can produce adverse effects can be either tacit or express. And such coordination need not be unlawful in and of itself. According to the 1992 Guidelines, to coordinate successfully, firms must
> (1) reach terms of interaction that are profitable to the firms involved and
> (2) be able to detect and punish deviations. The conditions likely to facilitate these two elements are discussed separately, although they frequently overlap.
>
> In discussing how firms might reach terms for profitable coordination, the Guidelines avoid using the term "agreement," probably because no agreement or conspiracy within the meaning of Section 1 of the Sherman Act is necessary for the profitable interaction to occur. As examples of such

[94] Horizontal Merger Guidelines, at section 0.1.

> profitable coordination, the Guidelines list "common price, fixed price differentials, stable market shares, or customer or territorial restrictions." Sometimes the facilitating device may be as simple as a tradition or convention in an industry.

They go on to note the mechanisms that might be used and the usefulness of the HHI in this regard.

> Oligopoly conditions may or may not require collusion that would independently violate Section 1 of the Sherman Act. A supracompetitive price level may be maintained through price leadership (usually the leader is the largest firm), through observance of a well-established trade rule (e.g., a convention of a 50 percent markup in price among competing retailers), or through strategic discipline of nonconforming members of the industry…
>
> To the extent that one or very few members of a concentrated industry have much higher market shares than other members, the opportunities for strategic disciplining may expand… The expanded ability of the larger firm to coerce price discipline is reflected in the Herfindahl-Hirschman Index (HHI), which will assign a high concentration index to an industry with a very large participant. An industry with the same number of participants, each of them roughly equal in size, will have a lower index.[95]

The area of noncollusive, oligopoly behavior has received a great deal of attention. A variety of models have been developed in which it is demonstrated that small numbers of market participants interacting in the market, especially on a repeated basis, can learn to signal, anticipate, and parallel one another to achieve outcomes that capture a substantial share of the potential monopoly profits

D. THE ECONOMIC THEORIES OF MONOPSONY AND MONOPOLY POWER

Antitrust law and practice recognizes that monopoly and monopsony are flip sides of the same anticompetitive coin.

> The mirror image of monopoly is "monopsony." A monopsonist is a monopoly buyer rather than seller. Although most antitrust litigation of market power offenses has involved monopoly sellers rather than buyers,

[95] Herbert Hovenkamp, *The Law of Antitrust: An Integrated Handbook*, Hornbook Series (West Group, St. Paul, 2000), pp. 596-597.

> monopsony can impose social costs on society similar to those caused by monopoly.[96]
>
> Monopsony is often thought of as the flip side of monopoly. A monopolist is a seller with no rivals; a monopsonist is a buyer with no rivals. A monopolist has power over price exercised by limiting output. A monopsonist also has power over price, but this power is exercised by limiting aggregate purchases. Monopsony injures efficient allocation by reducing the quantity of the input product or service below the efficient level.[97]

Monopsony power has received less attention in antitrust practice for a variety of reasons. Monopoly and monopsony frequently occur together and monopoly is the more inviting antitrust target.[98] The impact of this exercise of market power, in the first instance, may be to lower prices paid by monopsonist buyers, which poses a conundrum for antitrust law, which usually focuses on price increases.[99]

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[96] Hovenkamp, p. 13-14.

[97] Lawrence Sullivan and Warren S. Grimes, *The Law of Antitrust: An Integrated Handbook,* Hornbook Series (West Group, St. Paul, 2000) at 138-139.

[98] Id. at 138-139.

> Antitrust law has been slow to develop a coherent set of principles for assessing monopsony power. One reason for this is that many firms possessing monopsony power in the purchase of goods or services also possess monopoly power when the goods or services are resold. For example, the monopsony power that a cable TV franchise possesses in purchasing television programming becomes monopoly power when that programming is distributed to the franchise's cable subscribers. When a monopsonist is also a monopolist, attacking the monopoly conduct may be the politically more popular enforcement option because the monopoly conduct has a direct impact on the price paid by consumers.
>
> Although there is no theoretical basis for assuming that monopsony power is less injurious to consumer welfare than monopoly power, the direct injury that monopsony occasions is to the seller of goods and services, not to the end consumer. To the extent antitrust chooses politically popular enforcement initiatives, it is understandable that it would focus on a monopoly that raises prices to consumers rather than a monopsony that depresses prices to sellers.

[99] Hovenkamp, at 14.

> By reducing its demand for a product, a monopsonist can force suppliers to sell to it at a lower price than would prevail in a competitive market... If the price is suppressed they will reduce output to a level that once again equals their marginal costs. In any event, both price and output will fall below the competitive level when the buyer is a monopsonist. Some productive assets will be assigned to products that would have been the supplier's second choice in a competitive market. As a result, monopsony allocates resources inefficiently just as monopoly does.

However, the leading antitrust texts recognize that a careful economic analysis of the abuse of monopsony power leads to the more traditional and typical anticompetitive effects.[100]

> The monopsonist reduces its buying price by reducing the amount of some input that it purchases. If the input is used in the output in fixed proportions, then the output must be reduced is well. This suggests two things: (1) the monopsony buyer that resells in a competitive market will charge the same price, but its output will be lower than if it were a competitive purchaser; (2) the monopsony buyer (or cartel) that resells in a monopolized (or cartelized) market will actually charge a higher price than if it were a competitive purchaser.[101]
>
> But antitrust attacks on monopsony abuses do occur and enforcement efforts can lead to a potentially wider interest in market power abuses of powerful buyers.
>
> For example, in addressing vertical restraints, the theoretical literature has increasingly recognized that some restraints are a product of market power in the hands of downstream dealers that buy from their suppliers. Increased public interest also followed the Federal Trade Commission's pursuit of a vertical restraints case against Toys "R" Us alleging that the powerful retail chain exercised monopsony power in preventing suppliers from selling on equal terms to other retailers.[102]

In fact, not only is monopsony power the object of traditional antitrust practice,[103] but also it has a very long-standing presence in seminal cases.

> Although the Court did not use the term "monopsony," it has not hesitated in a number of cases to apply Section 2 of the Sherman Act to monopsony

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> The important policy implication of monopsony is that it reduces rather than increases output in the monopsonized market. Many federal judges have failed to see this. The consumer welfare principle in antitrust, or the notion that the central goal of antitrust policy should be low prices, has often suggested to courts that monopsony is not all that important an antitrust policy concern.

[100] Roger D. Blair and Jeffrey L. Harrison, "Antitrust Policy and Monopsony," *Cornell L. Rev.* 1991.
[101] Id. at 15.
[102] Sullivan and Grimes, at 139.
[103] John Lauck, "Toward an Agrarian Antitrust: New Direction for Agricultural Law," *N.Dak. L. Rev* 499, 1999; John J. Curtin, Daniel L. Goldberg and Daniel S. Savrin, "The EC's Rejection of the Kesko/Tuko Merger: Leading the Way to the Application of a 'Gatekeeper' Analysis of Retailer Market Power Under U.S. Antitrust Law," 40 *B.C. L. Rev.* 537 (1999).

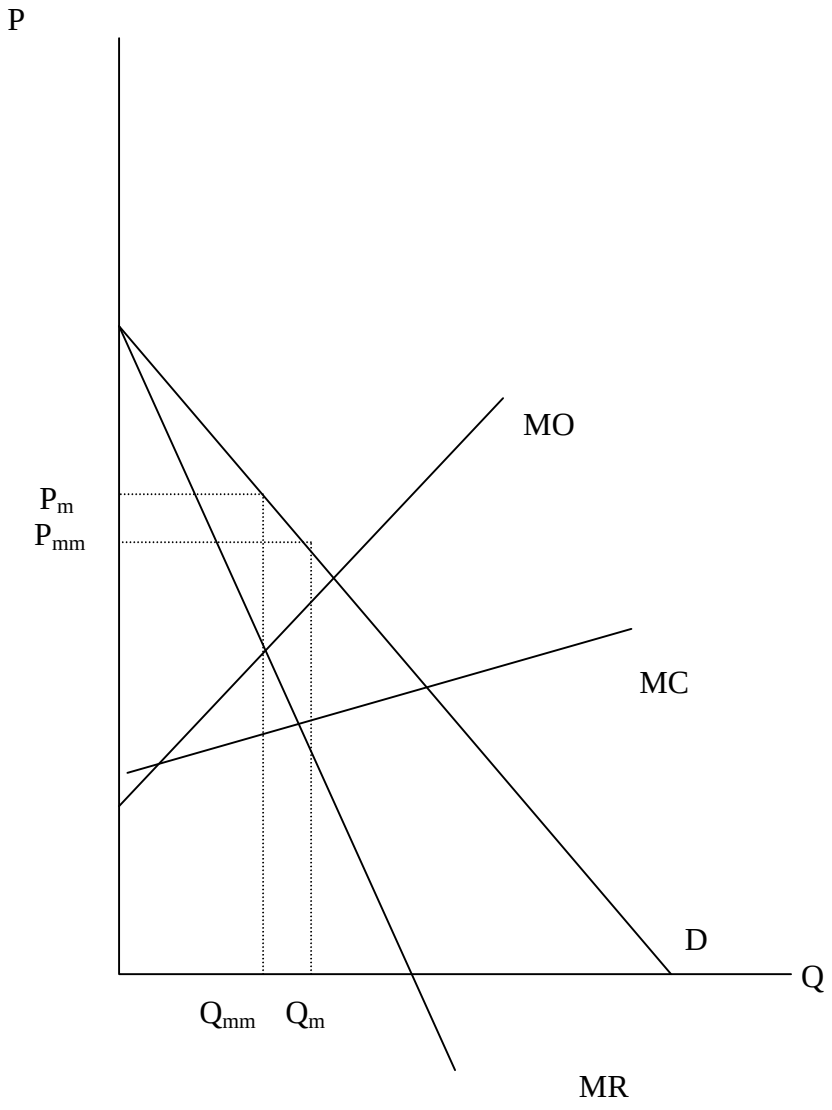
> power. An early example of this was the 1911 Standard Oil case, involving allegations that Standard Oil used its monopsony power over the railroads to dictate the terms by which the railroads would deal with rivals of Standard Oil. Standard Oil was by no means the sole purchaser of railroad transportation, but its substantial position in the oil industry and the relative importance of a railroad maintaining its petroleum business probably gave Standard Oil a substantial measure of monopsony power. The Justice Department directed another Section 2 attack on monopsony power at movie theater owners in United States v. Griffith. In Griffith, the defendants owned movie theaters in towns in Oklahoma, Texas and New Mexico, some of them in competition with rival theaters in the same town, others operating as the sole theater in town. The Justice Department successfully invoked Section 2 in condemning the defendants use of their buying power to gain favorable terms from movie distributors...
>
> The unspoken premise of Griffith is that the Court will apply the same standards of proof to a monopsony claim under Section 2 that it would apply to a monopolization claim.[104]

Referring to Exhibit VI-2, Hovenkamp discusses monoposony power as the monopoly power "turned upside down," but leading to the same result – higher prices – when it is combined with monopoly power.

> Consider this illustration.
> A monopoly manufacturer of aluminum is also a monopsony purchaser of bauxite.
>
> "Marginal outlay" refers to the total additional cost that the monopsonist incurs when it purchases one more unit. By contrast, "marginal cost" refers to the cost of the one additionally purchased unit. While the monopolist generally maximizes profits by equating marginal cost and marginal revenue, the monopolist that is also a monopsonist in an input market maximizes profits by equating marginal outlay and marginal revenue.
>
> [Exhibit VI-2] illustrates. It shows the relevant demand (D), marginal revenue (MR), marginal cost (MC) and marginal outlay (MO) curves of a firm that purchases a single input in a monopsonized market and resells this input in a monopolized market. Considering the firm simply as a monopolist in the output market, it would equate MC and MR. The monopoly price

[104] Id. at 139.

EXHIBIT VI-2:
THE COMBINATION OF MONOPOLY AND MONOPSONY POWER



Reproduced from Hovenkamp, Herbert, *Federal Antitrust Policy: The Law of Competition and Its Practice,* Hornbook Series (West Group, St.Paul; 1999),Footnote 13, p. 15.

> would be Pm and monopoly output would be Qm. However, if the monopolist is also a monopsonist in the market for the input and its marginal cost curve slopes upward, then its marginal outlay curve will slope upward as well, only twice as steeply. That is, the relation between marginal cost and marginal outlay is exactly the same as the relation between demand and marginal revenue, except turned upside down. The monopolist/monopsonist maximizes its profits by equating MO and MR. This yields a monopoly/monopsony price on Pmm'and an output of Qmm.[105]

Even if the sole effect of monopsony power were to reduce the prices paid to programmers who were its targets, it would be objectionable under the 1992 Act, since Congress expressed great concern with promoting diversity and the reduction of output of suppliers (programmers) would be an affront to the Act.

Sullivan and Grimes note that the exercise of monopsony power is more likely in specialized products. They specifically include cable TV programming in the list of markets likely to be afflicted with the exercise of monopsony power.

> Monopsony is thought to be more likely when there are buyers of specialized products or services. For example, a sports league may exercise monopsony (or oligopsony) power in purchasing the services of professional athletes. An owner of a chain of movie theaters, some of which are the sole theaters in small towns, may have monopsony power in the purchase or lease of movies. Cable TV franchises may exercise monopsony power in purchasing television channels that will be offered to their subscribers.
> Id.[106]

> At the same time, the abuse of monopsony power is more likely when the product is undifferentiated. Where products are relatively undifferentiated and capacity primarily distinguishes firms and shapes the nature of their competition, the merged firm may find it profitable unilaterally to raise price and suppress output. The merger provides the merged firm a larger base of sales on which to enjoy the resulting price rise and also eliminates a competitor to which customers otherwise would have diverted their sales. Where the merging firms have a combined market share of at least thirty-five percent, merged firms may find it profitable to raise price and reduce joint output below the sum of their premerger outputs because the lost markups on

[105] Hovenkamp, Footnote 13, p. 15.
[106] Sullivan and Grimes, p. 138.

> the foregone sales may be outweighed by the resulting price increase on the merged base of sales.[107]

In some respects, video programming is differentiated, in others it may not be. The NPRM recognizes this when it discusses the question of entry by imitation in genres.[108] The development of marquis shows and strong brands suggests differentiation. The development of look-a-likes suggests a lack of differentiation.

The 35 percent figure, given for routine monopsony power concerns, is well grounded in antitrust practice in the sense that mergers have been successfully challenged at this level.[109] Similarly, a 30% limit is well grounded in monopsony complaints. For example, in the Toys R Us case noted above, the market controlled was "20% of the national wholesale market and up to 49% of some local markets."[110]

This review of theoretical and practical literature on horizontal market structure leads to a clear conclusion that is reflected in much public policy. Based on decades of analysis, the expectation is that certain types of market structures are sufficiently conducive to anticompetitive outcomes to be a source of concern. The 30 percent figure used by the FCC is well grounded in this literature and practice.

E. CONCLUSION

This chapter has provided the detailed specification of where market power is a source of concern based on the economic literature in general and the DOJ *Merger Guidelines* in particular. We identify market structures that are linked to anticompetitive conduct. The key linkage is the increasing ease with which a shrinking number of

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[107] Merger Guidelines, Section 2.22.
[108] ¶ 17
[109] Peter Asch, *Industrial Organization and Antitrust Policy* (John Wiley, New York; 1983), Chapter 14.

competitors allows unilateral, parallel, tacitly collusive, or explicitly collusive action to take place. The concept has been extended to monopsony power.

[110] *In re Toys "R" Us, Inc.*, FTC No. 9278 (October 13, 1998).

VII. VERTICAL MARKET POWER ISSUES

A. SUMMARY

While horizontal market power has been the central focus of antitrust analysis and plays a key role in this proceeding, vertical market power is the driving force behind the horizontal limit. The concern is that the market power of the cable operators in the program distribution market can be used to distort the performance of the vertically related program production market. This chapter demonstrates that this is likely to be a serious problem in the multichannel video market.

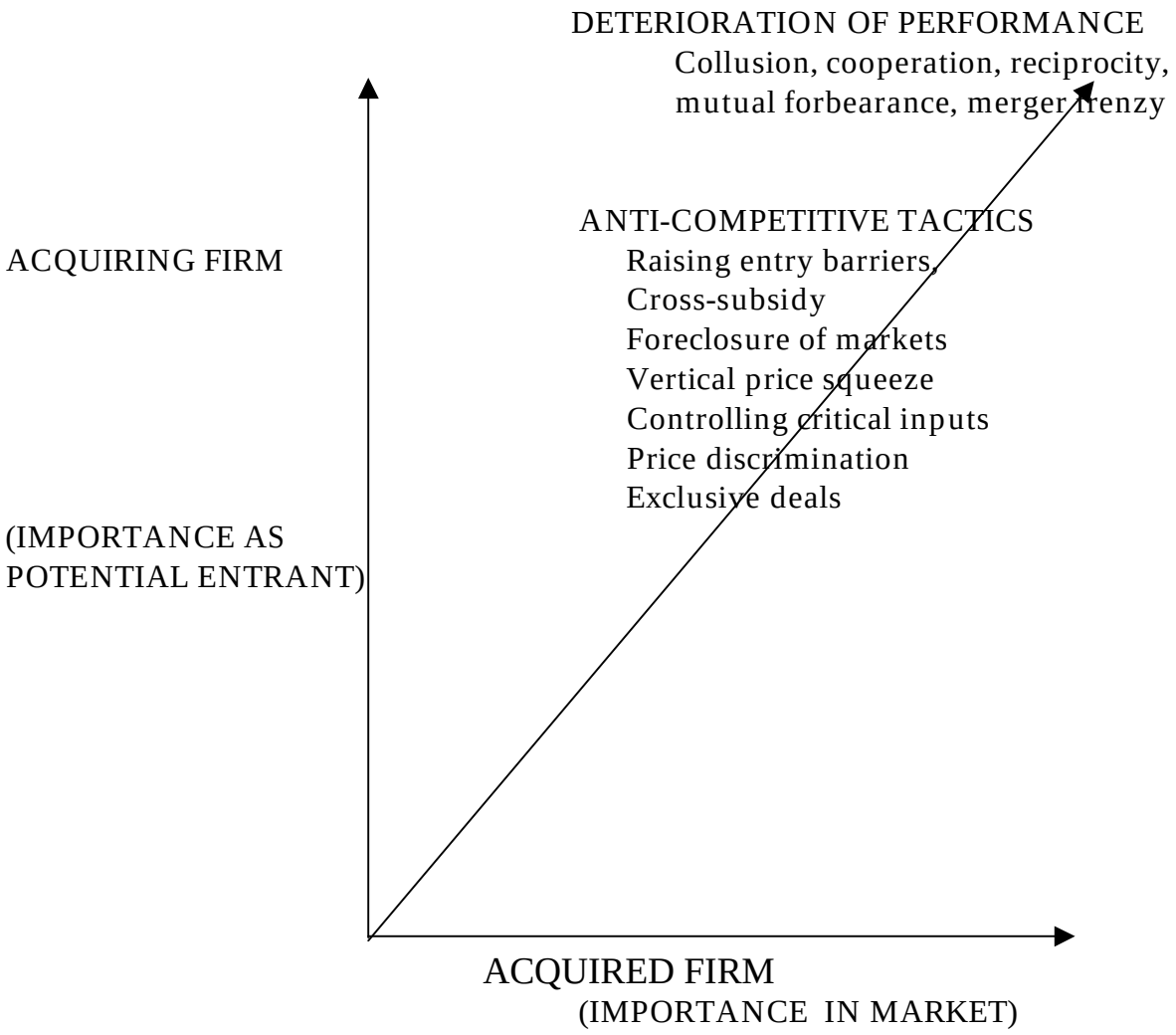
In the traditional literature, vertical issues have received some attention; these are reviewed first. In high technology industries, where platforms play a prominent role, vertical issues are receiving a great deal of attention as well. Relying on industry and non-industry comments, we identify two types of vertical discrimination – conduit and content – that appear to be serious threats to competition in the multichannel video market.

B. VERTICAL MARKET POWER RESULTS IN ANTICOMPETITIVE CONDUCT

The previous discussion focuses on horizontal marker power. Vertical issues are also a concern in this proceeding because cable operators have integrated into programming. Vertical integration can raise concerns, especially when dominant firms become integrated across markets for critical inputs.

Exhibit VII-1 summarizes the anticompetitive conduct and negative market performance that can emerge from the weakened market structures that result from the particular type of concentration caused by these mergers.

EXHIBIT VII-1:
THE SPECIAL PROBLEM OF CONGLOMERATES



Shepherd, William G., The Economics of Industrial Organization (Prentice Hall, Englewood Cliffs, NJ, 1985), pp. 289-304.

Vertical integration can create barriers to entry. By integrating across stages of production, incumbents may force potential competitors to enter at both stages, making competition much less likely.

> [V]ertical mergers may enhance barriers to entry into the primary industry if entrants must operate at both stages in order to be competitive with existing firms and if entry at both stages is substantially more difficult than entry at one stage.[111]
>
> Bain popularized the concept of barriers to entry and also discussed the importance of potential competition. Bain argued that vertical integration creates a capital barrier to entry by forcing potential entrant to contemplate entry at two stages of production rather than just one.[112]
>
> To avoid these hazards, firms entering either of the markets in question might feel compelled to enter both, increasing the amount of capital investment required for entry.[113]

Capital market hurdles are only one of the barriers to entry that vertical integration and conglomeration can create. Such mergers can also foreclose input markets to competitors.

> When all production at a level of an industry is "in-house," no market at all exists from which independent firms can buy inputs. If they face impediments or delays in setting up a new supplier, competition at their level will be reduced. The clearest form of this is the rise in capital a new entrant needs to set up at both levels.[114]
>
> Ores, special locations, or other indispensable inputs may be held by the integrated firm and withheld from others. The integration prevents the inputs from being offered in a market, and so outsiders are excluded. A rational integrated firm might choose to sell them at a sufficiently high price.[115]

Exclusive and preferential deals for the use of facilities and products compound the problem.

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[111] Perry, p. 247.
[112] Perry, p. 197.
[113] Scherer and Ross, p. 526.
[114] Shepherd, pp. 289-290.

> The first firms to integrate into neighboring stages reduce the number of alternative sources for other firms at either stage. This "thinning" of the market can increase the costs of market or contractual exchange. Subsequent integration by other firms then becomes more likely.[116]
>
> Restrictions may be set on areas, prices or other dimension … Only when they are done by small-share firms may competition be increased. When done by leading firms with market shares above 20 percent, the restrictions do *reduce* competition.[117]
>
> Similarly, a dominant firm may also use vertical integration to raise the costs of its competitors … By leaving the open market thin, competitors may be unable to expand without significantly driving up the input price, they may be subject to higher prices set by the fewer remaining suppliers, or they may incur higher transaction costs for having to negotiate contracts with suppliers…[118]

The market structural conditions that result from the concentration and integration of the industry make behavioral abuse more easily effective. Cross-subsidization becomes possible,[119] although this is by no means the only available instrument of anti-competitive conduct. Vertical integration facilitates price squeezes and enhances price

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[115] Shepherd, p. 290.
[116] Perry, p. 247.
[117] Shepherd, p. 294.
[118] Perry, p. 197.
[119] Asch, Peter and Rosalind Senaca, *Government and the Marketplace* (Dryden Press, Chicago: 1985), p. 248.

> Subsidization: The conglomerate firm can choose to behave in a predatory fashion in one market, subsidizing its predation from profits earned elsewhere.
>
> The simple concept involved in cross subsidizing is that conglomerates can use profits from branch A to support deep, "unfair" price cuts by branch B …

Shepherd, p. 302.

> If all branches of a diversified firm are dominant in their markets, their pooled resources are likely to increase their dominance through greater price discrimination, threats of punitive actions, and so forth. By contrast, a string of small-share branches is more likely to promote competition than to reduce it, if it can help its members at all

discrimination.[120] Cable firms can impose higher costs on their rivals or degrade their quality of service (withholding flagship programming) to gain an advantage.

> This could happen, if, for example, the conduct of vertically integrated firms increased risks for nonintegrated firms by exposing downstream specialists to regular or occasional price squeezes or made it difficult for upstream specialists to find a market for their output in times of depressed demand.[121]

There is a growing body of theoretical and empirical analysis that has reinvigorated concerns about the anti-competitive impacts of vertical integration, particularly in the cable industry.[122] Concerns arise that not only will the dominant firm in the industry gain the leverage to profitably engage in anti-competitive conduct, but also the dynamic processes in the industry will clearly shift toward cooperation and coordination rather than competition. The issue is not simply collusion, although that is clearly a concern.

> The *Guidelines* do recognize three major competitive problems of vertical mergers in concentrated industries. First, forward mergers into retailing may facilitate collusion at the manufacturing stage by making it easier to monitor prices or by eliminating a "disruptive buyer." [123]

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[120] Scherer and Ross, p. 524.

> Substitution elasticities of unity and less normally imply that inputs are indispensable, that is, that no output can be produced until at least some use is made of each relevant input. When the monopolist of an input indispensable in this sense integrates downstream, it can make life difficult for remaining downstream competitors. It can refuse to sell the input to them, driving them out of business. Or it can sell it to them at a monopoly price, meanwhile transferring input at marginal cost to its affiliated downstream units, which, with their lower costs, can set product prices at levels sufficiently low to squeeze the rivals our of the market.

[121] Scherer and Ross, p. 526.

[122] On the cable industry see Ordover and Braunstein, op. cit. or more general arguments see Krattenmaker, T.G. and S. C. Salop, "Anti-competitive Exclusion: Raising Rivals' Costs to Achieve Power Over Prices," The Yale Law Journal, 92:2 (1986); Ordover, J., A. O. Sykes and R.D. Willig, "Non-price Anti-Competitive Behavior by Dominant Firms Toward the Producers of Complementary Products," in F. M. Fisher (Ed.), Antitrust and Regulation (Cambridge: MIT Press, 1985).

[123] Perry, p. 247.

Beyond collusion, a mutual forbearance and reciprocity occurs as spheres of influence are recognized and honored between and among the small number of interrelated entities in the industry.

> Now we consider the big picture, rather than market-by-market effects. Imagine an extreme situation, with five big diversified firms extending into all major sectors. They coexist in parallel, touching one another in hundreds of markets. Whatever their effects on each market might be, they pose a larger problem of spheres of interest, or diplomatic behavior replacing competition …
>
> Reciprocity is an exchange of favors. Reciprocal buying is one form of it. At its simplest, firm A buys from firm B because of some purchase that B makes from A …
>
> Reciprocity: The large conglomerate may have numerous opportunities for reciprocal buying arrangements.
>
> Mutual forbearance: More generally (it is sometimes claimed) large firms treat each other with deference, avoiding competitive confrontation whenever possible.[124]

The final behavioral effect is to trigger a rush to integrate and concentrate. Being a small independent firm at any stage renders a company extremely vulnerable to a variety of attacks.

> It is possible that business firms undertake vertical integration mergers not to enhance the level of monopoly power at some stage, but to redistribute it. Oligopolies often settle down into behavioral patterns in which price competition atrophies, even though some or all sellers suffer from excess capacity. Non-price rivalry then becomes crucial to the distribution of sales. One form of nonprice competition is the acquisition of downstream enterprises which, all else (such as prices) being equal, will purchase from their upstream affiliates. If acquisition of this sort deflects significant amounts of sales, disadvantaged rivals are apt to acquire other potential customers in self-defense, and reciprocal fear of foreclosure precipitates a bandwagon effect in which the remaining independent downstream enterprises are feverishly sought.[125]

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[124] Asch and Senaca, p. 248.
[125] Scherer and Ross, pp. 526-527.

> Triggering: If there are 10 nonintegrated firms and only one of them integrates, then little affect on competition might occur. But if this action induces the other 9 to do the same, the ultimate impact of the first "triggering" move may be large. Any increase in market power is magnified.[126]

C. VERTICAL MARKET POWER IN THE CABLE AND COMMUNICATIONS INDUSTRIES IS INCREASINGLY PROBLEMATIC

1. Industry Players Complain that Vertical Integration Leads to Anticompetitive Outcomes

Historically, vertical market power issues have received less attention than horizontal issues, but "the increasing number of mergers in high-technology industries has raised both horizontal and vertical antitrust issues.…the interest in and analysis of vertical issues has come to the forefront.[127] A number of recent mergers in the communications industries (AT&T/MediaOne, AOL/Time Warner, SBC/Ameritech, Bell Atlantic/GTE) between increasingly large owners of communications facilities have elicited vigorous analysis of the abuse of vertical market power.

There is no hesitation by owners of one set of facilities to criticize the anticompetitive impacts of allowing owners of the other facilities to gain too large a market share. They argue that it provides leverage and an incentive to discriminate against both alternative transmission media and alternative content suppliers. For example, experts for the local telephone companies pointed out that cable companies were abusing their market power over coaxial cable to prevent streaming video from competing against their core monopoly cable TV service. This is part of a clear pattern of cable companies frustrating competition for the core monopoly service.

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[126] Shepherd, p. 290.

[127] Daniel Rubinfeld and Hal. J. Singer, "Open Access to Broadband Networks: A Case Study of the AOL/Time Warner Merger," *Berkeley Technology Law Journal* 16 (2001), p. 632.

> AT&T's acquisition of MediaOne represents a traditional cable strategy of controlling alternative source of delivery for video programming. Before AT&T's recent cable acquisition intiative, the most recent implementation of this anticompetitive strategy was the attempt by a coalition of cable firms to control satellite delivery of video programming, the first alternative medium for multichannel video programming… The acquisition of MediaOne will allow AT&T to control broadband Internet delivery of video programming. Even AT&T's own economic experts admit that "Internet video streaming clearly competes, at a minimum, with video programming offered by cable systems, satellite companies, and television broadcasters.[128]

Even after AT&T had become the nation's largest cable TV company, it was still criticizing local telephone companies for abusing their monopoly control over their telephone wires. AT&T complained about bottleneck facilities, vertical integration, and anticompetitive bundling of services. Needless to say, AT&T refuses to accept the same public policy obligation to provide open access to the approximately 20 million cable homes that its cable wires pass through, including 2 million in Texas (about one-third as many as SBC has in the residential sector in that state) where it was opposing long distance entry.

> Today, SWBT is exploiting its control over essential xDSL-related inputs, not only to prevent advanced services competition from AT&T and others, but also to perpetuate its virtual monopoly over the market for local voice services…
>
> SWBT has not, in fact, complied with its statutory duties to provide nondiscriminatory access to xDSL-capable loops (47 U.S.C. s. 271(c)(2)(B)(ii)&(iv)) and the operational support systems and processes that are needed to enable Texas consumers to benefit from a competitive market for xDSL services (47 U.S.(c)(2_(B)(ii))…
>
> SWBT must also have policies, procedures, and practices in place that enable AT&T (by itself, or through partners) to provide consumers with the full range of services they desire, including advanced data services. Otherwise they will not be able to purchase <u>some</u> services – and will therefore, be less inclined to obtain <u>any</u> services – from AT&T. Thus, SWBT's inability (or unwillingness) to support AT&T's and other new entrants' xDSL needs not only impairs competition for advanced services but also jeopardizes competition for voice services as well.

[128] Hausman, Sidak and Singer, p. 133.

> As both the Commission and Congress have recognized, high-speed data offerings constitute a crucial element of the market for telecommunications services, and, because of their importance, the manner in which they are deployed will also affect the markets for traditional telecommunications. Many providers have recognized the growing consumer interest in obtaining "bundles" of services from a single provider. Certainly SBC, with its $6 billion commitment to "Project Pronto" has done so. AT&T is prepared to compete, on the merits, to offer "one-stop shopping" solutions. Competition, however, cannot survive if only a single carrier is capable of providing consumers with a full package of local, long distance, and xDSL services.[129]

The long-distance companies and competitive local exchange carriers have made the same point about the merging local exchange carriers. As their experts argue,

> This report review, in summary form, the empirical evidence that the proposed SBC-Ameritech and Bell Atlantic-GTE mergers will have competition in local exchange, interexchange, and combined-service markets due to footprint effects. The economic logic of competitive spillovers implies that the increase in ILEC footprints resulting from these proposed mergers would increase the ILECs' incentive to disadvantage rivals by degrading access services they need to compete, thereby harming competition and consumers.[130]

In a somewhat different context, small cable companies have exposed the incentive that large cable companies have to discriminate. They give examples of such discrimination that takes place in spite of the program access rules and make a strong case that larger entities have larger incentives to discriminate.[131]

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[129] AT&T SBC Comments, pp. 9… 10… 11… 12.

[130] John B. Hayes, Jith Jayaratne, and Michael L. Katz, *An Empirical Analysis of the Footprint Effects of Mergers Between Large ILECS*, April 1, 1999, p. 1; citing "Declaration of Michael L. Katz and Steen C. Salop," submitted as an attachment to *Petition to Deny of Spring Communications Company L.P,* in Ameritech Corp. and SBC Communications, Inc., for Consent to Transfer of Control, CC Dkt. No. 98-141 (filed Oct. 15, 1998) and *Petition to Deny of Spring Communications Company L.P,* in GTE Corporation and Bell Atlantic Corporation for Consent to Transfer of Control, CC Dkt. No. 98-184 (filed Nov. 23, 1998).

[131] "Comments of the American Cable Association, *In the Matter of Implementation of the Cable Television Consumer Protection and Competition Act of 1992, Development of Competition and Diversity in Video Programming Distribution: Section 628 (c)(5) of the Communications Act: Sunset of Exclusive Contract Prohibition*, Federal Communications Commission, CS Dkt. No. 01-290, December 3, 2001.

2. Conduit and Content Discrimination Arise Because of the Large Size of Vertically-Integrated Firms, Leading to Anticompetitive Outcomes

All of this finger-pointing by industry players reflects more than the obvious and somewhat embarrassing hypocrisy of self-interested corporations – there is a strong theory of discrimination outlined by these parties.

The experts for the local telephone companies spend a great deal of time demonstrating that "contrary to the claims of the hands off advocates… a vertically integrated broadband provider such as AT&T will have a strong incentive and opportunity to discriminate against unaffiliated broadband content providers."[132] They point out that "the traditional models of discrimination do not depend on the vertically integrated firm obtaining some critical level of downstream market share."[133] Nevertheless, the size of the

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As discussed above, exclusive programming contracts will offer major MSOs opportunities to increase competitive advantage, maximize profits, and increase company value. Absent restraint, rational MSOs will respond to those economic incentives and enter into exclusive distribution arrangements. The Commission can safely assume that these consequences would follow a complete sunset of the prohibition on exclusive contracts. As discussed below, outside of Section 628(c)(2)(D), programming is already being withheld from small cable companies.

[132] Hausman, Sidak and Singer, p. 134.

[133] Hausman prohibition on exclusive contracts. As discussed below, outside of Section 628(c)(2)(D), programming is already being withheld from small cable companies.

[133] Hausman, Sidak and Singer, p. 134.

[133] Hausman, Sidak and Singer, p. 156; ACA, p. provides the calculation for cable operators

The major MSOs will be the clear winners in these transactions. MSOs granted exclusive distribution rights will have an opportunity to attract DBS subscribers with exclusive programming, resulting in increased subscriber revenues (a minimum of $40-$50 per subscriber) and increased system values (at least $3,500-$5,000 per subscriber).

Where do ACA members fit into these transactions? Nowhere. ACA members operate locally, not regionally or nationally. In situations involving regional or national exclusive distribution rights, there is little incentive to carve out exceptions for smaller cable systems. For each small system subscriber lost under exclusivity, the vertically integrated program provider will likely lose revenue between $0.10 and $0.75 per month, depending on the service. In contrast, for each former DBS subscriber gained through regional or national exclusive program offerings, the MSO with exclusive distribution rights will gain all monthly revenue from that

vertically-integrated firm matters since "a larger downstream market share enhances the vertically integrated firm's incentive to engage in discrimination."[134] Two types of discrimination can be practiced by integrated broadband providers – conduit and content.

In implementing conduit discrimination, the vertically-integrated company refuses to distribute its affiliated content over competing transmission media.[135] In so doing, it seeks to drive consumers to its transmission media and weaken its rival.[136] This is profitable as long as the revenue gained by attracting new subscribers exceeds the revenue lost by not making the content available to the rival. Market size is an important factor.[137]

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subscriber, plus increased system value. In economic terms, an external cost of this gain will be the cost to small cable companies and consumers of reduced program diversity.

[134] Hausman, Sidak and Singer, p. 156.

[135] Hausman, Sidak and Singer, p. 159.

> [A] cable broadband provider will engage in conduit discrimination if the gain from additional access revenues from broadband users offsets the loss in content revenues from narrower distribution…
>
> To capture the gains from such discrimination, the vertically integrated cable provider must have a cable footprint in which to distribute its broadband portal service, either through direct ownership or through an arrangement to share the benefits of foreclosure with other cable providers

[136] ACA, p. 14.

> **Vertically integrated programming providers will have an incentive to enter into regional or national exclusive programming contracts aimed at DBS competitors.**
>
> To gain a competitive advantage over EchoStar/DirecTV, owners of vertically integrated programming will likely enter into exclusive programming contracts with preferred regional or national MSOs, both affiliated and non-affiliated. The most efficient and valuable basis to grant exclusivity will be on a regional or national basis, rather than on a franchise-by-franchise basis.

[137] Rubinfeld and Singer, p. 567.

> *Hence, a cable broadband provider will engage in conduit discrimination if the gain for additional access revenues from broadband users offsets the loss in content revenues form narrower distribution.*
>
> What determines whether conduit discrimination will be profitable. Simply put, if a cable broadband transport provider that controls particular content only has a small fraction of the national cable broadband transport market, then that provider would have little incentive to discriminate against rival broadband transport providers *outside of its cable footprint.* The intuition is straightforward: out-of-franchise conduit discrimination would inflict a loss on the cable provider's content division,

Content discrimination involves an integrated provider "insulating its own affiliated content from competition by blocking or degrading the quality of outside content."[138]

> Content discrimination… would benefit the cable provider by enhancing the position of its affiliated content providers in the national market by denying unaffiliated content providers critical operating scale and insulating affiliated content providers from competition. Content discrimination would thus allow the vertically integrated content provider to earn extra revenues from its own portal customers who would have fewer opportunities to interact with competing outside content.[139]

One of the more dynamic benefits of discrimination is the potential to devalue competitors, either driving them out of business or making them attractive takeover targets. This problem occurs to the smaller entities in the industry.[140] This would also be a dynamic benefit to the content provided by the affiliated supplier.[141]

> while out of region cable providers would the primary beneficiaries of harm done to non-cable competitors.

[138] Hausman, Sidak and Singer, p. 159.

[139] Hausman, Sidak and Singer, p. 159.

[140] ACA, p. 14.

> **Vertically integrated programming providers will have an incentive to deny programming to small cable companies that are competitors.**
>
> In competitive situations, owners of vertically integrated programming have a powerful incentive to deny programming to small cable companies. A handful of ACA members already have service areas that overlap those of some major MSOs. Because of the expansion of MSO facilities and the expansion of independent cable systems, competition between MSO's and ACA members will likely increase. By offering exclusive programming, an MSO will gain an overwhelming competitive advantage over an independent cable operator. As discussed above, the MSO will gain subscribers and monthly revenues worth far more than any license fees lost (or higher license fees paid) through exclusive distribution arrangements.
>
> **Vertically integrated programming providers will have an incentive to deny programming to acquisition targets…**
>
> Many ACA members own cable systems adjacent to systems owned by major MSOs. A common transaction in the industry, and an important exit strategy for smaller systems, is the sale of a system to a major MSO. As in any acquisition, the buyer has an incentive to obtain the system at the lowest price.
>
> Cable systems are generally valued on revenues or cash flow, with the subscriber base being a key factor in those measures. By denying access to programming, an owner of vertically integrated programming could readily decrease the revenues and subscriber base of a small acquisition target. The MSO buyer could then acquire the system at a deflated price. A less obvious exercise of market power would occur in

D. CONCLUSION

This chapter has added the final layer of competition policy theory which the Commission describes as essential to enacting a meaningful horizontal limit. The ability of cable operators to leverage market power across vertical markets or layers of the platform has been described. Judging by the strong concerns expressed by very large market participants who would have to interconnect with and confront vertically-integrated MSOs, this is a substantial problem. Size is critical, as increasing size fosters the incentive and ability of vertically-integrated firms to discriminate against their rivals.

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the context of sale negotiations, where the threat of denial of program access could force price concessions.

[141] ACA, p. 13.

The cable-affiliated programmer will probably win in these transactions as well. The competitive advantage from exclusive distribution rights will increase MSO demand for exclusive programming deals, supporting higher license fees. The increased license fees will offset, and probably exceed, loss of revenues from excluded distributors. In this way, vertically integrated programmers can also gain from exclusivity.

PART THREE:
MARKET POWER IN THE CABLE TV INDUSTRY

While it is critical in this proceeding to establish the theoretical underpinning of policy, public policy must be based on empirical facts. The industry has engaged in the opposite of penetration pricing, with substantial price increases at all phases of the adoption cycle. We observe dramatic price increases, bundling of products, and extremely high q ratios. In short, there is a great deal of market power, and the track record in the cable industry bears little resemblance to a Schumpeterian innovator and instead looks more like monopolistic market power.

The structure of the cable industry and the pattern of conduct it exhibited after the passage of the Cable Act of 1984 led Congress to revisit its policy of deregulation and impose new structural restraints to prevent the abuse of market power. Congress observed a continuing monopoly at the point-of-sale, increasing concentration at the national level and growing vertical integration between programming and distribution. It responded with legislation directing the Commission to develop a structural limit on ownership (in the 1992 Cable Act) and left that edict in place in the Telecommunications Act of 1996.

Congressional reasoning was well-grounded in contemporary economic theory and the empirical reality of the cable TV industry. Standing alone, each of the structural conditions – virtual monopoly at the point of sale, vertical integration between distribution and programming, and concentration at the national level – merits strong concern. Taken together, the combination of these three factors gives integrated cable operators a great deal of market power.

Market power at the point-of-sale is readily transmitted back up the value chain when cable operators become vertically integrated. Reduced competition at the point-of-sale enables them to favor their own programming or hinder unaffiliated programming in reaching the market, since unaffiliated programs have little or no chance of reaching consumers within the service areas that the cable operators dominate. Once they become vertically integrated, cable companies have incentives to withhold programming from potential competitors in (downstream) distribution markets or to squeeze those competitors by driving up their costs.

A substantial market share for dominant firms in the national market for programming is an independent problem, which is reinforced by horizontal concentration and vertical integration. Given the nature of television programming, with its high first-copy costs, producers need to achieve a large audience quickly to survive. By controlling a substantial number of eyeballs, cable operators can make or break programming. Exercising monopsony power as buyers, they can squeeze programmers by holding down what their pay or by insisting on sharing the profits (demanding equity stakes). Once they become vertically integrated, their incentive to squeeze out rivals is reinforced. The fewer the alternatives available for specialized inputs (creative producers), the easier their task of controlling the programming market.

In addition, the lack of competition at the point of sale enables cable operators to exercise market power in a variety of ways. Price increases and other forms of pricing abuse can be imposed on the public, which has few alternatives for multichannel TV service. The bundling strategy of the cable companies rests on market power, tying together products of differing elasticities and forcing consumers to take or leave the whole bundle. Lacking

competition, cable operators scrimp on quality. They do not fear losing their customers to others if they provide an inferior product. These factors are relevant to the ownership limit in that the Commission must consider "other public interest factors" in setting the limit.

With a chapter devoted to each aspect of structure, conduct and performance, as well as a demonstration that satellite is not an all-purpose competitor to cable, we show that there is significant abuse of market power that would be worsened by a relaxation of the horizontal limit on ownership. This part concludes with a demonstration that the 30 percent limit is justified both on the basis of market structure analysis and the narrow "open field" analysis previously conducted by the Commission. If anything, a 30 percent limit allows the industry to become more concentrated than it should be, given the economic characteristics and historical behavior patterns of the industry.

The track record of competition in the cable industry described in this part certainly cannot be a source of support for the claim that this industry is behaving in a Schumpeterian manner. Schumpeterian monopoly rents are transitory, but almost two decades after deregulation, the market share of cable operators in their core product and geographic markets is still approximately 85 percent.[142] While cable companies complain about being prevented from buying up more TV eyeballs, they have never competed for new markets by building new systems, which they have been allowed to do for decades. They never compete head-to-head. We find evidence of market power in the programming market as well. The programming market is highly concentrated with, and riddled by, joint ventures that dampen the rivalry between cable operators, especially since the dominant MSOs are vertically integrated into programming and controlling important marquis programs.

[142] About 40 percent of satellite subscribers are located in areas not served by cable.

The conduct of cable operators is consistent with the exercise of market power. A repeated pattern of discouraging entrants, foreclosure of markets, and extension of market power is identified. Historical and contemporary examples are given of this abusive conduct.

The performance of the industry exhibits clear signs of the exercise of market power. Prices have been rising dramatically. Bundling and price discrimination extracts consumer surplus. Tobin's q ratios have been rising and reflect the exercise of market power.

VIII. THE HIGHLY-CONCENTRATED STRUCTURE OF THE CABLE TV INDUSTRY

A. SUMMARY

Public interest commenters argue that the Commission's traditional approach, determining the national HHI fails to capture cable's true market power over subscribers, and thus does not accurately assess its ability to dictate to the program supply market. To determine cable's true market power via the HHI, the Commission must start from the HHI at the point of sale to the subscriber. This yields an HHI above 7000, indicating a highly concentrated market and the ability to wield monopsony power against programmers. We argue that this high level of concentration results from basic, underlying conditions and anticompetitive policies adopted by the industry.

Viewed as a national market for programming, the cable industry is moderately concentrated when the attribution rules upheld by the court are applied. The ownership of basic networks is highly concentrated. Joint ventures in programming further dampen competitive forces in the industry.

B. BASIC MARKET CONDITIONS: HIGH FIXED COSTS ON THE SUPPLY SIDE, LOW PRICE ELASTICITY ON THE DEMAND SIDE

Media industries in general and the cable industry in particular have a unique set of characteristics. On the supply side, the industry has long been typified by high fixed costs/ first-copy cost.[143] Moreover, as volume goes up, profit per unit increases.

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[143] Webb, G.K., The Economics of Cable Television (Lexington: Lexington Books, 1983), specifically mentions geographic natural monopoly. Others, such as Eli Noam (Monopoly and Productivity in Cable Television (Columbia University, Graduate School of Business, Research Program in Telecommunications and Information Policy, October 24, 1984; "Economies of Scale in Cable Television: A Multi-product Analysis," in Eli Noam, (Ed.), Video Media competition: Regulation, Economics and Technology (New York: Columbia University Press, 1985) identify economies of scale and scope, but stop short of calling the industry a natural monopoly. Even those

On the demand side, there is low substitutability. The result is a low price elasticity of demand and a moderate income elasticity of demand that reinforce the market power on the supply side of the point of sale. [144] This means that consumer resistance to price increases is limited[145] and that consumers are willing to pay more as their incomes rise. Cable's low elasticity of demand stems from the lack of alternatives and the popularity of television.

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who argue against natural monopoly concede economies of scale (see Smiley, A.K., Direct Competition Among Cable Television System (Economic Analysis Discussion Paper, Department of Justice, June 5, 1985, "Regulation and Competition in Cable Television," Yale Journal of Regulation, 1990; Hazlett, T. W., "Duopolistic Competition in Cable Television: Implications for Public Policy," Yale Journal of Regulation, 1990). In the debate over regulation/deregulation, the question is whether the economics are large enough to preclude competition. For the purposes of establishing reasonable rates in the absence of competition, the important point is to recognize that economies of scale exist and to take them into account in setting rates. Leland L. Johnson and David P. Reed, Residential Broadband Services By Telephone Companies? (Santa Monica, Rand, 1990), Appendix G, shows the cost of a contemporary cable system with broadband backbone and coaxial feeder loop, of $368 per home passed and $614 per subscriber, at 60 percent penetration. By implication, a penetration rate of 40 percent would generate costs of $920 (see also, Shooshan and Jackson, Measuring Cable's Market Power: Recent Developments, December 1988.

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

[145] As Landis and Posner put it (W. M. Landes and R. A. Posner, "Market Power in Anti-trust Cases," Harvard Law Review, 94: 1981, p. 50.)

> The higher the elasticity of demand for the firm's product at the firm's profit maximizing price, the closer that price will be to the competitive price, and the less, therefore, the monopoly overcharge will be... an infinite elasticity of demand means that the slightest increase in price will cause quantity demanded to fall to zero. In the opposite direction, the formula "comes apart" when the elasticity of demand is 1 or less. The intuitive reason is that a profit-maximizing firm would not sell in the

Low- to moderate-price elasticity and low- to moderate-income elasticity both feed off of fundamental television viewing patterns that have been established over four decades. Americans watch a significant amount of television – in the neighborhood of eight hours per day.[146] Television has come to be the premier source of information and entertainment in American life. Deeply entrenched viewing patterns and strong demand for entertainment, news, information, and sports make the market potential for cable huge. The ability to deliver large numbers of channels gives cable a huge advantage in meeting this demand.

C. LOCAL AND NATIONAL MARKET POWER IN THE CABLE INDUSTRY

1. Local Markets Are a Virtual Monopoly

Head-to-head competition between cable companies is virtually non-existent. Out of 3000 plus cable systems, head-to-head competition exists in fewer than 200, although another 150 have certified entry. In short, only bout 1 percent of franchise territories have experience head-to-head competition between cable companies. While a number of other communities have authorized additional overbuilding, this activity is slowing, as the regional bell operating companies pull back and pure overbuilders retrench.[147]

Cable's dominance as the multichannel medium is overwhelming, with a subscribership of approximately two-thirds of all TV households. Its penetration is over four times as high as the next multichannel technology, satellite. Because a large number of satellite subscribers live in areas that are not served by cable, competition in geographic

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inelastic region of its demand curve because it could increase its revenue by raising price and reducing quantity.

[146] Consumer Reports in Competitive Issues in the Cable Television Industry, Subcommittee on Antitrust, Monopolies and Business Rights, Committee on the Judiciary, United States Congress, March 17, 1988, at 244; U.S. Census Bureau, *Statistical Abstract of the United States: 2000*, Table 909.

markets is less vigorous than the national totals suggest. Moreover, as will be demonstrated below, cable and satellite occupy very different places in the market and are not head-to-head competitors.

This monopoly at the point of sale is reinforced by a strong trend toward regionalization in which one company gains ownership of many firms in a region. Clustering has increased sharply since 1994, up by almost 75 percent.[148] Approximately two-thirds of all subscribers were clustered at the end of 1997.[149]

The failure of competition in multichannel video is most evident in local markets. Approximately 95 percent of the homes passed in the country are served by only one cable company.[150] Satellite has about 10 million subscribers in markets where cable and satellite meet, suggesting cable retains an 85 percent market share at the point of sale.[151] The HHI index at the local level is above 7000, indicating an extremely concentrated market for multchannel video service. As discussed above, these market shares and levels of concentration for cable operators are virtual monopolies.

2. Local Cable Market Power is Exacerbated by National Concentration

Market power at the local level is reinforced by concentration at the national level. The dominant incumbent cable companies never compete head-to-head. In fact, if they were willing to compete with one another by building new cable systems, the ownership limit

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[147] FCC, Seventh Annual Report,, p. 20, notes that cable operators in only 330 communities have been granted status as effectively competitive on the basis of overbuilding.
[148] FCC, Seventh Annual Report, Table C-2.
[149]Paul Kagan Associates, *Major Cable TV System Clusters*, 1998.
[150] FCC, Seventh Annual Report, p. 20.
[151] FCC, Seventh Annual Report, p.34, notes increasing urban subscribers, but figure show that satellite is still disproportionately rural.

would not be binding. Subscribers that they won as new entrants would not count against the national cap.

Discussion of the concentration in the national market is not focused on the field of potential entrants into local distribution, it centers on the cable operators as purchasers of programming.

The wave of concentration in the industry is striking (see Exhibit VIII-1). When cable was deregulated in 1984, the distribution segment was not concentrated at all (HHI about 350), with the equivalent of about 30 equal sized competitors. A decade later, concentration had advanced to the point where the distribution segment had the equivalent of about 9 equal-sized competitors (HHI about 1100). As fewer and fewer firms exist in the industry, the chances that the dominant position in any given market will be challenged decline.

Although the FCC claims that the cable TV market falls just below the level of being moderately concentrated (HHI = 954), it arrives at this conclusion by ignoring AT&T's substantial ownership interests in Cablevision and AOL Time Warner. Taking AT&T's ownership interests into account places the cable TV market into the moderately-concentrated category. Including the TWE holdings, the market would be just below the highly-concentrated level. The two pending mergers (ATT/Comcast; EchoStar/DirecTV) would put it above the highly-concentrated level.

EXHIBIT VIII-1: CONCENTRATION OF NATIONAL CABLE EYEBALL MARKET

YEAR		4-FIRM	HHI
1984		28	357
1889		46	867
1992		48	928
2000			
	with attribution	60	1113
	with TW	69	1772
2002			
	with attribution ATT/Comcast EchoStar/DirecTV	75	1918

SOURCES: Federal Communications Commission, In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming, First Report, CC Docket No. 94-48, Seventh Report, CC Docket No 00132.
With attribution attributes 1.6 million TW and 4.3 million Cablevision subscribers to AT&T.

D. MARKET POWER IN THE PROGRAMMING PRODUCTION MARKET

1. Horizontal Analysis: Oligopolistic Programming Market Structure Hurts Consumers

Measuring horizontal concentration in programming production is more difficult, since programming is both national and regional and channel capacity differs across systems. A recent analysis by Hazlett and Bittlingmayer,[152] which frankly admits the market power of cable, provides insight. They present an analysis of cable TV network cash flow for 34 basic cable networks. The largest network accounts for just under half a billion dollars, the smallest of these has a cash flow of less than $2 million.. There are twelve owners on the list, but ownership (measured by cash flow) is highly concentrated. The HHI is approximately 2000. The four firm concentration ratio is over 80 percent.

Hazlett and Bittlingmayer offer the data as proof that cable operators do not discriminate, but it proves no such thing. This would be the case only under the outlandish assumption that complete foreclosure is the only proof of discrimination. In fact, one-third of the total programming cash flow is integrated, which is a substantial share that has been and will be growing.

Moreover, the monopoly rents earned by cable operators greatly exceed the cash flow earned by the non-integrated programmers. Hazlett argues that the monopoly rents earned by cable owners measured by the difference between system sales prices and reproduction costs are $4,000 to $5,000. Yet the non-affiliated cash flow represents about $40 per year per subscriber. In other words, the monopoly rents being capitalized in the sales

[152] Thomas W. Hazlett and George Bittlingmayer, *The Political Economy of Cable "Open Access* (Joint Center, Working Paper 01-06 May 2001), p 30.

prices of cable systems is 100 times the amount being paid to non-affiliated programmers. The non-affiliated programmers who dominate are almost exclusively broadcast networks (overwhelmingly ABC-Disney, Viacom-CBS). These are programmers who bring marquis brands from broadcast to the table and have must carry/retransmission rights, which they have used to leverage their way onto the cable wires. The result is a tight oligopoly of programmers on cable networks that splits the rents to a certain extent (with the cable monopolists gaining the lions share), but does not bode well for consumers or unaffiliated programmers.

2. Vertical Analysis: Vertical Integration in Programming Market Hurts Consumers

The concern about cable programming concentration has always had a vertical dimension to it. The analysis has always been focused on programming owned by MSOs since, as the owners of bottleneck facilities, MSOs could make or break programmers.

When both distribution and programming are owned by the same companies, there is no incentive to bargain at arms length to drive down the price of programming. Because the industry is horizontally-concentrated and vertically-integrated, the dominant firms control enough of the market to exercise price leadership. The dominant firms in production do not have to fear competitive programming since their control over eyeballs enables them to frustrate entry. They can increase their overall profits by increasing programming prices, since they reap rewards from sales to both integrated and non-integrated distributors.

Competitors who are not affiliated with the dominant local/regional monopolist have little ability or incentive to compete on price. Independent cable operators can pass price increases for programming through to consumers due to inelastic demand and lack of com-

petition at the point of sale. The lack of competition in programming also means that unaffiliated MSOs can do nothing about it. Since they cannot find lower-priced alternatives, they pay the increase to programmers and pass it through to consumers. Independent programmers do not compete on price because (1) they will not risk losing access to the eyeballs controlled by the integrated programmers and (2) they can live comfortably by following the leader. Everyone raises their own prices and lives comfortably under the umbrella established by the dominant firm.

As Exhibit VIII-2a shows, there are approximately 300 national and regional programming services listed in the FCC annual report on cable competition.[153] The MSO share at the national level, measured by the number of programs, is 35 percent. The MSOs have a smaller numerical share of the regional programming, at about 25 percent. However, regional subscribership is quite low, representing just five percent of the total.[154]

Dominant MSOs are much more prominent among the marquis shows, however, accounting for about half of the top twenty shows by subscribership and prime time rating. Consequently, by subscribership the dominant MSOs share of cable subscribers is closer to 50 percent.

The major cable MSOs who have programming interests are also thoroughly interconnected through joint ventures, as Exhibit VIII-2b shows. About one-third of their programming is tied up in joint ventures. Given the fact that these MSOs never compete head to head for subscribers and that they have parallel interests in a substantial portfolio of

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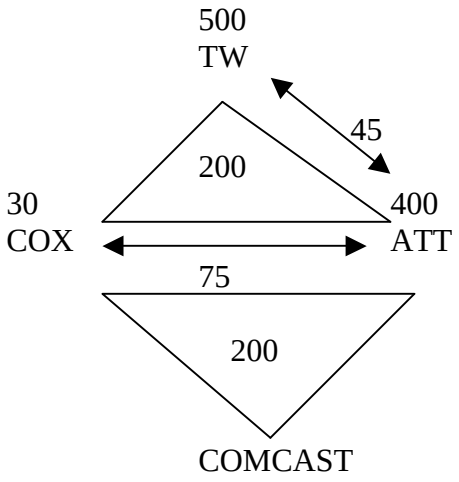
[153] Federal Communications Commission, *In the Matter of Annual Assessment of Competition in markets for the Delivery of Video Programming*, CS Docket No. 98-102, December 23, 1998.
[154] TvInsite, Database, September 17, 2001.

EXHIBIT VIII-2
THE ROLE OF LARGE MOSs AND JOINT VENTURES IN THE CABLE PROGRAMMING MARKET

a) PROGRAM OWNERSHIP

	NUMBER	PERCENT OWNED
		In which MSOs have a stake
		BY MSOs
National Programs	225	36
Regional	75	25
Top 20 Service By Subscription		45
Top 20 Prime Time Cable Shows		55

b) JOINT PROGRAMMING VENTURES OF DOMINANT CABLE MSO OWNERS
(Millions of Subscribers:



SOURCES: Federal Communications Commission, In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming, CC Docket No. 00-132, Seventh Report, Table D-1, D-2, D-3, D-6, D-7.

programs, the likelihood of them pursuing parallel interests is strengthened. This would provide a justification to assume reinforcing behavior in any quantitative estimation of market power.

E. CONCLUSION

The Commission recounts the factual basis on which the Congress laid its decision to require a horizontal limit at various places in the Notice. The qualitative structural conclusions are that cable is the

> "dominant nationwide video medium" with "over 60% of household with television subscribing to cable, a percentage "almost certain to increase." [155]
>
> and faced virtually no competition at the local level, and only limited competition at the regional and national level.
>
> The increase in vertical concentration between cable operators and programmers provided incentives and opportunities for cable operators to favor affiliated over non-affiliated programmers.[156]

These structural conditions continue to exist(WRONG WORD). Cable is still the dominant nationwide video medium, with over 60% of households. Cable still has a virtual monopoly at the local level and faces little regional and national competition. It is still vertically-integrated.

Whether the anticompetitive structure is a little worse or a little better on one dimension or the other does not alter the fundamental conclusion. Satellite is an alternative for some people in some places, but two is not enough to make a market reliably competitive. If the attribution rules are properly applied, the national eyeball market is more concentrated than it was in the late 1980s and early 1990s. Vertical integration persists and the increase

[155] ¶¶ 20 –21.
[156] ¶ 3

in the number of channels available has not deconcentrated viewing. Vertically-integrated marquis programming is still prevalent.

IX. CABLE INDUSTRY CONDUCT: A HISTORIC AND CONTINUING PATTERN OF MARKET POWER ABUSE

A. SUMMARY

Cable company conduct reflects the exercise of the market power conferred by industry structure. Companies do not conquer markets with innovation, they operate on a monopoly model that frustrates competition by leveraging and defending a franchise. There is a long history of anticompetitive conduct which weighed heavily on Congress as it considered how to protect consumers and promote competition after a disastrous decade of deregulation.

The historical tendency of the industry to engage in anticompetitive behavior remains in evidence. Regulators and law enforcement authorities have been repeatedly called up to check these tendencies. If the Commission had set the horizontal limit at a reasonably low level and enforced it, much of the abuse could have been avoided and the expense of applying after the fact regulatory fixes would have been saved.

B. THE LONG TRADITION OF ANTICOMPETITIVE CONDUCT IN THE CABLE INDUSTRY

Integrated MSOs have a long history of granting preferential access to subscribers for affiliated programmers and denying access to those who are not affiliated. Evidence of these problems is both qualitative and quantitative.[157] The dominant, integrated firms get the best deals. For example, large MSOs often secure "most favored nation" clauses from

[157] Ahn, Hoekyun and Barry R. Litman, "Vertical Integration and Consumer Welfare in the Cable Industry," *Journal of Broadcasting and Electronic Media*, 41.

programmers. Such clauses are supposed to guarantee an MSO as good a price as any other operator pays for programming, sometimes excluding Time Warner and TCI.[158]

Other examples of anticompetitive conduct include efforts to impose or obtain exclusive arrangements, price discrimination, and "dial disadvantage." Exclusive arrangements prevent competing technologies from obtaining programming, as well as preventing competition from developing within the cable industry.[159] Price discrimination against competitors and placing competitive programming at a disadvantageous location on the dial (e.g. very high, near other programs with low ratings), have once again become common practice in the cable industry.[160]

Allegations of anti-competitive cable practices are not limited to industry critics. The practices within the industry became so bad that even major players became involved in formal protests. Viacom and its affiliates, a group not interconnected significantly with the top two cabals in the industry, filed an antitrust lawsuit against the largest chain of affiliated

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[158] McAdams, John M. Higgins, "Hangover from Takeovers," *Broadcasting & Cable*, April 19, 1999.

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

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

competitors in its New York territory. Ultimately, it sold its distribution business to its competitors.

The landscape of the cable industry is littered with examples of these anti-competitive practices. These include, for example, exclusive deals with independents that freeze-out overbuilders,[161] refusals to deal for programming due to loopholes in the law requiring non-discriminatory access to programming,[162] tying arrangements,[163] and denial of access to facilities.[164]

The natural tendency of the industry's largest players to discriminate was demonstrated in the Time Warner/Turner/TCI merger proposal. The FTC rejected the Time Warner/Turner/TCI merger proposal and imposed conditions on it. It rejected a preferential deal for TCI's purchase of Time Warner programming and required TCI to reduce its level of ownership in Time Warner to less than 10 percent of nonvoting stock (i.e., a non-attributable, passive level). [165] With respect to the programming market it found:

> Entry into the production of Cable Television Programming Services for sale to MVPDs that would have a significant impact and prevent the anticompetitive effects is difficult. It generally takes more than two years to develop a Cable Television Programming Service to a point where it has a substantial

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[161] "Statement of William Reddersen on Behalf of Bell South Enterprises (hereafter, Bell South), p. 4, cites examples of suspected exclusive arrangements involving Eye on People, MSNBC, Viacom, and Fox, as does "Testimony of Deborah L. Lenart on Behalf of Ameritech (hereafter, Ameritech), Subcommittee on Telecommunications, Trade and Consumer Protection, Committee on Commerce, U.S. House of Representatives, July 29, 1997, p. 7.

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

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

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

[165] Federal Trade Commission, *In the Matter of Time Warner Inc.,Turner Broadcasting Systems Inc., Telecommunications Inc. and Liberty Media Corporation,* Complaint, Docket No., September 1997 (hereafter, Time Warner/Turner/TCI).

> subscriber base and competes directly with the Time Warner Turner "marquee" or "crown jewel" service throughout the United States. Timely entry is made even more difficult and time consuming due to a shortage of available channel capacity.[166]

In the Time Warner/Turner/TCI merger analysis, the FTC found that entry into the distribution market was difficult:

> Entry into the sale of Cable Television Programming Services to households in each of the local areas in which Respondent Time Warner and Respondent TCI operate as MVPDs is dependent upon access to a substantial majority of the high quality, "marquee" or "crown jewel" programming that MVPD subscribers deem important to their decision to subscribe and that such access is threatened by increasing concentration at the programming level, combined with vertical integration of such programming into the MVPD level.[167]

The FTC's enumeration of the ways in which the Time Warner/Turner/TCI merger was a threat to lessen competition are instructive for both the cable TV and the broadband Internet markets. First, with respect to programming, the FTC saw a number of grounds for believing competition would be lessened:

> enabling Respondent Time Warner to increase prices on its Cable Television Programming Services sold to MVPDs, directly or indirectly (e.g., by requiring the purchase of unwanted programming). Through its increased negotiating leverage with MVPDs, including through purchase of one or more "marquee" or "crown jewel" channels on purchase of other channels.
>
> enabling Respondent Time Warner to increase prices on its Cable Television Programming Services sold to MVPDs by raising barriers to entry by new competitors or to repositioning by existing competitors, by preventing such rivals from achieving sufficient distribution to realize economies of scale; these effects are likely, because
>
> (1) Respondent time Warner has direct financial incentives as the post-acquisition owner of the Turner Cable Television Programming Services not to carry other Cable Television Programming Services that directly compete with Turner Cable Television Programming Services; and

[166] Time Warner/Turner/TCI, pp. 7.
[167] Time Warner/Turner/TCI, pp. 7.

> (2) Respondent TCI has diminished incentives and diminished ability to either carry or invest in Cable Television Programming Services that directly compete with the Turner Cable Television Programming Services because the PSA agreements require TCI to carry Turner's CNN, Headline News, TNT and WTBS for 20 years, and because TCI, as a significant shareholder of Time Warner, will have significant financial incentives to protect all of Time Warner's Cable Television Programming[168]

The cable TV programming market has not changed since the FTC made these observations. If anything, it has gotten much worse, if for no other reason than it has an additional "crown jewels" to leverage against competitors and unaffiliated programmers. Cable now uses cable-broadband wire as its "crown jewel." It conditions access to cable-based broadband transmission capacity on the taking of "unwanted programming."

The FTC also concluded that the Time Warner/Turner/TCI merger could reduce competition in distribution markets by

> denying rival MVPDs and any potential rival MVPDs of Respondent Time Warner competitive prices for Cable Television Programming Services, or charging rivals discriminatorily high prices for Cable Television Programming services. [169]

C. THE CABLE INDUSTRY'S CONTINUING PATTERN OF EXCLUSION AND DISCRIMINATION

Little has changed in the vertically-integrated, horizontally-concentrated cable TV industry since the FTC reached those conclusions.

1. Conduit Discrimination Leads to Anticompetitive Outcomes

The Commission has recently been presented with a series of examples of how the dominant cable operators seek to deny content to potential and actual competitors. They use two approaches. First, vertically-integrated companies refuse to make programming they

[168] Time Warner/Turner/TCI, pp. 8.
[169] Time Warner/Turner/TCI, pp. 8.

own available. As the small cable operators point out, this exploits loopholes that the Commission has created (by failing to act) in the current law.

Overbuilders have faced vigorous efforts to prevent competition through exclusion from access to programming and regulatory tactics of incumbent cable operators.[170] Comcast has shifted some sports programming to terrestrial delivery, thereby avoiding the open access requirement of the 1992 statute. As cable operators become larger and more clustered, this strategy will become increasingly attractive to them. Specific areas where such programming has been denied are Phoenix, Kansas, Philadelphia and New York. The denial of access to marquis sport programming can have a devastating effect, with satellite providers in markets where foreclosure has occurred achieving a market penetration only one-quarter of the national average.[171]

Integrated MSOs wield immense power against smaller cable companies, exploiting loopholes in the program access rules.

> **MSOs are already responding to the incentives to deny small cable companies access to programming.**
> The incentives to deny programming and the consequences to program diversity are not hypothetical. In circumstances outside of Section 628(c)(2)(D), these incentives are already resulting in denial of programming to small cable companies.[172]

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[170] *RCN Telecom Service of New York, Inc. v. Cablevision Corp., et. al,* Docket No. CS01-127; *DIRECTV v. Comcast; EchoStar v. Comcast.* Problems can also occur on an event-by-event basis (see "Comments of Everest Midwest Licensee LLC dba Everest Connections Corporation," *In the Matter of Implementation of the Cable Television Consumer Protection and Competition Act of 1992, Development of Competition and Diversity in Video Programming Distribution: Section 628 (c)(5) of the Communications Act: Sunset of Exclusive Contract Prohibition,* Federal Communications Commission, CS Dkt. No. 01-290, December 3, 2001, p. 4; "comments of Gemini Networks, Inc.," p. 3.)

[171] Joint Comments, In the Matter of Implementation of the Cable Television Consumer Protection and Competition Act of 1992, Development of Competition and Diversity in Video Programming Distribution: Section 628 (c)(5) of the Communications Act: Sunset of Exclusive Contract Prohibition, Federal Communications Commission, CS Dkt. No. 01-290, December 3, 2001 p. 14.

[172] ACA, p. 15.

> BELD (Braintree Electric Light Department] competes in Braintree with AT&T, the USA's largest company, and Echostar/DirecTV, the USA's largest satellite companies. If AT&T and other major MSOs could withhold programming from use, our video business would likely fail and consumers in Braintree would lose the benefits of true facilities-based competition.
>
> **One major MSO is already denying BELD access to important regional programming.** BELD's situation provides a clear example of how a major MSO will use program access to thwart a small competitor. NECN [New England Cable News], a regional news network partly owned by AT&T, refuses to sell its service to BELD, purportedly due to an exclusive contract with AT&T. This denies our customers important regional programming and hurts our ability to compete.[173]

For the smaller entities, the current refusals to deal are not limited to sports programming. Other services have been denied, such as video on demand.[174]

Second, where the large MSOs do not have direct ownership of video services, they have obtained exclusive arrangements, thereby denying competitors and potential competitors access to programming.[175]

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[173] "Comments of Braintree Electric Light Department," *In the Matter of Implementation of the Cable Television Consumer Protection and Competition Act of 1992, Development of Competition and Diversity in Video Programming Distribution: Section 628 (c)(5) of the Communications Act: Sunset of Exclusive Contract Prohibition*, Federal Communications Commission, CS Dkt. No. 01-290, December 3, 2001.

> ACA, p. 16, elaborates.
>
> AT&T/New England Cable News ("NECN"). The Commission is familiar with NECN. In 1994, in response to a petition for exclusivity by Continental Cablevision, the Commission granted a limited waiver of Section 628(c)(2)(D) for NECN.[173] The Order gave NECN an 18-month window to enter into exclusive programming contracts, and the exclusivity terms were to end by June 2001. AT&T is the successor to Continental's attributable interest in NECN.
>
> NECN has recently denied access to its service to at least one ACA member based on an exclusive contract with AT&T. The small system seeking access to NECN competes with AT&T in one market. NECN now claims that it is delivered terrestrially, and it cannot provide access to its programming because of its contract with AT&T.

[174] Everest, p. 6.; "Comments of Qwest Broadband Services, Inc., *In the Matter of Implementation of the Cable Television Consumer Protection and Competition Act of 1992, Development of Competition and Diversity in Video Programming Distribution: Section 628 (c)(5) of the*

> AT&T/DigitalTVLand. AT&T owns Headend in the Sky ("HITS"), a wholesale distributor of digital programming via satellite. HITS services have been instrumental in enabling many smaller systems to expand channel offerings through digital services, and ACA has been a prime supporter of this service. Among the digital services carried by HITS is TVLand, a popular entertainment channel. But of all the channels carried by HITS, ACA members cannot receive digital TVLand from HITS. AT&T apparently has a national exclusive contract for the service. [176]

The exclusionary tactics apply not only to head-to-head cable operators and satellite providers, but also to DSL-based providers seeking to put together a package of voice, video, and data products. As discussed in the Internet chapter below, bundling is critical to entry into the emerging digital multimedia market.

> CTN [CT Communications Network Inc.], a registered and franchised cable operator, has been unable to purchase the affiliated HITS transport service from AT&T Broadband, the nation's largest cable operators, despite repeated attempts to do so…. Based on its own experience and conversations with other companies who have experienced similar problems, CTCN believes that AT&T is refusing to sell HITS to any company using DSL technology to deliver video services over existing phone lines because such companies would directly compete with AT&T entry into the local telephone market using both its owns system and the cable plant of unaffiliated cable operators. AT&T simply does not want any terrestrial based competition by other broadband networks capable of providing bundled video, voice and data services.[177]

Communications Act: Sunset of Exclusive Contract Prohibition, Federal Communications Commission, CS Dkt. No. 01-290, December 3, 2001, p. 4.

[175] Everest, p. 6, vies a different example.

[176] ACA, p. 15.

[177] "Comments of the Competitive Broadband Coalition," *In the Matter of Implementation of the Cable Television Consumer Protection and Competition Act of 1992, Development of Competition and Diversity in Video Programming Distribution: Section 628 (c)(5) of the Communications Act: Sunset of Exclusive Contract Prohibition*, Federal Communications Commission, CS Dkt. No. 01-290, December 3, 2001, p. 11.

Third, because the dominant MSOs are so large, they can influence important programmers not to sell to competitors and potential competitors. As the Commission noted, Ameritech and the WCA found that they were cut off from programming.[178]

One of the more prominent examples was summarized in the recent program access proceeding as follows:

> It is well known, for example, that News Corp. abandoned its 1997 joint venture with DBS operator EchoStar Communications Corporation (EchoStar) after incumbent cable operators responded to the transaction by refusing to discuss carriage of Fox cable programming. Unwilling to put the financial viability of Fox's programming at risk, News Corp. took the path of least resistance, left Echostar at the altar and switched its affections to the cable-controlled PrimeStar DBS service
>
> "Time Warner, Inc. and [Fox] appear to have entered a symbiotic truce following [Fox's] new proposed affiliation with cable TV industry-owned Primestar Partners L. P. [Fox] originally proposed a merger with EchoStar Communications Corp. to compete with cable TV operators. But according to industry sources, [Fox] received not-so-subtle signals from cable TV operators that its cable TV programming would have trouble finding carriage on their systems if the EchoStar deal went through.
>
> It was also reported that New Corp.'s abandonment of its joint venture with EchoStar was a prerequisite for at least one cable Mao's blessing of Fox's $2 billion acquisition of the Family Channel.[179]

The Commission asks for commenters to refresh the record on these anticompetitive practices, but it need only look to the program access proceedings to find ample evidence.[180] And, as Quest points out, the problem is not simply one of complete exclusion. Dominant, vertically-integrated MSOs can inflict "discriminatory or excessively burdensome terms and conditions of programming distribution."[181]

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[178] FNPRM, para. 28
[179] "Joint Comment," p. 8.
[180] "Comments of Qwest Broadband Services," and the Seventh Annual Report, 90.
[181] Qwest, p. 3; see also James N. Dertouzos and Steven S. Wildman, *The Economics of License Fee Discounts*,

Recent comments in the program access proceeding point to an even more stark demonstration of the power of cable to engage in content discrimination. Joint Comments note that the "retransmission consent process has provided even more evidence of the economic power that incumbents cable operators hold over programming services, even those owned by NBC, CBS and ABC. "[182] This is consistent with our earlier interpretation of the division of rents between cable operators and unaffiliated programmers. Here, cable market power is evidenced not by pricing, but by the ability to deny content to competing conduit providers.

> NBC, for example, surrendered exclusivity for the MSNBC cable network to incumbent cable operators in exchange for carriage of NBC broadcast stations. Similarly, during retransmission consent negotiations for carriage of CBS stations, CBS surrendered exclusivity for its own news-oriented cable channel, Eye on People. The Joint Parties have also learned that ABC surrendered exclusivity for the Soap net cable network to MSO Charter Communications in the Los Angeles market during retransmission consent negotiations for ABC broadcast stations. In other words, when confronted with dominance of the largest cable MSOs in local markets, NBC, CBS and ABC, like Fox, acquiesced to the MSOs' demand that they withhold their cable programming from competing distributors.

2. Content Discrimination Leads to Anticompetitive Outcomes

The problem is not limited to small cable operators or new entrant MSOs having difficulty gaining access to programming (conduit discrimination). It extends to programmers having difficulty gaining access to MSO distribution or what we have called content discrimination.

Powerful cable MSOs have been able to prevent, restrict, or restructure programming networks, diminishing competition, diversity, and innovation. This unfortunate trend has occurred in both the national and local cable programming marketplaces. We cite several

[182] Joint Comments, p. 9.

examples below. If the Commission engages in a serious fact-finding process, it will discover additional examples.

Rupert Murdock's plans to create the Fox News Channel in 1994, for example, were thwarted by both Time Warner and TCI.[183] In order to eventually receive carriage for Fox News, Murdoch had to loan then TCI "$200 million…and an option to buy 20 percent of the network." Other programmers who did not have an investment in the country's then largest MSO suffered. "To make room (for Fox News), Malone cleared out existing networks like a bowling ball cracking into the tenpin. The arrival of Fox News in Denver pushed Court TV to split the programming day with Spice, a pay-per-view sex network."

Recent comments in the program access proceeding summarize these events aptly:

> It is also well known that Fox News Channel ("FNC") owes its very existence to Telecommunications, Inc. ("TCI," since acquired by AT&T), whose agreement to carry FNC on systems serving 90% of TCI's subscrigbers was critical to the successful launch of the network. Not coincidentally, Fox made FNC available to incumbent cable operators on an exclusive basis. Like the saga of News Corp./EchoStar, FNC's launch and subsequent exclusivity to the cable MSOs is a case study of how the largest incumbent cable operators control the destiny of new programming services, and why programmers sell to cable's competitors at their own risk.[184]

Even the BBC was stymied by MSOs who had other cable news programming interests.[185] The BBC was prevented by cable MSOs from establishing a cable news channel as far back as 1991. In 1998, the BBC announced it hoped to form agreements with cable operators to carry BBC World, its international news service, within the next two or three years. A CNN spokesman, Steve Haworth, is quoted as saying, "Competition is always good

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[183] Stephen Keating, Cut Throat: High Stakes and Killer Moves on the Electronic Frontier Johnson Books, Boulder, CO., (1999), pp. 17-18, characterizes the incident as described in this paragraph.
[184] Joint Commenters. P. 8.
[185] Heidi Przybyla, "BBC uses D.C. as Beachhead for American Invasion," *Washington Business Journal*, characterizes the incident as described in this paragraph.

for journalism, but I think that the BBC will find this to be a very tough marketplace for them. Remember, this is a second attempt for them," referring to BBC World's unsuccessful first attempt to gain US cable distribution. BBC World was launched in 1991 but only made its first appearance in the United States in 1997 after it made a deal with 25 public television stations for them to carry daily news bulletins. BBC, as the Commission knows, was only able to secure some digital distribution after it partnered with MSO-linked Discovery Channel, creating the BBC America channel.

Note that our examples are not from the era before digital distribution created additional opportunities for potential carriage. Powerful MSOs even have the power of life and death over well-established programmers who are resident on the cable system.

For example, in a recent interview with Black Entertainment Television (BET) president and CEO Debra Lee, she acknowledged that plans to establish BET II, a family and public affairs channel, were scuttled because "the industry just didn't embrace it."[186] According to Lee, BET heard from AT&T and others that the industry wanted to see "another black channel." As Lee told Multichannel News: " We were saying, Well, if that's the case, we'll be glad to do it….We put together a 24-hour programming schedule and sent it to the major cable operators, and there just wasn't a lot of interest."

Indeed, additional minority channel programming fare is very much endangered. According to Multichannel News, "one year after Viacom's blockbuster purchase of BET, several African American-targeted networks are fighting an uphill battle…" for carriage.[187] "Despite continued calls for more programming for African-American viewers, industry observers said Viacom's $3 billion acquisition has given BET and its related analog and digital

[186] "BET's Lee Searches for Viacom Synergies," *Multichannel News*, December 3, 2001.

services greater leverage—thus making it more difficult for upstarts New Urban Entertainment Television (NUE-TV), Major Broadcasting Co. and World Network to register significant distribution gains." The article notes that the ability of Viacom to bundle BET services with their networks like MTV will give BET an advantage over their programming competitors.

The Arts channel Trio has "lacked the leverage to make cable operators sit up and take notice" since its 1994 launch, despite its digital tier ambitions.[188] Consequently, the network's owners (which included the Canadian Broadcasting Company), decided it had to sell the channel to the well-connected Barry Diller's USA Networks. But the price to secure US MSO carriage appears to have changed the channel's original mission of "films, dramas, and documentaries." Now, under Diller, the early 1970's series "Rowan and Martin's Laugh-In" will "anchor Trio's prime-time line-up along with reruns of the PBS music series Sessions at West 54th."

At the local level, AT&T eliminated a San Francisco Bay Area cable news channel after the channel's other owners no longer had the protection secured by a retransmission consent agreement.[189] The BayTV News Network was a "local news and information channel" created as a result of "retransmission-consent negotiations between AT&T's predecessor, Tele-Communications Inc., Liberty Media, and then-KRON owner Chronicle Broadcasting." KRON was then the NBC affiliate in San Francisco (KNTV in San Jose became the new NBC affiliate on January 1, 2002). KRON owner Young Broadcasting said they had made "numerous improvements" to Bay TV News and had "achieved significant gains

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[187] "Minority Nets Continue Distribution Push," *Multichannel News*, December 3, 2001.
[188] "Barry's New Baby," *Cablevision*, June 11, 2001.
[189] "AT&T Pulls Plug on BayTV News Network," Multichannel News, July 9, 2001.

in viewership." Yet AT&T, according to Multichannel News, decided to end the channel and give its slot to the Food Network."

In August of 1998, Time Warner Cable announced that it would launch an all-news, 24-hour TV channel in Austin, Texas to be available to 220,000 area subscribers, with the specific intent of focusing on central-Texas news. The A.H. Belo Corporation, a media company that currently owns 18 broadcast television stations and four daily newspapers nationwide (including 4 stations and the *Dallas Morning News* in Texas), had also planned to start a cable news channel during the following year.[190] In January of 1999, Belo launched the Texas Cable News (TXCN), another CNN-style cable news program that was to run in the Dallas-Ft.Worth area on TCI and Marcus cable.[191] Belo intended to invest $15 million in TXCN over the course of 1999, and according to the broadcast division president Ward Huey Jr., they were already negotiating with Time Warner Cable for distribution on their cable systems in Austin, San Antonio, and Houston by the time of the announcement of the launch.

According to a February 26, 1999 article in the *Austin American-Statesman*, Belo then purchased KVUE Channel 24 in Austin from Gannett Company for $55 million and a Sacramento station (KXTV-TV).[192] The executive vice-president of Belo was quoted as saying, "We have always wanted to get into the Austin market just because it not only is a good complement to what we already have, but it now gives us two-thirds of the homes in the state of Texas." The addition of an Austin channel would allow Belo to use KVUE's

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[190] "CNN-Style channel planned for Austin." *Austin American-Statesman*. By R. Michelle Breyer. August 22, 1998. Business; p. D1.
[191] "New Cable Operation to Tex-ize the news." *Austin American-Statesman*. January 1, 1999. Metro/State; p. B2.

news reports on TXCN. However, the article states flatly that "…most viewers shouldn't expect to see TXCN in the Austin area any time soon. That's because the region's primary cable television provider, Time Warner Cable, is planning its own 24-hour news channel and isn't expected to carry TXCN." By May of 1999, Time Warner Cable still does not carry TXCN. Dianne Holloway reports in the *Austin American-Statesman* that, "Belo has been trying for months to break into the Austin television market with its Texas Cable News channel."

Bill Carey, president of Time Warner Cable in Austin, justified the decision to exclude TXCN by saying, "I'm sure [Belo] do what they do very well, but we haven't seen any interest among our customers in state news…. I think of news channels the way I do newspapers, and only local sells. News 8 [TWC's cable news channel] fills a badly needed niche: instantly accessible news and weather with a strong local focus. I don't know of any newspapers or news channels that succeed with statewide or regional news."[193]

In September of 2000, Belo and Time Warner entered into an agreement that would allow the former to air its TXCN on TWC in exchange for splitting the $25 million bill to create two more cable news stations in Houston and San Antonio. In an article on the deal, Heather Cocks noted that Time Warner had "resisted carrying the Dallas media company's 18-month-old Texas Cable News because of a perceived conflict with the News 8 Austin station that Time Warner launched last year."[194] She quotes the senior vice president of Belo as saying, "We've been having conversations with Time Warner since we launched

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[192] "Belo adds KVUE to Texas TV holdings." *Austin American-Statesman*. By Kim Tyson. February 26, 1999. News; p. A1, characterizes the incident as described in this paragraph..

[193] "TV's new motto: All the news that's fit to air—and then some." *Austin-American Statesman*. By Dianne Holloway. May 29, 2000. Lifestyle; p. E1.

TXCN in January of last year, but it got serious this past spring….To be on cable in Texas, they're obviously a major player."

The companies will split resources for the new channels, and the board of representatives for each channel will be comprised of 50 percent Belo and 50 percent Time Warner. The TXCN airs on channel 230 in Houston on Time Warner's digital tiers only.[195]

D. CONCLUSION

Conduct is inherently the least quantifiable of the elements of the analytic paradigm. Since the Congressional intent that animates this proceeding is prophylactic and predictive, examining observable conduct as the basis of establishing the rule is especially problematic. If we find just one example of bad behavior that would have been prevented by the rule, does that justify it? Individual actions can be dismissed as "just" anecdotes, yet many actions take place in private and may never be seen. The number of examples that would be necessary to demonstrate the need for a rule could never be specified. Thus, there is danger in demanding too much from, or relying too much on, specific examples of abusive action. That is why it is important to embed a discussion of actions in the overall analytic framework. This chapter has shown a historic and continuing pattern of behavior that is consistent with the exercise of market power that is made possible by structural conditions in the cable TV industry.

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[194] "Time Warner Cable to carry Belo's Texas news channel." *Austin American-Statesman*. By Heather Cocks. September 26, 2000. Business; p. D1.
[195] "Local cameras will roll on 24-hour news channel." *Houston Business Journal*. By Missy Turner. http://houston.bcentral.com/houston/stories/2001/04/30/story5.html

X. THE CABLE INDUSTRY'S LACKLUSTER PERFORMANCE EVIDENCES THE NEED FOR THE HORIZONTAL CAP

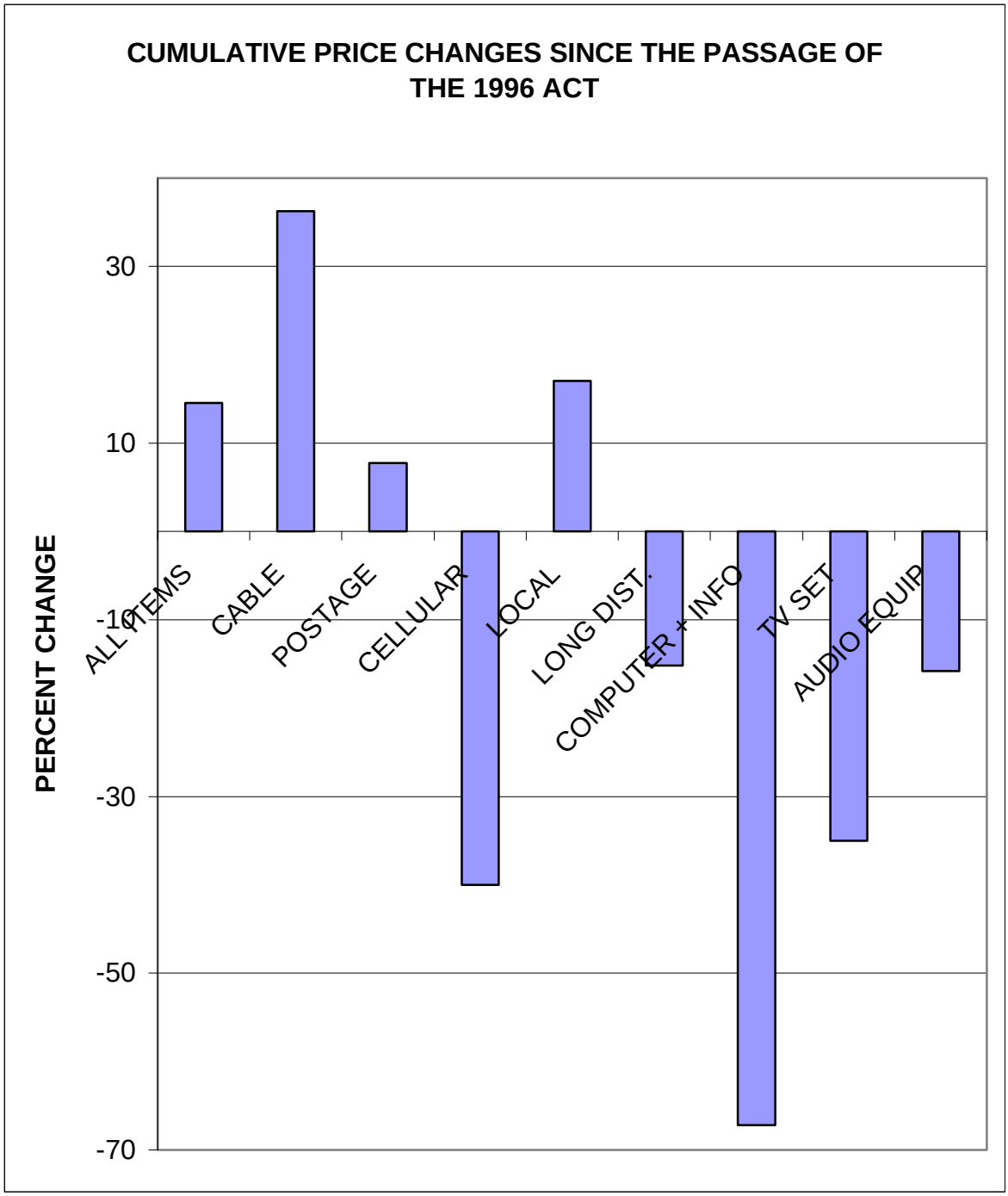
A. SUMMARY

The performance of the cable industry plays an important role in this proceeding as it sheds light on the structural and conduct-based problems the Congress determined needed to be addressed. The rate regulation provisions of the 1992 Act, which directly addressed the most obvious indicator of performance, were subsequently repealed. Not surprisingly, unregulated rates have increased rapidly. Bundling and price discrimination are also quite evident. Similarly, cable system values reflect the unregulated ability of operators to raise prices. The performance measures are consistent with the existence and exercise of market power. The premise on which Congress based the call for a horizontal limit is affirmed by the facts.

B. CABLE PRICES HAVE INCREASED MUCH FASTER THAN INFLATION

The most direct manifestation of the consumer complaint against cable market power is in the prices charged to consumers. Cable companies have used their market power to drive prices up faster than virtually every other consumer commodity in the past decade and a half (see Exhibit IX-1). Prices are up about 2.5 times as much as general inflation. Indeed, during all periods when cable prices were not regulated, prices have increased at about two to three times the rate of inflation. Compared to other industries that have been swept up in the digital revolution, like telephone networks and computer services, cable is performing very badly.

EXHIBIT IX-1



Source: Bureau of Labor Statistics, *Consumer Price Index.*

Despite all of the talk about changes in technology and more aggressive efforts to stimulate competition in the 1996 Telecommunications Act, rate increases during the period since its passage have been similar to increases in the period after the passage of the 1984 Act, when rates were partially, then fully, deregulated. In fact, rates increased faster after the 1996 Act than at any time after deregulation in 1984.

Not only have prices increased, but the industry has also restructured its revenue stream to maximize the leverage afforded by its market power. It has engaged in bundling, price discrimination, and other anti-consumer behavior (including activities such as efforts to impose negative check-offs and tie-in sales), driving consumers to buy bigger and bigger packages of programs at higher prices. While basic packages were being expanded and bundled to force consumers to pay higher prices, rates for pay services were flat. With consumers forced to buy more and more programs, the industry has increased its advertising revenues even more sharply than its other sources of revenue.

It is clear that pricing/packaging in this way is intended to force consumers to take the package. In economic terms it transforms consumer surplus into producer surplus. Although consumers would be less willing to pay for certain elements of the larger cable programming package, they must swallow the whole thing because their access to the desired elements is tied to those they do not want. The companies never offer channels on an *a la carte* basis to determine if consumer demand exists. Consumers are forced to pay for the added, low value channels because they do not want to give up the whole bundle. Since there is no competition, there is no real alternative.

This is a prime illustration of the theory of extraction of consumer surplus that can be found in the economic and marketing literatures.[196] The key point here is that the ability to add programming to the basic package allows the cable operator to charge more for basic service than its value. Even where over-the-air signal might be competitive, this bundling gives cable operators the opportunity to exercise market power. People pay for something they apparently could get for free because they are actually buying something else--access to the multiple channels.[197]

C. CABLE SYSTEM VALUES AND TOBIN'S Q PROVIDE EVIDENCE OF MONOPOLISTIC PRICING

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[196] Joseph P. Guiltinan, "The Price Bundling of Services: A Normative Framework," Journal of Marketing, 51: April (1987), at 75.

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

[197] Pricing philosophy in the industry clearly exhibits an effort to capture consumer surplus. As an article in an industry journal pointed out just before deregulation (Celia Conrad, "Choosing Cable Programming Services," Cable TV and New Media, 4:9 (1986):

> If viewers can purchase one channel and watch a second channel for free, they never will pay the market value of the second channel. A more profitable alternative for the pay television operator would be to offer program type A on the first channel and program type B on the second, and then sell both channels as a package. At an appropriate price, consumers will purchase the package. Even if the costs of scrambling were minimal, the package selling strategy would be more profitable than selling each channel individually.
>
> The practice of bundling recognized that consumers have preferences not only for program types but also for program variety. For example, some consumers might pay $25 for service A only; $25 for service B only, but $37.50 for a bundle of both A and B. Bundling is like an insurance policy. Whatever occurs, the consumer can watch his or her preferred program. But package selling may be attractive even aside from its insurance policy attributes. With package selling, the profitability of carrying a program type depends not only on how much revenue it generates on its own, but also increases the total package's revenues.

For cable systems, the most frequently used measure of the extraction of value from consumers is the sale price of systems. When systems sell for a lot more than the cost to build them, the assumption is that entry barriers are preventing competition from driving down the price.[198] Since systems can be built for a lot less than they are being sold, there must be something preventing entrants from coming into the field. The incumbent owners are clearly enjoying the benefits of the added value that barriers to entry are creating by selling at inflated prices.[199] In the cable industry, entry is extremely difficult. Incumbents hold a franchise and they resist over-building with a vengeance.[200] Moreover, even if a potential entrant exists, the integrated nature of the industry denies that entrant access to programming, which is necessary to compete.

The best and most direct interpretation of Tobin's q in this case is that it represents a massive monopoly premium, earned by cable operators who possess market power. Exhibits IX-2 and IX-3 show estimates of the transaction price for cable systems compared

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

[199] Formally, the ratio is called Tobins q and it is represented as the ratio of the sales price to the reproduction cost of the assets. This measure has been used for the past decade in the cable industry. In particular, it was used by telephone companies in arguing that they should be allowed to enter the cable TV business, see Shooshan and Jackson, Measuring Cable Market Power: Recent Developments, December 1988; S. J. Grossman, On the Misuse of Tobin's Q To Measure Monopoly Power, February 26, 1990.

[200] Senate Committee Report at 13-14; House Committee Report at 45; Noam, 1984, op. cit., at 15.

EXHIBIT IX-2

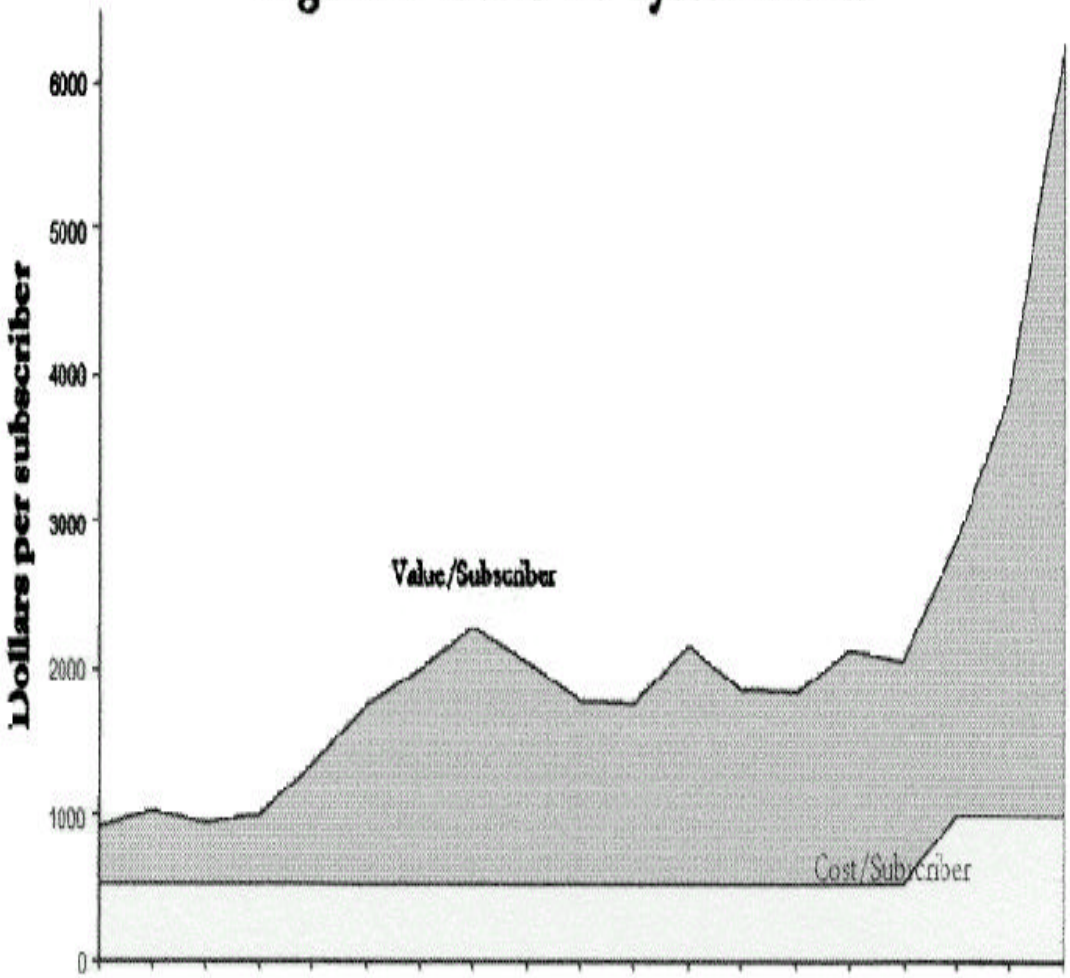
TRENDS IN TOBIN'S Q

YEAR	CABLE TV	
	System Sale Price (a)	Reproduction Cost
1983	1026	645 (b)
1986	1341	400-723 (c)
1988	1998	490-603 (d)
1992	1766	706 (e)
1994	1869	550(f) - 700 (g) - 828 (h)
1997	1899	
1998	2900	
1999	4100-5000 (i)	
basic		500-700 (j)
interactive		2000 (j)
2000	5000-6000 (i)	1300 – 1500 (f)

SOURCES:

a) Kagan Associates Inc., *Cable TV Master Database*, various issues.
b) H. L. Vogel, *Entertainment Industry Economics* (Cambridge University Press, Cambridge, 1986).
c) Shooshan and Jackson, *Opening the Broadband Gateway: The Need for Telephone Company Entry Into the Video Services Marketplace*, October 1987.
d) Shooshan and Jackson, *Measuring Cable Industry Market Power*, March 2, 1990., Leland L. Johnson and David P. Reed, *Residential Broadband Services By Telephone Companies*? (Santa Monica, Rand, 1990).
e)David P. Reed, *Residential Fibre Optic Networks* (Artech House, Boston, 1992), Tables 5.3 and B.8.
f) Thomas Hazlett and George Bittlingmayer, *The Political Economy of Cable "Open Access"* (Joint Center, Working Paper 01-06, May 2001)
g) Johnson, Leland, and David P. Reed, *Residential Broadband Services By Telephone Companies*? (Santa Monica, Rand, 1990).
h) Bell Atlantic, *In the Matter of the Application of The Chesapeake and Potomac Telephone Company of Maryland and Virginia for Authority Pursuant to Section 214 of the Communications Act of 1934, as amended, to Construct, Operate, Own and Maintain Facilities and Equipment to Provide a Commercial Video Dialtone Service within a Geographic Territory Defined by the Maryland and Virginia Portions of the Washington Local Access Transport Area, December 1994, Exhibit 3; U.S. West, In the Matter of the Application of U.S. West, Inc., for Authority Pursuant to Section 214 of the Communications Act of 1934, as amended, to Construct, Operate, Own and Maintain Facilities and Equipment to Provide a Commercial Video Dialtone Service in Portions of Colorado Springs*.
(i) These are widely reported prices paid per subscriber in the wake of the AT&T-MediaOne deal.
(j) Morgan Stanley Dean Witter, *Digital Decade*, April 6, 1999.

Figure 1. Cable TV System Rents



Note: 2000-1 = Jan. – June 2000.

Sources. Values: Hazlett & Spitzer, supra note 14, 22; FCC, First Cable Report, Table B-9; FCC, Seventh Cable Report, Table B-8. Costs: See footnote 13.

to estimates of reproduction costs. There is no doubt that there was a tremendous increase in q ratios after deregulation.

These numbers show that at the time of deregulation, the premium paid for systems was about $400. Tobin's q was about 1.6. This premium rose steadily until 1988, when systems were selling at $1500 more than their reproduction costs. Tobin's q had risen to 3 to 4. These figures were quite damning and the cable industry first tried to deny the fact that Tobin's q had grown dramatically, but finally was forced to fell back on efforts to justify the increase.[201] These q ratios cannot be explained away, however, except by monopolistic pricing.

First, a great deal of evidence, in addition to Tobin's q ratios, suggests the exercise of market power. This includes increasingly-concentrated markets, direct evidence of anti-competitive activity (including refusals to deal, efforts to obtain exclusivity), bundling and other marketing abuses. The precipitous rise in the ratio after deregulation strains the credibility of alternative explanations. One must accept a dramatic rise in good will and management skills or research and advertising after deregulation to buy these arguments.

Given the failure of the cable industry to deliver on many of its service promises, it is hard to accept the good will or management arguments. The nature of programming did change after deregulation and penetration did increase, but there is no evidence to support the industry's claim that this required the massive increases in rates that have sustained the run up in cable system sales prices.

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[201] Shooshan and Jackson, Measuring Cable Market Power: Recent Developments, December 1988, S. J. Grossman, On the Misuse of Tobin's Q To Measure Monopoly Power, February 26, 1990; Paul W. MacAvoy, *Tobin's q and the Cable Industry's Market Power,* February 28, 1990

During the regulated period of the 1990s, the premium declined. Price controls squeezed the monopoly profits. In 1994 the premium was about $1000 and Tobin's q declined to about 2.5. Since then, deregulation has driven the prices through the roof, with prices approaching $5,000 and premiums exceeding $4,000.

In spite of all the claims about alternative sources of video programming, the problem is growing worse, measured at the level of prices and monopoly rents (as described in Exhibit IX-3).

D. THE IMPLICIT LERNER INDEX DEMONSTRATES THE MARKET POWER IN THE CABLE INDUSTRY

The FCC has estimate demand and price elasticities for cable service. In spite of the fact that demonstrating the FCC has not shown a cross price elasticity between cable and satellite, which would be a critical step towards demonstrating that cable and satellite are substitutes,[202] the FCC finds that satellite subscribership "exerts a small" influence on the demand

[202] The claim that cable and satellite are substitutes, in spite of the fact there is no price effect of satellite on cable is simply incorrect. In economics, substitutes exhibit a positive cross elasticity.

Pearce, George, The Dictionary of Modern Economics (MIT Press, Cambridge,1984), p. 94.

Cross Elasticity of Demand. The responsiveness of quantity demanded of
one good to a change in the price of another good.
Where goods i and j are substitutes the cross elasticity will be positive-i.e. a fall in the price of good j will result in a fall in the demand for good
i as j is substituted for i. If the goods are complements the cross elasticity will be negative. Where i and j are not related, the cross elasticity will be zero.

Taylor, John, B., Economics (Houghton Mifflin, Boston, 1998), p. 59.

A sharp decrease in the price of motor scooters or rollerblades will decrease the demand for bicycles. Why? Because buying these related goods becomes relatively more attractive than buying bicycles. Motor scooters or rollerblades are examples of substitutes for bicycles. A substitute is a good that provides some of the same uses or enjoyment as another good. Butter and margarine are substitutes.

for cable services. The FCC's econometric analysis indicates that cable has substantial market power.

The demand and supply elasticities estimated by the FCC in its most recent econometric analysis are low. The elasticity of demand is 1.452, which the FCC describes as "somewhat price elastic." The elasticity of fringe, satellite supply is .136, which is quite low. As a consequence, under the typical circumstances in MPVD markets, cable operators can raise prices by 50 over percent, indicating a large degree of market power. Consider satellite a "competitive fringe that could expand readily, but is limited by its general characteristics to the cross demand elasticity it has previously demonstrated. The national average market share for cable service in markets in which cable and satellite compete is 85 percent.

Market power at the point of sale in a typical cable market can be estimated as follows based on the market shares and elasticities.

In general, the demand for a good will increase if the price of a substitute for the good rises, and the demand for a good will decrease if the price of a substitute falls.

Bannock, Graham, R.E. Banock and Evan Davis, Dictionary of Economics (Penguin, London, 1987).

Substitutes. Products which at least partly satisfy the same needs of consumers. Products are defined as substitutes in terms of cross-price effects between them. If, when the price of records goes up, sales of compact discs rise, compact discs are said to be a substitute for records, because consumers can to some extent satisfy the need served by records with compact discs. This account is complicated by the fact that, when the price of an item changes, it affects both the REAL INCOME 01 consumers and the relative prices of different commodities. Strictly, one product is a substitute for another if it enjoys increased demand when the other's prices rises and the consumer's income is raised just enough to compensate for the drop in living standards caused (pp. 390-391).

Cross-price elasticity of demand. The proportionate change in the quantity demanded of one good divided by the proportionate change in the price of another good. If the two goods are SUBSTITUTES (e.g. butter and margarine), this ELASTICITY is positive. For instance, if the price of margarine increases, the demand for butter will increase (p. 99).

$$L = \frac{S}{e_m^d + e_j^s (1 - s_i)} = \frac{.85}{1.452 + .136\,(.15)} = .58$$

Even if we assume the competitive fringe (satellite) were not restrained by its small market share (i.e. set the market share equal to 1 instead of .15), the Lerner Index would be .54.

There is clearly a great deal of market power at the point-of-sale. As discussed earlier, this provides a key ingredient for discrimination. Cable operators need not fear loss of subscribers at the point of sale resulting from discrimination against non-affiliated programmers. The ability of consumers to switch suppliers or cut back demand is limited.

E. CONCLUSION

The evidence of market power at the level of performance is overwhelming. There is no denying the fact that "cable operators possess substantial market power in subscription video markets."[203] Looking back at the First Annual report and the other evidence of the extent of cable market power in the early 1990s, these performance measures indicate not only that cable operators have market power, but that it has been increasing. The HHI, the Lerner Index,[204] and Tobin's q are all higher today than they were in 1992..

[203] Hazlett and Bittlingmayer, p. 3.
[204] The current Lerner index if higher that two-thirds of those estimated.

PART FOUR:
THE IMPACT OF NEW TECHNOLOGY ON THE CABLE INDUSTRY'S MARKET STRUCTURE

Because cable operators avoid competing with each other head-to-head, alternative distribution media have been viewed by policy makers as the vehicles to break the cable monopoly. For almost two decades since the deregulation of cable, consumers have been told that some new technology is just around the bend. In this part, we examine the technological champions that have been pushed forward by policymakers – satellite and the Internet. The discussion in the previous part suggests that those promises have not been fulfilled. By examining the characteristics of these two technologies we can understand why they have, as yet, been unsuccessful in breaking the monopoly power of cable.

Satellite was the highly-touted savior in the 1990s, but as we have seen, it did not curtail pricing abuse or diminish cable's market power. We find that satellite is not the all-purpose competitor it is claimed to be.

It is restricted to two niches – a rural niche and a mega-service niche. In the rural niche, which accounts for 40 percent of satellite subscribers, it does not encounter cable as a competitor. The remaining satellite subscribers buy a high-volume, high-cost product that competes only with a small subset of upscale cable customers. In contrast, in the heart of the cable market – 42 million "lunch bucket" cable subscribers – competition is muted. While it may be true that satellite is available as a distribution mechanism in its market niches, it is also critically important to the horizontal limit argument that in this very substantial part of the market, competition lacks the driving force to compel cable to deliver quality. Accumulating a larger and larger footprint in this market would increase the incen-

tive of dominant MSOs to exclude programming. Clustering these markets would encourage them to evade the program access rules by distributing programming terrestrially.

The Internet is the savior projected for the first decade of the 21st century. It is entirely premature to base assert that consumers and programmers can be protected from the cable industry's market power by the Internet for three reasons.

First, to date, it has shown absolutely no ability to do so. It has made few inroads into the primary uses to which television is put or the revenues on which television is based.

Second, the commercial delivery of services over the Internet is beginning to take on traits similar to other commercial mass media. It is being dominated by a small number of large, integrated firms.

Third, and most importantly, the functionality that could provide direct competition to multichannel video programming is under the thumb of the incumbent monopolist cable operators. Cable controls the dominant and preferred facilities for the delivery of streaming video and it has extended its closed proprietary model to that functionality. The Commission has allowed cable companies to foreclose streaming video competition. Cable also controls much of the dominant video content. Under current policies, there is little chance that the Internet will undermine cable market power because cable can frustrate competition at two layers of the communications platform.

XI. SATELLITE IS NOT A SUBSTITUTE FOR CABLE

A. SUMMARY

The cable industry and the Federal Communications Commission claim that satellite services are a widely available alternative to monopoly cable franchises, and serve as a disciplining force at the point of sale and at the national level in the market for programming.

At the point of sale, as a distributor of programming to the public, it is argued that if cable operators raise their prices too high or let their quality slip (by favoring their own programming or scrimping on programming expenses to increase profits) people will switch to satellite.

At the national level, as a buyer of programming, satellite is said to provide access to eyeballs. It is claimed that as an independent buyer of programs it becomes part of the open field necessary to allow programmers who are not owned or affiliated with cable operators to reach a large enough audience to succeed.

Because satellite has been touted as the primary (perhaps sole) competitor to cable, it merits special attention. If cable lacks significant multichannel competition, it will not be pressed to deliver quality products and program producers will not have an effective alternative distribution mechanism to reach the public. We have consistently argued and shown that in reality, satellite services do not play nearly as competitive a role in core segments of the multichannel transmission and program distribution markets as the industry would like us to think. For the “lunch bucket” cable subscriber, satellite is not an effective alternative for cable.

This chapter demonstrates that at this point satellite is far from the all-purpose competitor to cable that its devotees claim (see Exhibit X-1). Satellite remains primarily a niche market player, with little ability to discipline cable either at the point of sale or in the national programming market. Satellite serves two quite distinct and relatively small niches:

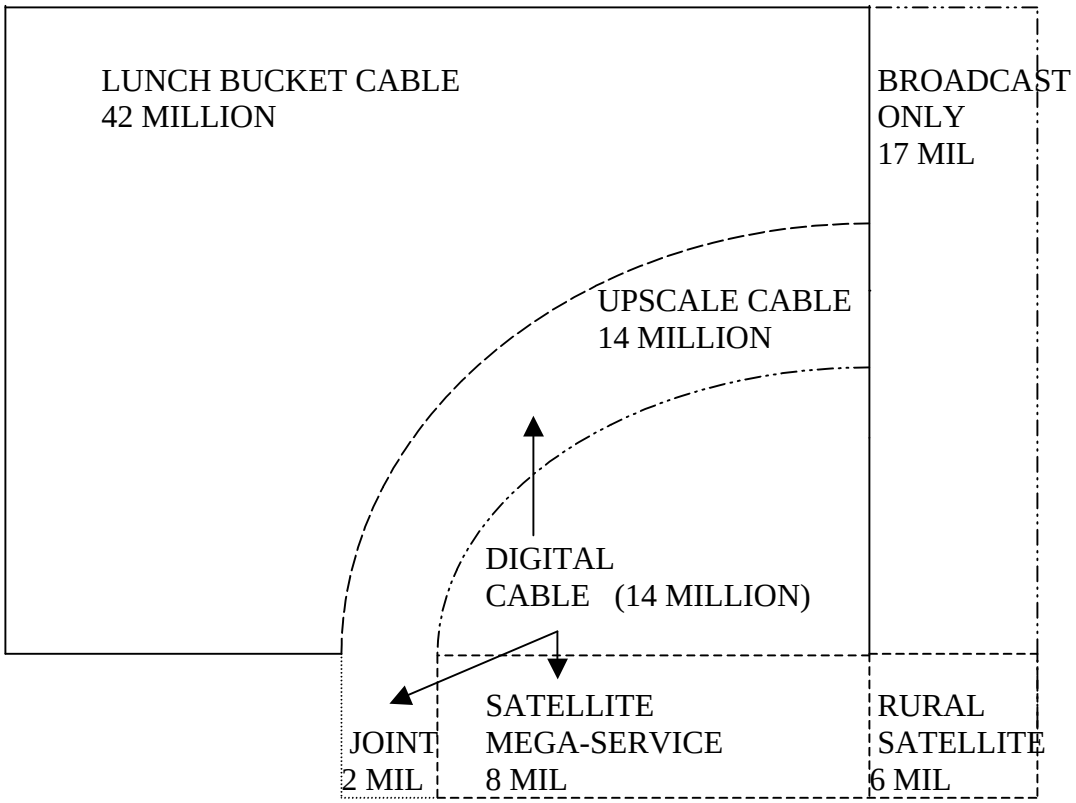
- rural communities, where cable is unavailable or inferior and
- high-volume specialty programming markets, where cable has not generally had much to offer.

Satellite is simply not an effective competitor for the vast majority of cable subscribers outside of these relatively-small product and geographic markets. Moreover, satellite's ability to discipline cable in upscale markets is diminishing. As digital cable and cable modem services expand, satellite's advantage in the high-end niche programming market will erode. Consequently, neither economic deregulation in the commercial marketplace nor relaxation of diversity policies in the marketplace of ideas can rely on satellite's ability to discipline cable.

This chapter demonstrates this conclusion with two types of data. First, we examine pricing and other behavior patterns in the multichannel television market. Second, we present evidence from a recent survey conducted by Consumers Union of satellite and cable subscribers.

FIGURE VIII-1

THE MULTICHANNEL VIDEO DISTRIBUTION PRODUCT SPACE



B. THE REPEATED FAILURE OF CROSS-TECHNOLOGY COMPETITION UNDER THE COMMUNICATIONS ACT

In 1984, the Congress gave the FCC the authority to deregulate price in competitive cable TV markets. The FCC determined that three over-the-air channels were enough. In addition, it was expected that head-to-head competition between cable companies would grow and that competing technologies would add further competition.[205] As a result, cable systems serving about 80 percent of the country were deregulated. When competition failed to materialize, cable prices exploded and a public outcry ensued.

In an effort to stave off legislation to re-regulate cable, the FCC reconsidered its three over-the-air rule and switched to six over-the-air stations as a standard. However, the pricing abuse was too great and the FCC's standard too weak to forestall legislation. Congress re-regulated rates in 1992 and placed a range of "procompetitive" conditions on the industry.

During the second period of regulation, rate increases were diminished and the satellite TV industry came into existence. Contrary to threats from the industry about stagnation,

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[205] "Testimony of Thomas Wheeler, President of the National Cable Television Association, " before the *Subcommittee on Communications of the Committee on Commerce, Science and Transportation*, United States Senate, June 21, 1989, pp. 4-5.

> Any analysis of cable ownership issues must begin with the fact that cable systems have developed as local monopolies. The premise of the 1984 Act was that cable would develop in a competitive market. Many legislators may have relied upon the promise of the cable industry that:
>
> > "A consumer will have a couple of choices of cable companies. There will be two cable wires running down the street." (citing Testimony of Preston R. Padden, President Association of Independent Television Stations, Inc." before the *Subcommittee on Communications, Committee on Commerce Science and Transportation*, United States Senate, February 16-17, 1983) pp. 126-127.
>
> Other legislators likely relied on the anticipation that cable would face competition from emerging technologies such as direct broadcast satellite.

regulation did not slow down the industry.[206] Cable added approximately 7 million subscribers between the end of 1992 and 1995, boosting the total to about 62 million. Its penetration rate grew at a slightly higher rate than at any time after deregulation in 1984.

During this period, satellite systems also grew from about 1 million to 4 million. Apparently, the growth of satellite did not discipline the cable TV industry. Since the passage of the 1996 Telecommunications Act, cable TV returned to its historic pricing pattern, unrestrained by the pressures of satellite competition. In real terms, cable rate increases were larger with the presence of an expanding satellite sector than without it.

One of the great disappointments of the 1996 Telecommunications Act has been the failure of competition from alternative technologies to break down the market power of the incumbents. Congress had great hopes for this form of competition.[207] In fact, the only facilities-based competitor for local telephone service actually mentioned by the Act's Conference report was cable TV.[208] Similarly, Congress devoted a whole section to telephone competition for cable through open video systems.[209] Neither of these has proven effective competition. Open video systems are non-existent.[210]

DBS fills a niche at the high end of the market. DBS's large channel capacity and high front-end costs dictate the packaging of large numbers of high priced channels and/or long-term contracts. As a result, DBS occupies a small competitive fringe and is incapable

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With the 20/20 vision of hindsight, it is now clear that there is no competition -- no head to head cable competition, and no effective competition from other media.

[206] FCC, Annual Assessment of the Status of Competition, various issues.

[207] This section is drawn from the Mark Cooper and Gene Kimmelman, *The Digital Divide Confronts the Telecommunications Act of 1996*, February 1999.

[208] Pub. L. 104-104, Conference Report, p. 148.

[209] Title II, part 5.

[210] Fifth Annual Report, Appendix C.

of disciplining cable TV pricing. DBS still costs more than twice as much as cable does, not including the front-end system costs, which undermines its ability to compete on price.

Even in the midst of the debate over delivery of local stations by satellite, the largest satellite provider eschews price competition for the basic package.

> Congress has been moving at an unusual speed to pass a bill that would give DBS providers the right to beam local network signals to local subscribers …
>
> "It's not a cure-all," said Hartenstein, who has run DirectTV since its inception in 1990. For one thing, Hartenstein's business plan is not based on beaming local network signals to his customer base, soon expected to top 9 million. Instead, he is suggesting that subscribers buy new antennas to supplement their coverage. DirecTV is working with retailers to have the specialized antennas available at reduced prices. He calls this program "Distant/Terrestrial," meaning he sends you all the cable and movie channels you could dream of (for which he can charge), and you pick up the free network feeds with an extra antenna.

Furthermore, Hartensteins' game plan does not include fighting for cable customers by undercutting cable prices. Analysts for the DBS and cable industries have figures out which indicate that the average American homeowner will cough up $30 per month for TV. Above that level, both camps believe, many consumers will bolt and run. Hartenstein seems determined to compete on quality and depth of service, not on price.[211]

Even in the midst of the debate over delivery of local stations by satellite, the largest satellite provider, Direct TV, made it clear that price competition for the basic package was not in the offering. The segmentation of the market has become more and more apparent as the new right to retransmit local bills has been granted.

> "What is going to happen is every few months there is going to be a new development," [Thomas Egan, a cable and satellite analyst with PaineWebber in New York] said. "I think what will happen is they will try to compete less on price and try to compete more on services."

[211] Mundy, Alicia, "The Price of Freedom," *MediaWeek*, March 29, 1999, p. 32.

> Mr. Egan said expected cable companies to focus their energy on high-speed Internet and new digital services, while satellite companies would be focusing on increased programming.[212]

The vast majority of cable customers are victimized by cable pricing because the high-cost, high-capacity DBS offering exceeds their means or their needs. A recent study by the FCC did not find a significant price disciplining effect of satellite on cable.[213] Cable makes much more money by increasing prices for basic cable than competing in the DBS niche. The revenue gained by increasing cable prices to existing subscribers since the Telecom Act of 1996 exceeds the revenue lost to all DBS-only subscribers by almost 2-to-1 and all DBS-only subscribers in areas where cable is available by 3-to-1. Cable revenues added from new subscribers, <u>at the higher prices</u>, just about equaled cable revenues lost to new DBS-only subscribers in areas where cable is available at the old prices.[214]

The addition of high-priced digital cable and cable modem Internet services strengthens cable's advantage over satellite.[215] These high-end services allow cable operators to attack the high-end niche that satellite occupies. Cable will be able to leapfrog satel-

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[212] Clausing, Jeri, "Satellite TV is Poised for New Growth," *New York Times*, November 26, 1999, p. C-6.

[213] Federal Communications Commission, *Pricing Analysis*, February 2001. The study did find a weak subscriber effect. Even though satellite is not cross elastic on price, larger satellite subscribership does have a small effect in taking subscribers away from cable. There is also evidence that satellite is much more effective where cable quality is weak. Neither of these observations is inconsistent with our argument that satellite is not sufficiently competitive to discipline cable pricing.

[214] The pricing strategy was apparent to some industry observers, as a Cisco publication noted (Abe, George, *Residential Broadband* (Cisco Press, Macmillan Technical Publishing, 1997), p. 217.

> Cable MSO management apparently agrees it is necessary to get more from each subscriber. Since the passage of the Telecom Act of 96, cable operators have taken the opportunity to raise subscription rates more than twice as fast as the consumer price index, clearly not a strategy for getting new households.

[215] Boersma, Matthew, "The Battle for Better Bandwidth – Should Cable Networks be Open?," *ZDNet*, July 11, 1999.

lite at the high-end of the market, particularly when it is bundled with high-speed Internet access.

C. Survey Results Show That Cable And Satellite Are Viewed Differently By Consumers

The previous sections have demonstrated the inability of satellite to discipline cable with qualitative data on pricing and marketing and quantitative data on product substitution. This section examines survey data to ascertain whether these findings are consistent with the perceptions of consumers. It explores two traditional aspects of market analysis from a public policy (particularly an antitrust) point of view. When economists analyze competition in markets they refer to product and geographic competition. The survey evidence suggests that there are significant disjunctures between the satellite and cable products in both regards.

These observations are based on patterns that are readily identifiable in a number of data sets. For example, Centris, which does weekly surveying of multichannel video households, recently estimated that

- 40 percent of satellite subscribers live in areas where cable is unavailable,
- 2 million households subscribe to both satellite and cable, and
- digital cable and DBS households have relatively high PPV buy rates.[216]

Respondents to the Consumers Union survey (CU Survey) exhibit these characteristics, as well, but the detailed questions on preferences and demographic characteristics enable us to use the data to explore the implications of these patterns. In particular, we explore the characteristics of satellite and digital cable subscribers. As the above quotes from Cen-

teris and the analysis in the previous sections indicate, the deployment of digital cable triggers competition within the niche that satellite has occupied.

For the purpose of describing the competitive landscape between cable and satellite, we describe the following market segments in the subsequent text.

- Cannot get cable: Those who have satellite and cannot get cable are approximately 6 million subscribers.
- Satellite only: Those who have satellite and can get cable, but choose to get satellite only are about eight million subscribers.
- Satellite+ cable: Those who have satellite and cable are about 2 million subscribers.
- Digital Cable: Those who have digital cable are about 14 million subscribers.
- Analog cable: Those who take only analog cable are about 56 million subscribers.
- Lunch Bucket (basic) Cable: After examining viewing patterns and bills, we identify a group of cable subscribers we call the "lunch bucket crowd," who have analog cable and take only the basic and expanded basic tiers of service. The are about 42 million subscribers.

1. Satellite Has a Rural Niche

This section identifies the rural niche market that is served by satellite in which cable offers limited competition to satellite . It has long been recognized that satellite subscribership is much higher in rural areas. Simply put, satellite penetrated first and foremost in areas where cable was not available.

For example, in filings at the FCC, DirecTV states that its subscriber base was half urban and half rural.[217] In the recent past, however, it claims that bout two thirds of new subscribers have been from urban areas. Given that over three-quarters of the U.S. popula-

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[216] Centris, *Digital Cable and DBS households are 25% more likely to be on the web,* March 20, 2001.
[217] Seventh Annual Report, para 66.

tion lives in urban areas, satellite subscribers are still disproportionately rural. In the CU survey, 41 percent of respondents live in areas classified as having fewer than 100,000 people. In fact, the vast majority of places that fall in this category have fewer than 10,000 residents.[218] Thus, the survey respondents seem typical of satellite subscribers.

This can be seen in the data in two ways. First, as Exhibit X-2a shows, we find that respondents in low density areas are much more likely to say they could not get cable. Over half the respondents (55 percent) who live in places with less than 100,000 people said they could not get cable. In contrast, less than one quarter (24 percent) of respondents who live in places with more than 2 million people said they could not get cable.

[218] *Statistical Abstract of the United States*

EXHIBIT X- 2: GEOGRAPHIC MARKETS OF CABLE AND SATELLITE

a) AVAILABILITY OF CABLE TV TO SATELLITE SUBSCRIBERS
BY SIZE OF PLACE OF RESIDENCE

		Satellite owners		
		Cannot get cable	Can get cable	ALL
	(n)			
Less than 100,000	(511)	55%	45%	100%
100,000 to 499,000	(170)	39	61	100
500,000 to 2,000,000	(236)	33	67	100
2,000,000+	(311)	24	76	100
TOTAL	100	100	100	

Notes: The distributions are significantly different at the .001 level (Chi square = 89.2, df =3).

b) SIZE OF PLACE OF RESIDENCE OF SATELLITE AND CABLE SUBSCRIBERS

	Satellite owners		Cable Subscribers
	Cannot get cable	Can get cable	
n =	499	729	679
Less than 100,000	57%	31%	17%
100,000 to 499,000	13	14	15
500,000 to 2,000,000	15	22	21
2,000,000+	15	33	47
TOTAL	100	100	100

Notes: The distributions are significantly different at the .001 level (Chi square = 46.1, df =3).
Source: Consumers Union Survey

Exhibit X-2b looks at this data in another way that enables us to compare satellite subscribers. The majority (57%) of those who said they could not get cable live in places with less than 100,000 people. Another 13 percent of satellite owners who said they were unable to get cable live in places with between 100,000 and 500,000 people. Only 31 percent of satellite owners who said they had access to cable live in places with fewer than 100,000 people.

In contrast to the satellite owners, cable subscribers are much more likely to come from large places. Approximately 47 percent of cable subscribers come from places with over 2,000,000. Another 21% live in places with between 500,000 and 2,000,000. In other words, approximately 70 % of the satellite owners who say they cannot get cable live in places with fewer than half a million people, whereas 68% of cable -only subscribers live in places with more than half a million people.

This analysis shows a substantial part of the satellite base for which head-to-head competition with cable appears to be muted. For approximately 40% of the satellite subscribers cable cannot compete.

2. Dual Service Respondents Indicate that Cable and Satellite are Complements, not Substitutes

Approximately 11 percent of the respondents take both cable and satellite service. This percentage is consistent with the figure of about 2 million subscribers cited above. For these customers, the two would appear to be complements rather than substitutes.

One reason to take both is that local programming is more limited for satellite. Satellite subscribers who also take cable have a lower cable bill than other cable subscribers. They are almost three times as likely to report that their cable bill is less than $30 per month

(46 percent to 17 percent), suggesting they take the basic tier which gives them the local channels they cannot get with satellite. They also report watching many fewer channels than other satellite subscribers and cable subscribers.

Thus, in this survey, just under 60 percent of respondents either cannot get cable or appear to view it as a complement, rather than a substitute. Slightly more than 40 percent of the respondents have a choice between satellite and cable and choose satellite over cable. They are the focal point of the remainder of the analysis.

3. Satellite Customers Are More Satisfied than are Cable Customers

This section analyzes the responses of satellite subscribers who have both cable and satellite available.

The subset of consumers who take satellite only does so because it is perceived as a high volume, higher quality service. The most frequent reason given for taking satellite is the large number of channels (see Exhibit X-3a). Three quarters of the satellite -only subscribers are attracted by the large number of channels and 40 percent cite dissatisfaction with cable channel selection. A majority also says cable costs too much.

A direct question posed on the value of proposition of satellite and cable knits these responses together. Respondents were asked "Overall, how good a value (in terms of programming choices and quality) do you consider this system to be, given the costs?" Satellite fared better (see Exhibit X-3b).

EXHIBIT X-3: VALUING SATELLITE AND CABLE SERVICES

a) REASONS FOR SUBSCRIBING TO SATELLITE SERVICES

SATELLITE POSITIVES	Only Satellite
n =	597
Wider selection	
Lg. # of Channels	75
Sports selection	26
Pay-per-view selection	24
Audio selection	21
Higher Quality Sound & Pictures	31
CABLE NEGATIVES [b/]	
Cost too much	51
Poor selection of channels	40

b) VALUE PROPOSITIONS FOR SATELLITE

	Satellite only	All cable
n =	487	646
Excellent	35	6
Good	59	63
Poor	7	31
TOTAL	100	100

Note: The distributions are significantly different at the .001 level (Chi Square = 18.1, df=4).

c) VALUE PROPOSITIONS FOR CABLE AND WILLINGNESS TO SWITCH

	Willing to switch	Not willing to switch	Total
n =	95	460	
Excellent	0	100	100
Good	12	88	100
Poor	31	69	100
TOTAL	17	83	100

Notes: The distributions are significantly different at the .001 level (Chi square = 254.1, df=2).
Source: Consumers Union Survey

Overall, satellite subscribers are much more favorable about the value proposition than cable subscribers. Although for both services the most frequent response was 'good value,' for satellite there was a much larger group of subscribers who see their value as excellent than for cable (30 percent v. 6 percent). In contrast, for cable there was a much larger group who see their service as a poor value than satellite (31 percent v. 8 percent).

However, dissatisfaction with the cable value proposition does not always translate into a decision to subscribe to r satellite. Only 17 percent of the cable respondents said they would consider switching to satellite. Those who are willing to switch are much more likely to have expressed dissatisfaction with the cable value proposition. Nevertheless, less than one-third of those who said cable is a poor value are willing to switch.

Given the attraction of satellite's wide selection, we should not be surprised to find that satellite owners have very different viewing patterns than analog cable subscribers (Exhibit X-4). In the table the arrows highlight the relevant differences.

EXHIBIT X-4:
VIEWING PATTERNS
(Percent of Respondents)

	SATELLITE ONLY			SATELLITE + CABLE			CABLE ANALOG			CABLE DIGITAL		
	N	O	D	N	O	D	N	O	D	N	O	D
n*												
PROGRAM TYPE												
Broadcast Networks	30	26	45	4	26	70	1	4	75	2	22	76
Local Pub. Access	68	23	9	48	38	14	29	62	9	32	52	10
Std. Cable/ Sat Channels	5	48	47	25	39	36	3	61	36	4	58	38
Premium Movie	37	34	30	78	15	7	73	22	5	38	34	28
Premium Sports	67	27	7	86	9	5	81	16	3	59	29	12
Pay-per-View	48	51	2	89	11	0	95	5	1	71	21	2

Notes
N = Not at all; O = Once a month to a few times a week; D= Daily or almost daily.
* = Sample size vary across the comparisons but to nonresponses. Cell sizes and statistical tests are available upon request.
Source: Consumers Union Survey

Satellite-only subscribers are less likely to watch broadcast networks and local public access channels (which they probably cannot get). Even the satellite subscribers who also get cable are less likely to watch local public access channels. Satellite only subscribers are more likely to watch premium movie, sports and pay per view channels than those who get cable and satellite or analog cable subscribers. However, digital cable subscribers look more like satellite only subscribers than analog cable subscribers in their purchases of premium movies, sports and pay-per view.

Examination of the data reveals that the cable analog group has a clearly identified subgroup which we call the basic, or "lunch bucket," cable group. Eighty percent of the cable analog group subscribe to only basic and expanded basic service and takes no additional tiers. This represents the largest segment of cable subscribers by far, with 42 million. The remainder of the analog cable group is more upscale, subscribing to, on average, a total of 4 tiers.

4. Pricing Differences Between Cable and Satellite Show that they are Considered Different Products

As suggested in the quotes from Centeris in the introduction, the demographic and consumption patterns of market segments receive a great deal of attention in the industry literature, since knowing the kind of market is important to investors and others who are trying to assess future revenue prospects. We are not concerned about whether one market is upscale or not as a measure of how much revenue can be extracted from a market, but are interested instead in whether products are likely to compete across the market segments.

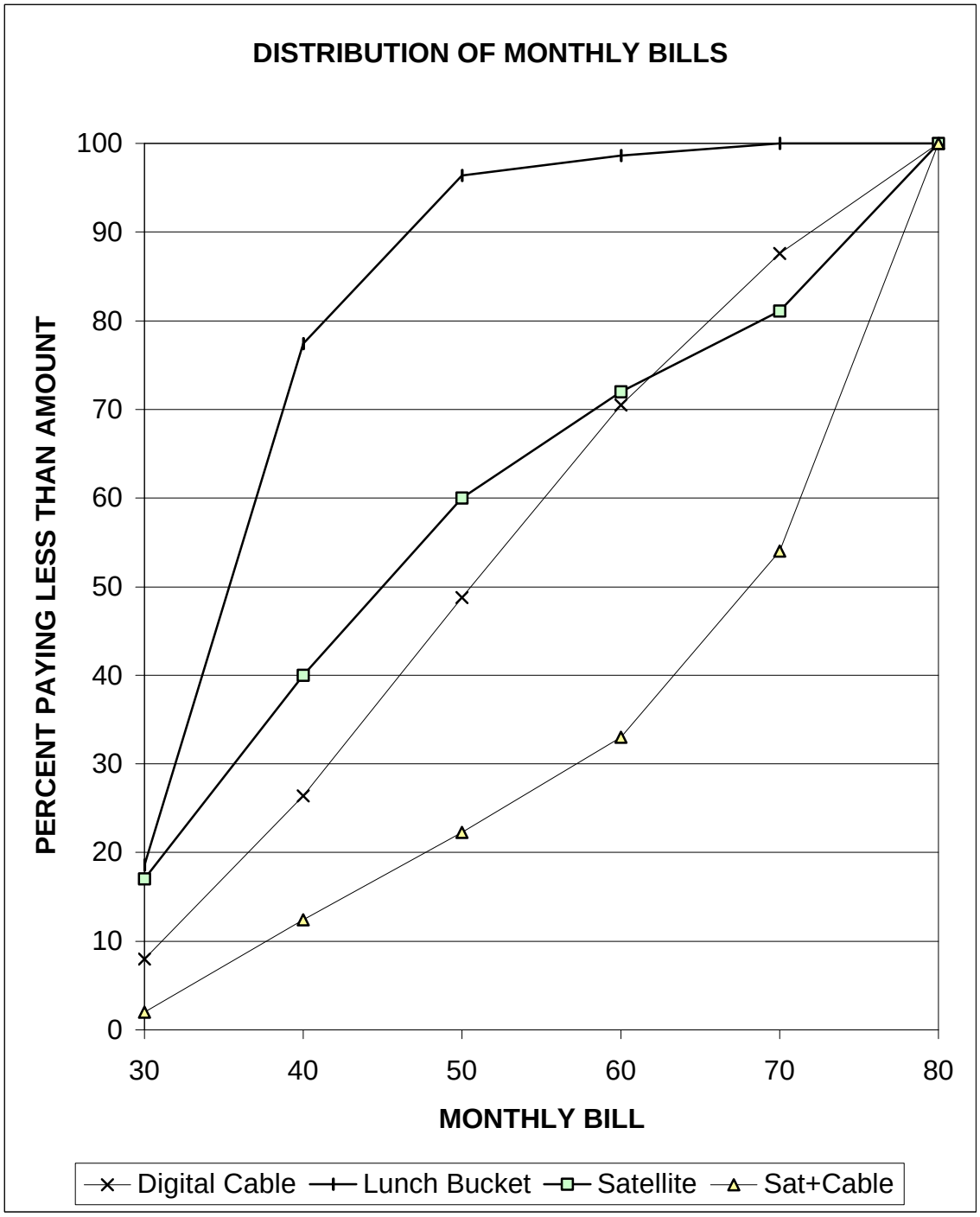
Pricing is a good example of the difference between market analysis and policy analysis. The issue of whether satellite is more expensive than cable is always confounded

by differences in quality. Satellite is a different product. Satellite tends to deliver more channels. It has higher front end costs. Just over two-thirds of the respondents paid for their satellite system and the median cost was $200. Over half paid for installation, and the median was $75. In contrast, over four-fifths of cable subscribers paid less than $25 for installation. Pricing has varied historically. When we looked at costs we looked at the last year only. Cable costs have been increasing and satellite costs have been declining. Nevertheless, even renting the equipment, which has become an option, adds to the cost.

Monthly charges exhibit different patterns, particularly when the market segments are considered. Exhibit X-5 compares the "lunch bucket" cable group (analog no additional tiers) to the satellite- only group in areas where cable is available as well as digital cable and satellite plus cable. There are very few satellite subscribers who take a small package of services similar to this group of cable subscribers.

Taking this view, the lunch bucket cable group reports a substantially lower bill (median of $36) with the distribution skewed to the low end (95 percent spend less than $50). At the other extreme are those who take cable and satellite. They have a median bill of $68, with the distribution skewed to the high end (almost 80 percent spend more than $50). Digital cable and satellite subscribers fall between the two extremes, both with a median bill of about $50 and an even distribution of bills.

EXHIBIT X-5


DISTRIBUTION OF MONTHLY BILLS
PERCENT PAYING LESS THAN AMOUNT
100
90
80
70
60
50
40
30
20
10
0
30
40
50
60
70
80
MONTHLY BILL
Digital Cable
Lunch Bucket
Satellite
Sat+Cable

additional tiers) to the satellite-only group in areas where cable, digital cable, and satellite plus cable are available as well.

Taking this view, the lunch bucket cable group report substantially lower bills (median of $36) with the distribution skewed to the low end (95 percent spend less than $50). At the other extreme are those who take cable and satellite. They have a median bill of $68, with the distribution skewed to the high end (almost 80 percent spend more than $50). Digital cable and satellite subscribers fall between the two extremes, both with a median bill of about $50 and an even distribution of bills.

D. CONCLUSION

Of the eighty million multichannel video subscribers who live in areas where cable and satellite are both available, fewer than 15 percent have chosen satellite over cable. These subscribers have preferences and viewing patterns that are quite distinct from the typical "lunch bucket" cable subscriber. They are, however, similar to digital cable subscribers. The number of subscribers to digital cable now almost equals the total number of satellite subscribers and it has been growing about twice as fast, especially in areas where both cable and satellite are available. Digital cable is a new technology development that hems in satellite as a competing product.

It is clear that consumers can choose how much they want to pay above a basic level by switching between services or opting into or out of tiers of service. However, that does not demonstrate that the presence of satellite in the market disciplines the pricing practices of cable for basic cable, which is so critical to the public policy debate. All three types of data examined in this chapter suggest that for a large segment of the cable market, it does not.

The differentiation in the product market enhances the market power of cable companies. As we have seen, they have relentlessly raised basic cable rates in the exercise of that market power. The absence of competition in this core monopoly product of cable has similar implications for programming quality. To the extent that they need to invest, they directs their efforts elsewhere, developing niche products or extending their market power into neighboring markets, as the discussion of broadband demonstrates.

XI. THE INTERNET DOES NOT SERVE AS A SUBSTITUTE FOR CABLE

A. SUMMARY

The Internet does not affect our calculus for a horizontal ownership limit, because instead of functioning as a substitute for cable or a way to circumvent the cable monopoly bottleneck, cable's control over the next-generation broadband Internet reinforces their monopoly power. There are two reasons to consider the Internet in this proceeding. First, there are those who would like to believe that the Internet will finally be the technology that will break the monopoly of cable. Second, Congress extended its concerns about the exercise of market power to advanced services delivered over cable networks. If cable operators sell advanced services under the same anticompetitive terms and conditions as they sell video services, one could argue that a horizontal limit could be imposed on those grounds alone. Under the statute, the need for a horizontal cap would be justified on the basis of the effect on this market. The issue of nondiscriminatory access to high-speed Internet connections has profound implications for the future of the Internet, but this is the subject of another proceeding. These comments address only the anticompetitive leverage being exercised by the cable operators in this market as it affects the video market.

Contrary to the naïve expectations of the Commission, proprietary control of the physical facilities has not led facility owners to open their networks and embrace potential competitors at any layer of the communications platform.[219] Wishful thinking cannot provide the market forces necessary to discipline a product space that neither the Internet nor cable TV have as yet successfully entered or occupied. That the product spaces were differ-

[219] NPRM, 39, 42, asserts that cable operators will not harm competing programmers, as the Commission had earlier claimed they would open their networks to competing Internet Service Providers.

ent in the past or may be different in the future cannot provide market discipline in the present.[220]

B. THE INTERNET HAS NOT MADE SIGNIFICANT INROADS INTO THE TV MARKET

1. Usage Patterns Indicate that the Internet is Not a Substitute for TV

The Internet has not yet evolved into a ubiquitous mass communications medium that can challenge the other media.[221] It accounts for less than 4 percent of viewing hours and advertising dollars. It appears to occupy a new media space.[222] It provides a national, non-video product.[223]

People pop on an off to meet their short, narrowcast needs, but are not glued to the tube and do not generate a great deal of advertising revenue (or, for the moment, ancillary revenues). It is a personal productivity device particularly well-suited to information intensive users.[224] For the vast majority, it is a shopping mall at the fingertips of subscribers, en-

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[220] Kraus, S and D. Davis, *The Effects of Mass Communications on Political Behavior* (University Press, 1996). Tankel, Johnathan David and Wenmouth Williams, Jr., "The Economics of Contemporary Radio," *Media Economics: Theory and Practice*, 2nd ed., Alison Alexander, James Owers and Rod Carveth, Eds. (Lawrence Erlbaum Associates, 1998).

[221] This section draws heavily on Comments of Consumers Union, et al, Newspaper Broadcast, Chapter III.

[222] Stempell, Hargrove and Bernt, p. 75 present the results of a unique longitudinal study that allowed for careful elaboration of research findings. They emphatically reject the notion that the Internet is stealing attention from other media.

> Our finding seem consistent with the speculation from many quarters that the Internet has taken people away form other media. However, [it], tells a different story. Almost exactly half of our sample indicated they are using the Internet at least once a week, so we compared use of other media by those who use the Internet and those who do not. Users and non-users of the Internet both used network TV news to about the same extent. Those who use the Internet were slightly less likely to use local TV news, but the difference was not statistically significant. Those who use the Internet were more likely than those who don't use it to be regular newspaper readers and regular radio news listeners. So the Internet is not stealing readers from newspapers or listeners from radio.

[223] It can be argued that before the advent of TV, radio occupied this product space (see Tankel and Williams).

[224] Stempel, Hargrove and Bernt, p. 78.

hancing daily activities. Internet traffic is made up of few hours on online time per week spread over a dozen sessions with a minute or so at any given page. The leading advertisers on the Internet are a completely different group than one sees on television.[225]

A recent study from the UCLA Center for Communications Policy makes this point (see Exhibit XI-1).[226] Respondents report about 10 hours on line, a large increase from previous years, but only about two-thirds of that time is at home, where most TV watching takes place.

The primary use of the Internet is for what can best be described as daily business. E-mail is by far the single largest use of the Internet. Combined with chatting, communications take up the largest share of users time. Diversions, like games, downloading music or browsing are the second-largest category. News and information gathering come next, followed by work and personal improvement activities. Commercial activities are the final general types of uses. These activities may represent a powerful revolution in the way we conduct our lives that enables users to be more effective in meeting their needs, but it does not suggest any fundamental change in use of video mass media.

> Clearly an information seeking device helps explain the greater newspaper use by Internet users, and this information-seeking behavior may run two ways. Internet users may turn to their newspapers or newspaper readers may go to the Internet for more information on a given topic. Either is possible sequentially as a supplemental information-seeking behavior. What is at least not practical is going from either the Internet or the newspaper to TV news to seek additional information on a given topic. TV news is not organized in a way that makes this practical or even possible in many cases.

[225] This discussion is based on Nielson ratings for May and June 2001.

[226] : UCLA Center for Communication Policy, *Surveying the Digital Future: Year Two,*, November 2001.

EXHIBIT XI-1:
DISTRIBUTION OF INTERNET ACTIVITIES
(In Percent)

	Very Experienced Users	New Users
Communications		
E-Mail	23.5	22.1
Chatting	6.5	1.6
Diversion		
Browsing	16.1	12.2
Games	5.7	2.8
Music Download	2.8	2.0
Information Gathering		
News	6.1	3.4
Medical	5.2	4.2
Entertainment	5.1	3.8
Personal Betterment		
Professional Work	8.2	2.7
School Work	3.8	3.0
Job Search	2.7	2.7
Commercial Activities		
Stock Trading	4.5	2.9
Shopping	4.3	3.3
Banking	3.1	.9

Source: UCLA Center for Communication Policy, *Surveying the Digital Future: Year Two,,* November 2001

This is particularly true in the area of news. The Internet has not changed dramatically altered the role of commercial video news viewing. The Commission's Notice in the Newspaper/Broadcast Cross-Ownership proceeding struggles with the limited role of the Internet in the commercial mass media products space.[227] It states that "studies suggest that some Americans are turning to the Internet for news instead of TV, in particular broadcast TV."[228] It cited a Pew Research Center study as support for this proposition. Unfortunately, the Newspaper Notice did not look carefully at the cited research from the point of view the impact of the Internet. The data actually indicate that sources are becoming more concentrated, not less, with video continuing to play the overwhelming role in news dissemination, as shown by Exhibit XI-2).

It is certainly true that network news and network news magazine shows have lost some viewership. However, so have the major non-network (cable) shows like CNN and C-Span. Where did the viewers go? They went to the cable-based offerings of the network stations. In other words, while viewing may be shifting from over-the-air to through-the-wire, according to this data, it is actually becoming more concentrated in the major TV networks.

It is important to note that viewership of local broadcast news has not dropped off, despite of the growth of local cable news. Although this would appear to suggest some increase in institutional diversity of sources, the growth reflects a shifting of viewing from over-the-air to through-the-wire.

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[227] "Order and Notice of Proposed Rulemaking," *In the Matter of Cross-Ownership of Broadcast Stations and Newspapers; Newspaper/Radio Cross-Ownership Waiver Policy*, MM Docket No. 01-235, 96-197, September 13, 2001 (hereafter, Newspaper Notice).
[228] Newspaper Notice, p. 8.

EXHIBIT XI-2:

WATCHING TV NEWS PROGRAMS
(Percent of Respondents

	1993		1999	
	Sometimes or Regularly	Regularly	Sometimes or Regularly	Regularly
NATIONAL				
Network News	81	58	58	30
Network Magazine News	89	52	75	31
CNN	69	35	55	21
C-Span	36	11	21	4
FOX CABLE	na		45	17
CNBC	na		42	13
MSNBC	na		38	11
LOCAL				
Broadcast	83	77	80	56
Cable	na		51	29

Pew Research Center, Internet Sapping Broadcast News Audience, June 11, 2000

Ironically, after the Notice incorrectly attributes the decline in broadcast TV viewership to the Internet, it did raise other questions about the ability of the Internet to steal eyeballs from the networks. The Notice stated that

> The growth of news-oriented websites likewise might not be considered particularly significant, because many do not focus on local news and information, and those that do are often operated by existing local media, such as broadcast stations and newspapers.[229]

The Notice does not explore this issue, but it footnotes an article observing that many online journalism companies are going out of business. In fact, the Pew study cited by the Notice has data that shows that this problem existed before the Dot.Coms turned into Dot.Bombs. The survey, conducted in mid-2000 asked respondents whether they had ever heard of specific online news sources and whether the sources are believable. Respondents were much more familiar with the web sites of existing broadcast and newspaper firms and found them much more believable (as Exhibit XI-3a shows). Many fewer respondents had never heard of the TV and major newspaper related sites. The use of online media has not substantially changed individual news sources. Exhibit XI-3b, constructed from the Pew research cited in the Notice, makes this clear. Of the three media, TV has lost the least viewership**.** The emergence of use of online media to access news may have reduced radio and TV viewing somewhat, but not a great deal.

The recent study from the UCLA Center for Communications Policy reinforces this point.[230] Respondents report spending about 4 minutes per day on line gathering news. They report about 25 minutes per day reading the newspaper. The Pew study shows the respondents spent over half an hour a day watching TV news and 15 minutes a day listening

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[229] Newspaper Notice, p. 9.
[230] *Surveying the Digital Future*, November 2001.

EXHIBIT XI-3

a) FAMILIARITY WITH ONLINE NEWS SOURCES

	BELIEVE	NEVER HEARD OF
SLATE	2	68
SALON	3	65
ABOUT	10	55
ZDNET	12	56
GO .	14	49
CNET	21	41
LYCOS .	24	38
AOL	39	22
NETSCAPE	39	20
FOX	41	16
NYT	41	16
USATODAY	51	12
MSNBC	54	11
YAHOO	54	8
ABC	56	11
CBS	58	11
CNN	61	10

b) SOURCES OF NEWS

	1990/91	1998/99
REGULARLY		
TV News	80	75
Newspaper	71	63
Radio	56	46
YESTERDAY		
TV News	68	62
Newspaper	56	47
Radio	44	44
On-Line		21

Pew Research Center, Internet Sapping Broadcast News Audience, June 11, 2000

to radio news. In other words, traditional media account for twenty times as much news gathering time as the Internet.

2. The Internet is Itself Highly-Concentrated

One of the more troubling aspects of the commercial Internet, especially in light of AOL's decision to become a major cable company is the remarkable ability of the commercial aspects of the Internet to become concentrated (see Exhibit XI-4). The increasing concentration of the Internet is stunning.

Even before AOL acquired Time Warner, its bundling was like cable's bundling, adding more and more features that glue in different segments of the market. AOL makes much more in subscription revenue then the entire Internet generates in advertising revenue.[231] This is somewhat greater than the proportion of subscription to advertising on cable. The enthusiasm for the AOL Time Warner merger derives in part from the fundamental similarity of the subscription-based models of cable TV, print publications and the Internet.[232]

AOL's dominance of subscribership in the U.S. is widely noted (30 million subscribers, putting its market share above 50 percent). Its market share makes it a leading firm in a highly-concentrated market.[233] Even more striking is the growth in the concentration of usage.

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[231] A low estimate of AOL subscription revenues is $8 billion. Internet Advertising revenue is estimated in the range of $1-2 billion.

[232] Walls Street Analysts praised the merger on these grounds (see Bernstein).

[233] A Leading or dominant firm proviso was included in the 1982 Merger Guidelines but was subsequently dropped. Shepherd talks about firms with a 50 percent or more market share as leading firm and a source of concern.

EXHIBIT XI-4:

ORDER OF MAGNITUDE ESTIMATES OF
MASS MEDIA MARKET CONCENTRATION

MARKET AND PERIOD OF MARKET Of MOST RECENT DATA	LEVEL OF CONCENTRATION HHI	CATEGORY	TYPE OF
Internet (2000)			
Subscribers	2500	High	Tight Oligopoly
Viewing Time	1200	Moderate	Loose Oligopoly
Search Engines	1100	Moderate	Loose Oligopoly

SOURCES AND NOTES:

Jupiter Research, *Online Media Consolidation Offers No Argument for Media Deregulation*, 2001; Sheu, Tair-Rong and Kathleen Carley, "Monopoly Power on the Web – A Preliminary Investigation of Search Engines," *20th Telecommunications Policy Research Conference*, October 27, 2001.

> Because the number of potential online channels is infinite, some assume that market dominance is an impossibility on the Internet. This is faulty reasoning. Gauging consolidation online simply requires a different measuring stick than it does off-line.
>
> Analysis of Media Metrix data over the past three years shows an incontrovertible trend toward online media consolidation…. Between March 1999 and March 2001, the total number of companies controlling 50 percent of user minutes online decreased by nearly two-thirds, from 11 to four.[234]

Because AOL has such a dominant position (over 30 percent of all Internet user minutes last year were spent on AOL), the HHI in this market is about 1200, well above the moderately-concentrated threshold. The four-firm concentration ratio also falls in the range where concerns about concentration and the abuse of market power begin.

Search engines fall in a similar range. The HHI is at about the level of moderately-concentrated (1100). The four-firm concentration ratio is at the tight oligopoly level, just under 60 percent.

C. Restrictions On Streaming Video Technology Block The Internet From Competing With Cable

The notion that the Internet would make it possible to stream video through to consumers in head-to-head competition with cable operators was dealt a death blow when the Commission failed to take action to require non-discriminatory access to the telecommunications services and facilities operated by cable companies. Rather than becoming an avenue of competition to pry open the cable monopoly, the Commission has allowed the cable monopoly to extend its closed proprietary model to the Internet and use access to high speed Internet connections to reinforce its grip.

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[234] Jupiter Research, *Online Media Consolidation Offers No Argument for Media Deregulation*, 2001.

The first effect of allowing facility owners to exercise their market power in the high-speed Internet is a vigorous defense of their core monopoly. AOL saw this as the first outcome of the failure to ensure open communications platforms.

The first set of actions taken by cable system operators in rolling out their Internet services was to restrict streaming video.[235] Before AOL became a cable owner, it pointed out that the first effect of allowing facility owners to exercise their market power in the high speed Internet sector is a vigorous defense of their core monopoly.

> We submit that, to answer this question, the Commission should examine certain critical "mega-effects" of the proposed AT&T/MediaOne combination. First, the FCC should consider how this merger's video and Internet access components together would service to keep consumer from obtaining access to Internet-delivered video programming – and thereby shield cable from competition in the video market.[236]

AOL did not hesitate to point out the powerful anticompetitive effect that integrating video services in the communications bundle could have. The video component of the bundle is certainly one of the most important of the components.

> The second "mega-effect" of this proposed merger is of even broader potential consequence. With this merger, AT&T would take an enormous next step toward its ability to deny consumers a choice among competing providers of integrated voice/video/data offerings – a communications marketplace that integrates, and transcends, an array of communications services and markets previously viewed as distinct.[237]

Experts for the local telephone companies identified a series of tactics that could be used to disadvantage competing content providers.

> There are several ways in which a vertically integrated broadband provider can discriminate against unaffiliated content providers. First, it can give preference to an affiliated content provider by caching its content locally…

[235] Hausman, Sidak and Singer, p. 133.
[236] AOL, FCC, p. 8.
[237] AOL, FCC, pp. 9-10.

> Such preferential treatment ensures that affiliated content can be delivered at faster speed than unaffiliated content.
> Second, a vertically integrated broadband provider can limit the duration of streaming videos of broadcast quality to such an extent that they can never compete against cable programming…
> Third, a vertically integrated firm such as AT&T or AOL-Time Warner could impose proprietary standards that would render unaffiliated content useless… Once the AT&T standard has been established, AT&T will be able to exercise market power over customers and those companies trying to reach its customers.[238]

As Northnet put it when complaining about Time Warner, AOL's cable subsidiary:

> Video streaming has received an immense amount of attention not only because it might compete directly with the cable TV product, but also because it embodies the qualitative leap in functionality and quantum jump in speed that broadband Internet provides.
>
> Video streaming is foreclosed as a threat to Time Warner's services. By singling out current cable TV customers for an extremely high floor price for independent ISP broadband Internet service, Time Warner is leveraging its monopoly position in cable into the broadband Internet market.
> Time Warner asserts complete control over video streaming by controlling the economic terms on which Quality of Service is offered.
>
> Time Warner goes on to build a wall around the video market with pricing policy that dissuades ISPs from competing for the Internet business of cable TV customers. Time Warner buttresses that wall with a marketing barrier and a service quality barrier that can further dissuade ISPs from competing for TV customers. Independent ISPs point out that cable operators use control over functionalities to control the services available on the network.[239]

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[238] Hausman, Sidak and Singer, pp. 160-161.

[239] They cite two conditions in the term sheet dealing with functionalities.

> TWC will not be required to provide QoS support for telephony or video streaming for the Service. QoS may be provided upon request and at an additional cost.
> To the extent ISP wishes to offer any functionality as part of the Service which: (a) is outside the scope of the Network Architecture; or (b) requires an Operator to acquire equipment or software or implement a change in the way the Operator processes, TWC shall have the right to approve such functionality, provided however that in the event TWC approves such functionality, ISP shall be obligated to reimburse for TWC its direct, out-of-pocket costs in implementing such new functionality. (NorthNet) Video streaming is foreclosed as a threat to Time Warner's services without Quality of Service guarantees. Time Warner asserts complete control over video streaming by controlling the economic terms on which Quality of Service is offered. It can define the functionality to prevent competition. Further, to the extent that an ISP develops or deploys facilities that enhance its video streaming

To the extent that any cable operators have voluntarily negotiated with unaffiliated ISPs, they have insisted on extremely high charges for access that renders it impossible for competitors to effectively enter the market. Proprietary control of the physical facilities has not led facility owners to open their networks. Quite the contrary has occurred. A ubiquitous open standard is being balkanized by leveraging the existing monopoly base of customers from a neighboring market through exclusion and product bundling. In short, the track record in the cable industry bears little resemblance to a procompetitive standards war.

Cable operators continued to insist on restrictions on the quality of service offerings that unaffiliated ISPs can make, which places them at a competitive disadvantage.[240] New

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capability, which Time Warner feels is "outside the scope of the Network Architecture," Time Warner wants a right of approval, even if it does not impose a cost on Time Warner. It gets to control the video competition. (NorthNet)

[240] Time Warner's Term Sheet and AT&T public statements about how it will negotiate commercial access after its technical trial give a clear picture of the threat to dynamic innovation on the Internet. There in black and white are all the levers of market power and network control that stand to stifle innovation on the Internet.

Prequalification of ISPs to ensure a fit with the gatekeeper business model
Applying ISPs must reveal sensitive commercial information as a precondition to negotiation
Restriction of interconnecting companies to Internet access sales only, precluding a range of other intermediary services and functions provided by ISP to the public (e.g. no ITV functionality)
Restriction of service to specified appliances (retarding competition for video services)
Control of quality by the network owner for potentially competing video services
Right to approve new functionalities for video services
A large nonrefundable deposit that would keep small ISPs off the network
A minimum size requirement that would screen out niche ISPs
Approval by the network owner of the unaffiliated ISP's home page
Preferential location of network owner advertising on all home pages
Claim by the network owner to all information generated by the ISP
Demand for a huge share of both subscription and ancillary revenues
Preferential bundling of services and control of cross marketing of services
Applying ISP must adhere to the network operator's privacy policy

Under these conditions, the commercial space left for the unaffiliated and smaller ISPs (where much innovation takes place) is sparse and ever shrinking.

functionalities must be approved whether or not they place any demands on the network.[241] AT&T's control of the architecture is just as explicit. It will pick and choose which service providers will get the fastest speeds. The favored service providers will be those affiliated with AT&T.[242]

Price squeeze and extraction of rents are apparent in the implementation of closed platforms. Hazlett and Bittlingmayer cite Excite@Home executive Milo Medin as describing the terms on which cable operators would allow carriage of broadband Internet to AOL (before it owned a wire) as follows,

> I was sitting next to [AOL CEO] Steve Case in Congress during the open access debates. He was saying that all AOL wanted was to be treated like Excite@Home. If he wants to be treated like us, I'm sure he could cut a deal with [the cable networks], but they'll take their pound of flesh. We only had

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[241] Time Warner Term Sheet,

> To the extent ISP wishes to offer any functionality as part of the Service which: (a) is outside the scope of the Network Architecture; (b) requires an Operator acquire equipment or software or implement a change in the way the Operator processes, TWC shall have the right to approve such new functionality , provided however that in the event TWC approves such functionality, ISP will be obligated to reimburse for TWC its direct, out-of-pocket costs in implementing such new functionality.

[242] Goodman, Peter S., "AT&T Puts Open Access to a Test," *Washington Post*, November 23, 2000 (hereafter Goodman).

> Founder Joe Pezzillo worries that the competitive gap could widen as broadband brings new business models.
>
> He envisions AT&T making deals with major music labels to deliver its own Internet radio, with AT&T providing the fastest connections to its partners and slower connections to sites like his. "Someone is not going to wait for our page to load when they can get a competitor's page instantly," Pezzillo said.
>
> AT&T says it has yet to formulate business models with partners, but the software the company has designed for the Boulder trial – demonstrated at its headquarters in Englewood, Colo. Last week – clearly includes a menu that will allow customers to link directly to its partners. Company officials acknowledge that AT&T's network already has the ability to prioritize the flow of traffic just as Pezzillo fears.
>
> "We could turn the switches in a matter of days to be able to accommodate that kind of environment," said Patrick McGrew, an AT&T manager working on the technical details of the Boulder trial.
>
> Though the Boulder trial is focused on technical issues alone, AT&T will study the way customers navigate the system as it negotiates with ISPs seeking to use its network…

> to give them a 75 percent equity stake in the company and board control. The guys aren't morons.[243]

The Time Warner Term sheet established a high price floor under sales of Internet service to cable TV customers. The Time Warner Term Sheet demanded 75 percent of subscriber revenues and 25 percent of ancillary revenues. This squeezes the margin on such customers and renders potential video stream competitors vulnerable to price squeeze. ISPs are also concerned that Time Warner proposes to charge for bit consumption, rather than minimum speeds. This would make video streaming a very expensive proposition. Smaller ISPs have complained about minimum payments. They are also concerned about a one-year minimum subscriber level required by Time Warner.

The industry has engaged in the opposite of penetration pricing, with substantial price increases early in the adoption cycle. Its policies on use of the network are clearly intended to prevent the cannibalization of its monopoly product by preventing streaming video from competing over their wires. Of equal importance, the restrictions on use short-circuit the critical flows of the Internet.

At the same time, it is important to note that there is consensus that cable is the dominant and preferred technology. The Wall Street analysts dismiss satellite and wireless as near-term competitors for cable modem service[244] and have an increasingly pessimistic view of DSL for the applications that will drive the residential video markets.[245] Cable's

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[243] Political Economy, p. 17.

[244] Bernstein, pp. 30… 33… 50 – 51.

[245] Paul Allen, owner of Charter Communications, the nation's 4th largest cable company recently reiterated the proposition that cable will be the dominant medium for broadband delivery to residential customers.

> The problem and opportunity of bandwidth dominated the late 1990s, as investors, technologists and users considered where to place their bets for faster access. Today, cable appears to be the winning horse. Paul Allen realized early on that cable offers

advantages are substantial and DSL is not likely to be able to close the gap.[246] The significance of the AOL switch to cable-based broadband cannot be underestimated in the damage that it does to the hoped-for competition between cable modems and DSL.[247] Although the

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> a pervasive, existing network, capable of robust bandwidth. Wireless and other channels will continue to play important roles, but cable will become the bandwidth solution for the masses

Bernstein, p. 46.

> Cable and DSL expected to dominate residential business; cable beats DSL near-term because of technology and operational advantages, but DSL wins in small-business because of coverage and performance...
>
> Cable is likely to stay ahead thanks to its early start, technical advantages, and its control of data displays on televisions in non-PC households. (Bernstein, 7)
>
> But xDSL has a number of significant limitations that make less than half of U.S. residential phone lines compatible with standard ADSL, and far fewer compatible with VDSL

[246] Bernstein, p. 1.

> As we go to press, the strategic merger of AOL and Time Warner has just been announced. The deal represents just the kind of shift in the broadband landscape that puts the access battle into a broader perspective. Assuming that the merger is consummated, resulting company will have extensive consumer content assets and asset connections to Time Warner's nearly 20 million cable households -- 85 percent of which are upgraded for two-way service. Obviously, this raises a large potential challenge for other companies' activity in either content or access, and may drive similar strategic counter moves. Above all else, AOL's decision is the strongest evidence to date that cable offers the broadest set of broadband assets available today. With AOL now aligned more closely with cable, DSL faces the challenge of competing in many markets without benefit of AOL as a *de facto* exclusive resale partner. Thus, the AOL-Time Warner deal indicates not only that cable is the advantaged platform today (as we observe elsewhere), but also that is likely to remain advantaged vis-a-vis DSL and other platforms in the future.
>
> Judicial, legislative and regulatory initiatives by RBOCs and ISPs (including AOL) to gain access to cable lines are seen as recognition of cable's strength, particularly in relation to the television set.

Merrill, p. 33.

> Now that AOL has its feet firmly the cable camp, access to negotiation should be much smoother. Second, we believe the AOLTWX merger reinforces the value of the cable pipe, as did Microsoft‘s investment in Comcast, Paul Allen’s acquisition binge that created the fourth largest MSO, Charter, and AT&T's acquisition of TCI, as well as its pending acquisition of MediaOne. Although competition will emerge against cable with viable technologies (DSL, DBS), cable has the most robust technology and four great technology oriented companies have voted with their pocketbooks.

telephone companies are reluctant to admit that their technology will have trouble competing, their experts have identified the advantages that cable enjoys.[248]

D. CONCLUSION

Given the usage pattern for narrowband Internet activities and the stranglehold that that cable operators have on high-speed Internet connectivity, not to mention the ownership and leverage they have over video content, it is simply not possible to conclude that the Internet poses a significant immediate threat to cable monopoly power in the multichannel video market. At present, the Internet in no way diminishes the need for a horizontal limit.

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[248] Hausman, Sidak, Singer, p. 149.

> It is possible that at some point in the future new technologies will emerge, or existing technologies will be refined, in such a way that they will compete effectively with cable-based Internet services… within the relevant two-year time horizon, neither DSL nor satellite-based Internet service will be able to offer close substitutes for cable-based Internet service. Hence, neither will be able to provide the price-disciplining constraint needed to protect consumer welfare.

PART FIVE:
THE 30 PERCENT LIMIT SHOULD BE REINSTATED OR LOWERED

Having thoroughly described the market structure and past behavior of the industry, we conclude that a structural limit on ownership to prevent the abuse of market power and to promote diverse sources of programming is justified. In this part, we demonstrate that the 30 percent limit is reasonable.

First we present a market structure analysis based on the Lerner Index and the HHI which suggests that a 30 percent limit is conservative. We then show that the FCC open field analysis was also well conceived and supported. Recent developments in the industry indicate that, if anything, the cap should be lowered to 20 or 25 percent.

We conclude the comments with a review of the implications of concentration and market power for the diversity goals of the statute. Diversity policy requires that the cap be set at the lowest reasonable level.

XII. A HORIZONTAL LIMIT OF 30 PERCENT IS JUSTIFIED

We have examined the market structure of the cable industry at both the point-of-sale and the national programming market and found a solid basis in economic theory and empirical evidence that cable operators possess market power. This section demonstrates that a 30 percent limit is reasonable and consistent with the intent of the Act.

A. ECONOMETRIC EVIDENCE OF THE NEED FOR A LIMIT OF 30 PERCENT OR LESS

The easiest way to quantify the question of the horizontal cap is to consider the Lerner Index in the national programming market. Consider the evidence on a 30 percent limit.

Market power in the national programming market for a firm with a 30 percent market share can be estimated as follows, based on the market shares and elasticities.

$$L = \frac{S}{e_m^d + e_j^s (1 - s_i)} = \frac{.3}{1.452 + .136\,(.7)} = .194$$

Because the cross elasticity that the FCC calculated for satellite is so low, the assumption we make about its market share does not matter a great deal (see Exhibit XII-1). These analyses make no adjustment for parallel or collusive behaviors in the programming market, which would be justified on the basis of past behavior.

EXHIBIT XII-1: LERNER INDICES FOR VARIOUS MARKETS GIVEN KNOWN

SUPPLY AND DEMAND ELASTICITIES

MARKET	SATELLITE MARKET SHARE	
	.7	1.0
NATIONAL		
30% LIMIT	.19	.18
20% LIMIT	.13	.13

The Lerner index suggests the presence of market power, as did the earlier analyses of pricing and Tobin's q. The DOJ has considered price effects in the 5 to 10 percent range sufficient to raise market power concerns. Landes and Posner give an example "for illustrative purposes only" in which they identify the market share necessary for a firm to charge a price 20% above marginal cost. The outcome of their analysis is described in Exhibit XII-2.

In this analysis, low elasticities of supply and demand result in the ability to raise prices by 20 percent with a market share of only 23 percent. The Department of Justice has expressed concerns about market power where prices could be raised by as little as 5 or 10 percent. Thus, as demonstrated above, given the structural characteristics of the multichannel video market, a structural limit is appropriate and a limit as low as 20 percent would be justified. The 30 percent limit is not only a reasonable figure, it is conservative.

An overview of the entire market also suggests that a 30 percent limit is reasonable. If the industry organized itself at the boundary of what the rule would allow, it would be composed of three firms with 30 percent market share and one with 10 percent market share (30, 30, 30, 10). This would be a highly-concentrated structure, with an HHI of 2800. The industry is clearly headed in this direction.

EXHIBIT XII-2:

LANDES AND POSNER HYPOTHETICAL ON MARKET STRUCTURAL CONDITIONS TO NEEDED TO SUSTAIN A TWENTY PERCENT PRICE INCREASE

	SUPPLY ELASTICITY	
	LOW (.5)	HIGH (3.0)
DEMAND ELASTICITY		
LOW (1.0)	23	61
HIGH (2.5)	44	46

B. THE FCC'S FORECLOSURE (OPEN-FIELD) ANALYSIS SUPPORTS THE NEED FOR A LIMIT OF 30 PERCENT OR LESS

As noted earlier, the FCC did not conduct the sort of market structure analysis presented throughout these comments. When the FCC set out to establish the horizontal limit required by Congress, it accepted Congressional judgment about the anticompetitive structure and nature of the industry. As we have shown in the previous theoretical discussion and empirical analyses, Congressional concern was well-founded ten years ago and remains so today.

This section also shows that the way the FCC arrived at the 30 percent limit was very conservative, given the Congressional intent and the evidence before the Commission. In fact, the FCC's open-field analysis would have supported a limit of 20 to 25 percent. Given current market conditions, such a lower limit is entirely justified today.

1. The FCC's Approach Was Far Too Narrow

Interpreting the congressional charge narrowly, the FCC set out to identify situations in which a small number of cable-system owners could prevent programming from successfully getting to market. This foreclosure analysis sought to identify how a wide and "open field" was necessary to provide programmers with a chance of getting in front of enough viewers to succeed. The FCC took a very narrow and conservative approach in three ways.

First, it erred by defining the word impede to mean foreclose. Foreclosure is only the most extreme form of anticompetitive behavior that could impede producers from getting their product to market.

Second, it erred when it identified the risk as any ***two*** large cable operators, acting in parallel or concert, to foreclose the market to a new entrant programmer. As we have

shown, anticompetitive outcomes are possible and become a source of public policy concern with more than two dominant players. The HHI of the industry that the FCC's horizontal limit would allow is 2800 – well above the highly-concentrated threshold of 1800. In a market of five equal-sized competitors (with an HHI of 2000), according to the FCC's foreclosure analysis, it would take the concerted or parallel action of four firms to effectuate the foreclosure that the FCC made the target of its policy**.**

Third, the FCC erred by defining the size of the open field needed very conservatively. That is, it set the size of the open field at a very low level. The hearing record indicates that a much larger open field may be necessary.

We have already elaborated on the first two points in the earlier part of the comments. This section elaborates on the third point. It describes why the 30 percent figure for a limit on ownership is in fact too high based upon the economics of program productions. Exhibit XII-3 shows the logical reasoning behind the FCC's arrival at the 30 percent figures.

2. The FCC Could Easily Have Selected a Lower Limit

The FCC set out to identify the number of subscribers that would be necessary to launch a successful network (see Exhibit XII-3). It determined that achieving a market of 15 to 20 million subscribers was necessary. There was strong evidence that a larger number

EXHIBIT XII-3: DETERMINING THE SIZE OF THE OPEN FIELD TO SET THE HORIZONTAL LIMIT: 1997 - 1998

NECESSARY SUBSCRIBER BASE TO SUCCEED (Millions)	15		20	
TAKE RATE BY MSO IF ACCESS IS ALLOWED	53%	36%	53%	36%
FIELD NEEDED TO BE OPEN (Millions)	28	42	38	56
SIZE OF TWO LARGE MSO'S TO CLOSE FIELD (Millions, based on 81 million subscribers at the time)	53	39	43	25
HORIZONTAL LIMIT NEEDED TO KEEP THE FIELD OPEN (% of 81 million subscriber market)	33	24	27	15

would be necessary to become attractive to advertisers. The comments generally agree that 30 to 40 million subscribers are necessary to attract this type of revenue.[249]

The FCC then estimated the number of MSO who might take (or not take) the show, even after there had been a decision to allow the show to be offered to MSOs. It found that the average carriage rate is between 36 percent and 53 percent. This led to an estimate of the size of the open field that was needed for programs to have a reasonable chance to succeed.

The horizontal limit was then calculated by estimating the number of subscribers who could be controlled by two MSOs that would not exceed the open field. This number was divided by 2 and taken as a percentage of the total market. The horizontal limit that is justified by this analysis ranges from 15 percent to 33 percent. Based on this analysis, the limit could easily have been set at 25 percent. Indeed, the FCC discussed the 20 percent limit, but rejected it on grounds that MSOs need larger scale for economic efficiency.

3. New Realities Justify a Lower Limit

The rule was developed several years ago and the FCC has repeatedly found that programming costs have increased. This has been cited as the largest justification for the dramatic price increases since the passage of the Telecommunications Act of 1996. If costs are increasing so dramatically, and assuming a competitive programming market as the FCC does, then it must revisit the analysis of the minimum open field to be successful. Program producers need a larger market to cover their costs. There is some evidence in the trade press that a much larger base of subscribers is necessary.

For example, Comcast is quoted as targeting 20 to 30 million subscribers for a highly targeted niche offering.[250] Indeed, networks need to debut with 10 million subscribers and

[249] Third Report, 56.

quickly reach 30 million if they are just going to survive.[251] As the Commission noted three years ago, "most digital networks can expect to run without advertising until they reach the 30 million subscriber count or higher.[252] Bravo, seeking a more mass audience network claims to need 60 million to do a good job.[253]

The FCC data were based on evidence gathered in the 1997-1998 period. Since then, programming costs have increased by over 50 percent. Exhibit XII-4 shows the impact on minimum open field that a 25 percent increase in the necessary subscriber base would have.

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[250] Joint Comments, p. 25, offer the following on the size and speed with which subscribers must be gained,

> Comcast announced the launch of G4, a video game-oriented network 100% owned by Comcast… Comcast stated that cable systems serving seven million subscribers have already agreed to carry the network, and that the network expects to be carried on systems serving another 2.5 to 5 million households by the end of the year… Comcast also indirectly confirmed that carriage by the largest cable MSOs is critical to the success of the network… Comcast, the principal investor in the project, said it could get ht venture off the ground for less than $200 million if it could make the channel available to 20 million to 30 million cable subscribers.

[251] Jean Bergantini Grillo, "What's Up With Originals?" *Broadcasting and Cable*, May 28, 2001.

> It became all or nothing, with lost of costs loaded upfront, he [Derek Baine, Senior Analyst, Paul Kagan Associates] explains. New nets were determined to debut with at least 10 million subs, and many were willing to pay anywhere from $7 to $10, or more, to get carriage.
>
> "Fox put aside $300 million to buy 30 million subs," Baine says. "If you are going to make that huge of an investment, then you'll need to come up with some glitzy, high profile programming."

[252] Ignazio Messina, "Cable's Digital Dogfight," *Cablevision*, March 12, 2001.

[253] Jim, Forkan, "And Now, a Commercial Break – On AMC," *Multichannel News*, October 22, 2001.

> Bravo, another Rainbow network, has increased its presence as an insertable channel on local cable systems by about 5 million this year to some 37 million subscribers, senior vice president of local ad sales John Duff said.
>
> In fall 1998, Bravo boosted its commercial load to three breaks per hour, after airing limited Public Broadcasting-style sponsorships. It began offering local avails in spring 1999.
>
> Duff projected that Bravo could hit 40 million insertable subscribers by year-end. Bravo's overall count reached 60.8 million subscribers, up nearly 12 million over a year ago.
>
> "That growth will draw attention on Madison Avenue, according to Bravo Networks Executive vice president of affiliate sales and marketing Gregg Hill.

In other words, we assume a subscriber base of 20 to 25 million for the open field needed. Even with the expansion of the market to 85 million households, the horizontal limit would have to be much lower. Even if we assume that take rates are higher (approximately 50 percent), the horizontal limit should be closer to 20 percent than 25 percent.

C. CONCLUSION

The clear agreement between the market structure analysis and the foreclosure analysis reflects the fundamental economics of the two layers of the multichannel video market that are the subject of this congressionally mandated policy – ownership of transmission facilities and production of content. Widely-accepted economic principles of public policy and empirical evidence on market structure, conduct, and performance support the conclusion that Congress was right to require a limit on horizontal ownership and that the limit should be set in the range of 20 to 30 percent of the market, as presently configured based on purely economic grounds.

Of course, Congress also mandated the horizontal limits on the basis of the well-established principle of promoting diversity in programming. That concern only reinforces the need to set the limit in the range of 20 to 30 percent.

"Things start to change when you get to 60 million," Hill said. "You get to critical mass."

EXHIBIT XII-4: DETERMINING THE SIZE OF THE OPEN FIELD TO SET THE HORIZONTAL LIMIT: 2002

NECESSARY SUBSCRIBER BASE TO SUCCEED (Millions)	20			25		
TAKE RATE BY MSO IF ALLOWED ACCESS	53%	50%	36%	53%	50%	36%
FIELD NEEDED TO BE OPEN (Millions)	38	40	55	38	50	69
SIZE OF TWO LARGE MSOS TO CLOSE THE FIELD (Millions, based on 85 million subscribers)	47	45	30	47	35	16
HORIZONTAL LIMIT NEEDED TO KEEP THE FIELD OPEN (% of 85 million subscriber market)	28	26	18	28	21	9

XIII. DIVERSITY GOALS REINFORCE THE NEED TO SET A HORIZONTAL LIMIT AT 30 PERCENT OR LESS

A. SUMMARY

Diversity is a sometimes slippery, but nevertheless essential, element of horizontal ownership limit; diversity demands a horizontal limit at 30% or less. The economic goal of ensuring and promoting competition leads to analyses that support precise estimates for a horizontal limit. The diversity goals are no less important, in many respects they are even more important. However, given their nature, they generally lead to less precise recommendations. They are more likely to support qualitative conclusion, such as more voices are better than fewer, structural separation of ownership of different types of institutions is important to preserve institutional diversity, local ownership is desirable to promote local content and points of view, etc.

In this proceeding, the diversity goals can be translated into a specific quantitative recommendation. To the extent that the FCC identifies a range of reasonableness for the horizontal limit, based solely on economic matters, it should choose a level within the range that creates greater diversity. It should have chosen 25 percent in 1999 and it should choose 20 percent today.

Given the important role that diversity can play in the regulatory analysis, we believe it is appropriate to review the legal and evidentiary basis of Congressional intent to promote diversity in the multichannel video market. Public policy, as articulated by Congress and the Supreme Court, has set very aggressive goals for diversity and the empirical evidence supports the need for structural limits to move toward those goals.

B. INCREASED DIVERSITY HAS A POSITIVE EFFECT ON CIVIC DISCOURSE

The inherent structural problems and non-economic qualities of information markets, especially as they affect civic discourse, are central to public policy.[254] Economic competition alone may not achieve the goals set out for the media.[255] Indeed, that media markets are prone to being highly concentrated, stems from the unique fundamental economic characteristics of these markets and they combine to create unique sources of "market failure" in media markets that are of extreme importance to diversity policy.[256] These have been widely recognized in the economic literature on the media and civic discourse.[257]

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[254] W.B. Ray, "FCC: The Ups and Downs of Radio-TV Regulation (Iowa: Iowa State University Press, 1990; Hopkins, Wat W., "The Supreme Court Defines the Marketplace of Ideas," *Journalism and Mass Communications Quarterly*, Spring 1996; C. M. Firestone and J. M. Schement, *Toward an Information Bill of Rights and Responsibilities* (Aspen Institute, Washington, D.C., 1995), Duncan H. Brown," The Academy's Response To The Call For A Marketplace Approach To Broadcast Regulation," 11 *Critical Studies in Mass Communications*, 257 (1994); Benkler, Free As The Air.

[255] Berry, Steven T., Joel Waldfogel, "Public Radio in the United States: Does it Correct Market Failure or Cannibalize Commercial Stations?," *Journal of Public Economics*, 1999 (71), point out free entry may not accomplish the economic goals set out for it either. There is evidence of the anticompetitive behaviors expected to be associated with reductions in competition, such as price increases and excess profits M. O. Wirth, "The Effects of Market Structure on Television News Pricing," *Journal of Broadcasting*, 1984; J. Simon, W. J. Primeaux, and E. Rice, "The Price Effects of Monopoly Ownership in Newspapers," *Antitrust Bulletin*, 1986; R. Rubinovitz (*Market Power and Price Increases for Basic Cable Service Since Deregulation*, (Economic Analysis Regulatory Group, Department of Justice, August 6, 1991); B. J. Bates, "Station Trafficking in Radio: The Impact of Deregulation," *Journal of Broadcasting and Electronic Media*, 1993.

[256] Waldfogel, Joel, *Who Benefits Whom in Local Television Markets?*, November 2001 (hereafter Television). Other papers in the series of studies of "preference externalities" were made a part of the record in conjunction with Joel Waldfogel's appearance at the FCC Roundtable, including, *Preference Externalities: An Empirical Study of Who Benefits Whom in Differentiated Product Markets*, 2000 (hereafter Radio); with Peter Siegelman *Race and Radio: Preference Externalities, Minority Ownership and the Provision of Programming to Minorities*, 2001 (hereafter Siegelman and Waldfogel); with Felix Oberholzer-Gee, *Electoral Acceleration: The Effect of Minority Population on Minority Voter Turnout*, (2001); with Lisa George, *Who Benefit Whom in Daily Newspaper Markets?*, (2000); as well as the statement *Comments on Consolidation and Localism* (2001);); with Felix Oberholzer-Gee, *Tiebout Acceleration:* Political Participation in Heterogenous Jurisdictions , (2001) (hereafter Participation).

[257] Baker, Democracy; Markets, identifies several schools of thought that link the structure of media markets to civic discourse policy include Sunstein, Cass, "Television and the Public Interest,"

The purpose of this section is to explain the basic characteristics of media products and to demonstrate how specific concerns about diversity are grounded in these characteristics. The second half of this section provides citations to specific empirical findings that document the diversity problems identified.

Two fundamental characteristics of media markets give rise to concerns about a range of market failures. High first-copy/fixed costs and the inability to substitute between (strong preferences for products) give rise to a number of failures or distortions in media markets –

- a preference externality in which minorities and other small or niche groups are underserved by the media,
- the exercise of ownership influence over the organization and content of media, and
- positive externalities, like policing abuse of power or providing an avenue for participation in civic discourse, are undersupplied by the media.

These economic failures lead to three areas of diversity policy goals. Policy should promote

- institutional diversity,
- source diversity, and
- viewpoint diversity.

California Law Review, 2000 (88) (hereafter Television), *Republic.Com* (Princeton: Princeton University Press, 2001). Benkler starts from similar assumptions about the nature of information and its relationship to democracy, in addition to Free As Air, see "Intellectual Property and the Organization of Information Production," forthcoming in *International Journal of Law and Economics*, "Through the Looking Glass: Alice and the Constitutional Foundations of the Public Domain," *Conference on the Public Domain"* Duke University Law School, (November 9-11, 2001), "Siren Songs and Amish Children: Autonomy, Information, and Law," *New York University Law Review*," 76 (April 2001); "Property Commons, and the First Amendment: Towards a Core Common Infrastructure," *Brennan Center for Justice, New York University Law School*, March 2000 (hereafter Core Common Infrastructure); "From Consumers to Users: Shifting the Deeper Structure of Regulation Toward Sustainable Commons and User Access," *Federal Communications Law Journal*, 56 (2000)

Successful pursuit of policy in these three areas will create media markets that provide an opportunity for speakers to have access to deliver messages and listeners to hear messages from independent sources, available in an array of independently controlled media. As a result, listeners will be exposed to a wider range of news, information and points of view about culturally relevant topics.

A. UNIQUE ECONOMIC CHARACTERISTICS

The conceptual underpinnings of the argument are well-known to media market analysts.[258] On the supply-side, media markets exhibit high first copy costs (Baker's term) or high fixed costs (Waldfogel's term).[259] On the demand-side, media market products are in some important respects nonsubstitutable (Baker's term) or exhibit strong group-specific preferences (Waldfogel's view).[260] High first-copy costs are one very important example of high fixed costs. Strong group-specific preferences are one very important example of non-substitutability of media products.

Baker and others have identified another important demand-side imperfection in media markets – the presence of advertising.[261] Advertising as a determinant of demand introduces a substantial disconnect between what consumers want and what the market produces. First, to a significant extent, because advertisers account for such a large share of the revenue of the mass media, the market produces what advertisers want as much as, if not more than, what consumers want. Second, because advertising in particular, and the media in general, are about influencing people's choices, there is a sense in which the industry creates

[258] Baker, Democracy, p. 42
[259] Waldfogel, Television, p. 1.
[260] Baker, Democracy, p. 43.

it own demand. The tendency to avoid controversy and seek a lowest common denominator is augmented by the presence of advertisers, expressing their preferences, in the market.[262]

1. An Economic Theory of Discrimination

To elaborate, let us review Waldfogel's argument and empirical approach. Some groups express strong preferences for specific types of programming or content. Programming that is targeted at whites is not highly substitutable for programming that is targeted at blacks, from the point of view of blacks. Baker argues that media types (newspapers vs. TV, for example) are also not substitutable.

If fixed costs and groups preferences are strong, producers must decide at whom to target their content. Given the profit maximizing incentive to recover the high costs from the larger audience, they target the majority and the minority is less well-served. Waldfogel's analysis describes the underlying economics in detail where there are strong differences in preferences between majority and minority populations. This might be termed an economic theory of discrimination "because it gives a non-discriminatory reason why markets will deliver fewer products – and, one might infer, lower utility – to 'preference minorities,' small groups of individuals with atypical preferences."[263] Discrimination results not from biases or psychological factors, but from impersonal economic processes.

> A consumer with atypical tastes will face less product variety than one with common tastes…. The market delivers fewer products – and less associated satisfaction – to these groups simply because they are small. This phenomenon can arise even if radio firms are rational and entirely non-discriminatory.
>
> The fundamental conditions needed to produce compartmentalized preference externalities are large fixed costs and preferences that differ sharply across groups of consumers. These conditions are likely to hold, to greater or lesser

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[261] Waldfogel, Television, p. 1.
[262] Baker, Democracy, *Advertising and a Democratic Press* (1994).
[263] Waldfogel, Radio, p. 27.

> extents, in a variety of media markets – newspapers, magazines, television, and movies.[264]

This economic process of discrimination is demonstrated by Waldfogel in all three of the major media types discussed in these comments and impacted by the Notice – newspapers, radio and television programming.

2. Political Implications of "Media Market Failure"

Waldfogel identifies two critical implications of his findings that bear directly and heavily on media policy. First, he challenges the validity of a critical economic assumption about media markets. Second, he raises the most fundamental issue of civic discourse since media markets are directly related to political activity.

> Friedman has eloquently argued that markets avoid the tyrannies of the majority endemic to allocation through collective choice. Mounting evidence that minority consumer welfare depends on local minority population in local media markets indicates that, for this industry at least, the difference between market and collective choice allocation is a matter of degree, not kind. It is important to understand the relationship between market demographic composition and the targeting of programming content because related research documents a relationship between the presence of black-targeted media and the tendency for blacks to vote.[265]

Waldfogel and Baker identify similar welfare and allocative impacts of this process. Waldfogel describes the impact at the microeconomic level.

> [If] another firm introduces an imperfect substitute for her favorite product, she can be made worse off. Suppose that some fellow consumers of her favorite product prefer the new product, but she does not. Suppose further that enough of her fellow customers are diverted from her favorite product to the new product so that her favorite product no longer attracts enough to cover its costs. Her favorite product is withdrawn. This negative preference externality mechanism operates like a tyranny of the majority in markets.[266]

Baker identifies a similar process at the macro level.

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[264] Waldfogel, Radio, pp. 27-30.
[265] Waldfogel, Local Television, p. 3.

> I have described how monopolistic competition among media goods can result in the success of products whose competitive success causes the failure of other media products that would produce more "consumer surplus" than the goods that prevail. The introduction of the new "synergistic" products is likely to cause a slight downward shift in the demand for other media products, causing some of them to fail even though producing them costs much less than their value to potential customers, thereby being capable of producing considerable but now lost consumer surplus…Another way to see this is that sometimes the hope of synergies purportedly justifying media mergers reflects the possibility of a greater ability to engage in more effective price discrimination or a greater likelihood of creating "blockbuster" or best selling products. These hoped for synergies, however, translate into public interest worries that the synergies lead to competitively caused damage to consumer welfare by eliminating more values alternatives.[267]

Beyond the general challenge that this to the assumptions of market efficiency, this economic process points directly to concerns that have been central to public policies that seek to enhance civic discourse – political participation and localism.

The political impact of the economic process stems from its impact on the ability to disseminate information. The tyranny of the majority in media market is linked to the tyranny of the majority in politics because the media are the means of political communications.

> We present evidence that electoral competition leads candidates to propose policies that are supported by proportionately larger groups and that members of these groups are more likely to turn out if they find the proposed policies more appealing. In addition, we show that candidates find it easier to direct campaign efforts at larger groups because many existing media outlets cater to this audience…
>
> Channels of communication that are used to disseminate political information rarely exist for the sole purpose of informing potential voters. The number of channels that candidates have at their disposal reflects the cost structure of printing newspapers, establishing radio stations, and founding political groups. To the extent that these activities carry fixed costs, channels that cater to small groups are less likely to exist. The welfare implications – if one

[266] Waldfogel, Radio, p. 3.
[267] Baker, p. 80.

> views the decision to votes as the decision to "consumer" an election -- are analogous to those of differentiated markets with fixed costs.[268]

Waldfogel finds that the preference externality operates in non-prime time programming because it is subject to greater local control and therefore can be more responsive to local market conditions.

> The local data indicate, to a grater extent than the national prime time or cable data, both the distance between black and white preferences and the fact that local programming, far more than national programming, caters to those preferences.[269]

Waldfogel sees indications of similar localism effects in newspaper markets as well, supporting the conclusion that "content origin matters."[270] He describes localism's effect on behavior in the preliminary findings of a study of the entry of a national newspaper into local markets as follows:

> How does national news media affect local news sources and local political participation?
>
> Preliminary results: increased circulation of national daily affects:
>
> - Local paper circulation – reduced targeted audience readership
> - Local paper positioning – toward local content
> - Local political participation – Reduces voting, less so in presidential years[271]

3. Ownership Implications of Market Failures

Baker rests his economic analysis on assumptions similar to Waldfogel's and agrees on the underlying dynamic of the market orientation of producers to create the tyranny of the majority for economic reasons. He then considers its implications for various types of behaviors and market outcomes.

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[268] Oberholzer-Gee and Waldfogel, Participation, pp. 36-37.
[269] Waldfogel, Local Television, p. 13.
[270] Waldfogel, Localism, p. 9.
[271] Waldfogel, Localism, p. 9.

First, Baker is particularly interested in (concerned with) how media owner preferences motivate programming and editorial decisions. In Waldfogel's argument, owners maximize profit in response to consumer preferences and discrimination is the unintended consequence of a unique juxtaposition of supply and demand characteristics. Baker argues that there is something more at work. Owners have preferences too.

The weak competition that results from the first copy/nonsubstitutability characteristics allows owners to earn monopoly profits and to use monopoly rents to pursue their personal agendas. Whatever their political preferences are, they can use both the economic resources made available by their market power and the unique role of the press to pursue those preferences.

> Nevertheless, within this type of competition, products' uniqueness or monopoly status often permits considerable margin for variation while still remaining profitable. The "potential" profit of the profit maximizing strategy can be realized and taken out as profit – which is what the corporate newspaper chains are accused of doing. However, the market itself does not require the profit maximizing response as it does in models of pure competition. Rather, the potential profit can instead be spent on indulging (or "subsidizing") the owners' choices about content or price.[272]

Even though this is not Waldfogel's central concern, when he looks at the question of ownership, he finds support for the view that ownership matters beyond "simple" economics. In his study of radio markets, Waldfogel found that "black owners enter in situations that white owners avoid."[273] He went on to consider possible explanation for this behavior and offered a hypothesis that relied on owner preferences:

> A second possibility is that black owners enter for "ideological" reasons, which means they are willing to forego some profits in order to provide a particular sort of programming. This hypothesis would rationalize the observation that black-owned and targeted stations have fewer listeners, on aver-

[272] Baker, Democracry, p. 43.
[273] Siegelman and Waldfogel, p. 23.

> age, that [sic] their white-owned counterparts (in markets with both white and black-owned, black-targeted stations). Black owners' willingness to accept smaller returns could explain why greater black ownership increases black-targeted programming: additional black owners are willing to enter low-profitability market niches (programming to small black audiences) that whites would not enter.[274]

Perhaps Waldfogel puts the word "ideology" in quotes to blunt its negative connotation. Baker presents the policy implications in terms that are familiar and relevant to the arena of diversity policy in civic discourse.

> Choice, not merely market forces, influences quality. Choice explains the variation both within and between ownership categories. Moreover, quality may provide some efficiencies and management qualities that sometimes increase the enterprise's potential for profits or quality. However, the incentives for executives (editors and publishers) in chain firms as well as the added pressures of public ownership are likely to be directed toward focusing on increasing profits. Possibly due to price of membership or involvement within a community that leads to dedication to or desires form status in that community, local ownership might be sociologically predicted to lead to greater commitment to and greater choice to serve values other than the bottom line.[275]

One set of behaviors that is particularly problematic for Baker involves undemocratic uses of media market power in pursuit of the private interests of owners through manipulation, cooptation and censorious behaviors.[276] This can undermine the watchdog role of the press or distort coverage of events, when it suits owners' interests.

The central fact that all of these discussion share is that market forces provide neither adequate incentives to produce the high quality media product, nor adequate incentives to distribute sufficient amounts of diverse content necessary to meet consumer and citizen needs. Sunstein states this general proposition as follows:

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[274] Siegelman and Waldfogel, p. 25.
[275] Baker, Democracy, p. 47.
[276] Baker, Democracy, pp. 73.

> Individual choices by individual viewers are highly likely to produce too little public interest programming in light of the fact that the benefits of viewing such programming are not fully "internalized" by individual viewers. Thus, individually rational decisions may inflict costs on others at the same time that they fail to confer benefits on others. In this respect, the problem "is not that people choose unwisely as individuals, but that the collective consequences of their choices often turn out to be very different from what they desire or anticipate.[277]

B. DIVERSITY IN CIVIC DISCOURSE

The unique "market failures" discussed in the previous section provide the basis for public policy intervention to ensure robust civic discourse. That is, if we were only concerned about the traditional market failures described in the previous section, we might rely on antitrust policy, perhaps with a more rigorous set of structural screens and a heightened concern for vertical/conglomerate issues. The unique market failures demand much more public policy intervention to promote ownership diversity, viewpoint diversity and institutional diversity.

The FCC's use of the terms source, viewpoint and outlet diversity glosses over the fact that ownership diversity must accompany outlet and source diversity for the latter two to have any meaning for First Amendment purposes.[278]

The importance of ownership diversity does not minimize the importance of outlet and source diversity.[279] Outlet diversity, as the FCC defines it, is critical to civic discourse for two reasons. Positive externalities flow from having a larger number of outlets. To the extent that media outlets are smaller and more local, they should be more accessible. Outlet

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[277] Sunstein, Television, p. 517, citing Frank, Robert H. and Phillip J. Cook, *The Winner Take All Society* (1999), p. 191, as well as Bourdieu, Pierre, *On Television* (The New Press, 1998), and Baker, C. Edwin, "Giving the Audience What it Wants," *Ohio State Law Journal* (1997 (58).

[278] "Comments of Consumer Union, et al, Newspaper Broadcast Crossownership.

diversity also should be promoted because of the ownership influence over structure of media organizations and content.[280] These preference externalities combined with media market concentration produce systematic under-service of minorities and owners' ability to express their preferences.[281] The number of independent owners is one critical measure of source diversity, but not the only measure.

Concerns about viewpoint diversity have their origin in the ability of various sources, as the FCC defines it, to reach the public. This applies equally to localism and local points of view. Institutional diversity is grounded in both the watchdog and experience externalities.[282] The quality of investigative reporting and the accessibility of different types of

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[279] It is important to note that whether sources are corporations or individuals, they must also be independent in order to serve First Amendment goals.

[280] Baker, Democracy, p. 85.

> To perform these, different societal subgroups need their own media. Admittedly, these subgroups (or their members) may not *necessarily* need to own or control their own independent media. Avenues of regular and effective media access might suffice. Still, much greater confidence that the media will serve the democratic needs of these groups would be justified if ownership or control was so distributed.

[281] Baker, Democracy, p. 75, describes the loss of valuable content as the result of merger as follows:

> The idea is, for example, that the merged entertainment company can benefit by presenting the same highly promoted fictional character in new mediums – in a theatre released movie, a television show, a book, a magazine excerpt, a musical CD based on the movie sound track, and especially in the case of children oriented media, as material representations or as characters in computer games. By clever placements, the enterprise can cross promote its various products – the broadcast news division or the magazine can do stories about the release of the enterprise's outstanding new movie or television show, or do in depth reports about the program's star characters, or about the Oscar or Academy award competitions, or other related matters of "great public concern." Or the combined local broadcast station and newspaper can share reporters, thereby reducing the outlays necessary to report on local affairs, or can at least require its reporting staffs to cooperate, thereby reducing the cost of each entity doing the reporting from scratch.
>
> Profitable, however, does not mean in the public interest. Often these "synergies" or efficiency "gains" occur by creating market-dominating media goods that, although profitable for the firm, may provide less value to the public than would the media goods they drive out of existence. In other cases, these synergies result from eliminating alternative pre-merger productive activities that provided significant positive externalities.

[282] Baker, Democracy, p. 87.

institutions to leaders and the public are promoted by institutional diversity. Institutional diversity is often reflected in ownership and viewpoint diversity; institutional diversity involves different structures of media presentation (different business models, journalistic culture and tradition) and these institutions often involve different independent owner and viewpoints across media.

We do not see exposure diversity as a measure of diversity policy. Public policy cannot, nor should it try to, make people listen and learn. What it should do, through structural policy, is to improve the chance that they will listen and learn. Structural policy can make it easier for people to hear civic discourse because it is spoken by louder voices. It can ensure a level playing field so that resources are available to make civic discourse attractive. It can prevent the narrowing of focus through institutional diversity so that important issues that might attract attention in one form of media are not excluded through merger. It can help to ensure that people who want to speak with different voices have access to the most commonly used media. It can force the mingling of ideas so that accidental exposure is more likely. Under the First Amendment, we can never tell people what to say, and we certainly cannot make them listen, but under the Communications Act and to serve our constitutional principles we can organize the structural rules of the industry to increase the probabilities that more people will engage in civic discourse.

Variety does not constitute diversity from a legal standpoint. The empirical evidence also indicates that gains in variety do not compensate for losses in diversity. The media's

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This plurality of media structures may provide security in that neither corruption that comes from government nor corruption that comes from the market is likely to be equally powerful within or equally damaging to all the organizational forms. For this reason, such a plurality of organizational structures will likely advance the

tendency to under-serve minority and atypical groups and the ownership influence over institutional configurations and content demonstrate why the claim that concentration in media market enhances diversity is wrong, or at best irrelevant.

The claim is that when one firm buys another, it may be able to provide a little more variety by covering a new "beat" or offering a hybrid format.[283] This slight increase in variety comes at the expense of the loss of a great deal of ownership or diversity. Everyone in the market loses an independent voice, while a small segment of the market gains better coverage. In fact, depending on the distribution of preferences, the least well-served in the market may become even less well-served, if the merged entity drives out sources that are targeted to the needs of minorities and atypical groups. Therefore, we believe that the Commission should focus on source, outlet and institutional diversity.

C. THERE IS BROAD EMPIRICAL SUPPORT FOR SOURCE AND VIEWPOINT DIVERSITY POLICY CONCERNS

The previous section uses a set of recent rigorous empirical studies to demonstrate general propositions and observations about the "failure" of media markets and the resulting need for policies to promote and protect civic discourse. There is a much broader body of work that supports these observations.

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media's checking function. Moreover, this diversity of media structures is likely to enable the media to better perform its multiple democratic assignments.

[283] Berry, Steven and Joel Waldfogel, *Mergers, Station Entry, and Programming Variety in Radio Broadcasting* (1999); George, Lisa, *What's Fit to Print: The Effect of Ownership Concentration on Product Variety in Daily Newspaper Markets* (2001). The Stevens and Waldfogel's analysis shows that radio market suffered a much larger loss of owners than they gained in formats and the gain in formats were hybrids (close to existing formats). There was no increase in listening. Similarly, the loss of owners exceeds the gain in variety in the newspaper markets with a very small increase in circulation. The variety gains in the newspaper study appear to have been limited to the largest, least concentrated markets.

1. Traditional Concerns

The economic interests of media owners continues to influence their advertising, programming choices,[284] and how they provide access to political information[285] as they always have, only on a grander scale.

Empirical evidence clearly suggests that concentration – fewer independent owners – in media markets has a negative effect on diversity.[286] Greater concentration results in less diversity, while diversity of ownership across geographic, ethnic and gender lines is associated with diversity of programming.[287]

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[284] Bazelon, pp. 230-231.

[285] W. L. Bennet, *News, The Politics of Illusion* (New York: Longmans, 1988); J. C. Busterna, "Television Ownership Effects on Programming and Idea Diversity: Baseline Data," *Journal of Media Economics*, 1988; E. S. Edwards and N. Chomsky, *Manufacturing Consent* (New York: Pantheon, 1988); J. Katz, "Memo to Local News Directors," *Columbia Journalism Review*, 1990; J. McManus, "Local News: Not a Pretty Picture," *Columbia Journalism Review*, 1990; J. McManus, "How Objective is Local Television News?", *Mass Communications Review*, 1991; Price, Monroe, E., "Public Broadcasting and the Crisis of Corporate Governance," *Cardozo Arts & Entertainment*, 17, 1999.

[286] H. J. Levin, "Program Duplication, Diversity, and Effective Viewer Choices: Some Empirical Findings," *American Economic Review*, 1971; S. Lacy, "A Model of Demand for News: Impact of Competition on Newspaper Content," *Journalism Quarterly*, 1989. T. J. Johnson and W. Wanta, "Newspaper Circulation and Message Diversity in an Urban Market," *Mass Communications Review*, 1993; W. R. Davie and J.S. Lee, "Television News Technology: Do More Sources Mean Less Diversity," *Journal of Broadcasting and Electronic Media*, 1993, p. 455; W. Wanta and T. J. Johnson, "Content Changes in the St. Louis Post-dispatch During Different Market Situations," *Journal of Media Economics*, 1994; D. C. Coulson, "Impact of Ownership on Newspaper Quality," Journalism Quarterly, 1994; D. C. Coulson and Anne Hansen, "The Louisville Courier-Journal's News Content After Purchase by Gannet," *Journalism and Mass Communications Quarterly*, 1995; Iosifides, Petros, "Diversity versus Concentration in the Deregulated Mass Media," *Journalism and Mass Communications Quarterly*, Spring 1999.

[287] M. Fife, The Impact of Minority Ownership on Broadcast Program Content: A Case Study of WGPR-TV's Local News Content (Washington, D. C., National Association of Broadcasters), 1979); M. Fife, The Impact of Minority Ownership on Broadcast Program Content: A Multi-Market Study (Washington, D. C., National Association of Broadcasters), 1986); Congressional Research Service, Minority Broadcast Station Ownership and Broadcast Programming: Is There a Nexus? (Washington, D.C., Library of Congress), 1988; T. A. Hart, Jr., "The Case for Minority Broadcast Ownership," Gannet Center Journal, 1988; K. A. Wimmer, "Deregulation and the Future of Pluralism in the Mass Media: The Prospects for Positive Policy Reform," Mass Communications Review, 1988; T. G., Gauger, "The Constitutionality of the FCC's Use of Race and Sex in Granting Broadcast Licenses," Northwestern Law Review, 1989; H. Klieman, "Content Diversity and the

Minority market segments are less well served.[288] Policies that promote ownership and participation of underrepresented points of view are a counterbalance to this tendency. To put the matter simply, minority owners are more likely to present minority points of view[289] and females are more likely to present a female point of view,[290] in the speakers, formats and content they put forward.

FCC's Minority and Gender Licensing Policies," Journal of Broadcasting and Electronic Media, 1991; L. A. Collins-Jarvis, "Gender Representation in an Electronic City Hall: Female Adoption of Santa Monica's PEN System," Journal of Broadcasting and Electronic Media, 1993; Lacy, Stephen, Mary Alice Shaver, and Charles St. Cyr, "The Effects of Public Ownership and Newspaper Competition on the Financial Performance of Newspaper Corporation: A Replication and Extension," *Journalism and Mass Communications Quarterly,* Summer 1996.

[288]Waldfogel, Radio, p. 20.

> Radio programming preferences differ sharply between black and whites between Hispanics and non-Hispanics, and (to a lesser extent) across age groups. Additional consumers bring forth additional products, but in this market the products brought forth are valuable almost exclusively to members of their own groups. This is an interesting finding, among other reasons, because it gives a non-discriminatory reason why markets will deliver fewer products – and one might infer, lower utility – to "preference minorities," small groups of individuals with atypical preferences.
>
> Is this an important effect in the economy, or a curious feature of radio markets?… The fundamental conditions needed to product compartmentalized preference externalities are large fixed costs and preferences that differ sharply across groups of consumers. These conditions are likely to hold, to greater or lesser extents, in a variety of media markets – newspapers, magazines, television, and movies

[289] Empirical studies demonstrating the link between minority presence in the media and minority-oriented programming include the following M. Fife, *The Impact of Minority Ownership on Broadcast Program Content: A Case Study of WGPR-TV's Local News Content* (Washington, D. C., National Association of Broadcasters), 1979); M. Fife, *The Impact of Minority Ownership on Broadcast Program Content: A Multi-Market Study* (Washington, D. C., National Association of Broadcasters), 1986); Congressional Research Service, *Minority Broadcast Station Ownership and Broadcast Programming: Is There a Nexus?* (Washington, D.C., Library of Congress), 1988; T. A. Hart, Jr., "The Case for Minority Broadcast Ownership," Gannet Center Journal, 1988; K. A. Wimmer, "Deregulation and the Future of Pluralism in the Mass Media: The Prospects for Positive Policy Reform," *Mass Communications Review*, 1988; Evans, Akousa Barthewell, "Are Minority Preferences Necessary? Another Look at the Radio Broadcasting Industry," *Yale Law and Policy Review*, 1990 (8); Dubin, Jeff and Matthew L. Spitzer, "Testing Minority Preferences in Broadcasting," *Southern California Law Review,* 1995 (68); Bachen, Christine, Allen Hammond and Laurie Mason, and Stephanie Craft, *Diversity of Programming in the Broadcast Spectrum: Is there a Link Between Owner Race or Ethnicity and News and Public Affairs Programming?,* Santa Clara University, December 1999); Mason, Laurie, Christine M. Bachen, Stephanie L. Craft, "Support for FCC Minority Ownership Policy: How Broadcast Station Owner Race or Ethnicity Affects News and Public Affairs Programming Diversity," *Comm. L. Pol'Y,* 2001 (6).

The dictates of mass audiences create a largest market share/lowest common denominator ethic that undercuts that ability to deliver diverse, locally-oriented,[291] and public interest programming.[292] Simply put, the existence of multiple outlets providing more examples of similar shows does not accomplish the goal of providing greater diversity of points of view.[293]

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[290] A similar line of empirical research dealing with gender exists, see Lacy, Stephen, Mary Alice Shaver, and Charles St. Cyr, "The Effects of Public Ownership and Newspaper Competition on the Financial Performance of Newspaper Corporation: A Replication and Extension," *Journalism and Mass Communications Quarterly,* Summer 1996; T. G., Gauger, "The Constitutionality of the FCC's Use of Race and Sex in Granting Broadcast Licenses," Northwestern Law Review, 1989; H. Klieman, "Content Diversity and the FCC's Minority and Gender Licensing Policies," *Journal of Broadcasting and Electronic Media*, 1991; L. A. Collins-Jarvis, "Gender Representation in an Electronic City Hall: Female Adoption of Santa Monica's PEN System," *Journal of Broadcasting and Electronic Media*, 1993; Lauzen, Martha M. and David Dozier, "Making a Difference in Prime Time: Women on Screen and Behind the Scenes in 1995-1996 Television season, *Journal of Broadcasting and Electronic Media*, 1999 (winter.); O'Sullivan, Patrick B., "The Nexus Between Broadcast Licensing Gender Preferences and Programming Diversity: What Does the Social Scientific Evidence Say?" *Department of Communication, Santa Barbara, CA.* (2000).

[291] Slattrey, Karen L. Ernest A. Hakanen and Mark Doremus, "The Expression of Localism: Local TV news Coverage in the New Video Marketplace," *Journal of Broadcasting & electronic Media*, 40, 1996; Carroll, Raymond L. and C.A. Tuggle, "The World Outside: Local TV News Treatment of Imported News," *Journalism and Mass Communications Quarterly*, Spring 1997; Fairchild, Charles, "Deterritorializing Radio: Deregulation and the Continuing Triumph of the Corporatist Perspective in the USA," *Media, Culture & Society*, 1999 (21).

[292] Bagdikian, Ben, *The Media Monopoly* (Boston, Beacon Press, 2000), pp. 182... 188; p. Clarke and E. Fredin, "Newspapers, Television, and Political Reasoning," Public Opinion Quarterly, 1978; M. Pfau, "A Channel Approach to Television Influence," Journal of Broadcasting and Electronic Media, 1990; D. T. Cundy, "Political Commercials and Candidate Image," in New Perspectives in Political Advertising (L. L Kai, et. al, Eds.); G. J. O'Keefe, "Political Malaise and Reliance on the Media," Journalism Quarterly, 1980; S. Becker and H. C. Choi, "Media Use, Issue/Image Discrimination," Communications Research, 1987; J. P. Robinson and D. K. Davis, "Television News and the Informed Public: An Information Process Approach," Journal of Communication, 1990; Voakes, Paul S. Jack Kapfer, David Kurpius and David Shano-yeon Chern, "Diversity in the News: A Conceptual and Methodological Framework," *Journalism and Mass Communications Quarterly*, Autumn, 1996.

[293] Evidence that increasing variety does not increase diversity can be found in see A. S. Dejong and B. J. Bates, "Channel Diversity in Cable Television," Journal of Broadcasting and Electronic Media, 1991; A. E. Grant, "The Promise Fulfilled? An Empirical Analysis of Program Diversity on Television," The Journal of Media Economics, 1994; Hellman, Heikki and Martii Soramaki, "Competition and Content in the U.S. Video Market," *Journal of Media Economics*, 1994 (7); Lin, C.A., "Diversity of Network Prime-Time Program Formats During the 1980s," *Journal of Media Economics*, 1995 (8); Kubey, Robert, Mark Shifflet, Niranjala Weerakkody, and Stephen Ukeiley, "Demographic Diversity on Cable: Have the New Cable Channels Made a Difference in the

There is clear evidence that greater concentration will reduce public interest, culturally-diverse programming,[294] and locally-oriented programming. [295] News and public affairs programming are particularly vulnerable to these economic pressures.[296] As market forces grow, these types of programming are reduced.[297] The quality of the programming is also compromised.[298]

Representation of Gender, Race, and Age?", *Journal of Broadcasting and Electronic Media*, 1995 (39)) as well as other nations (see Deakin, Simon, Stephen Pratten, "Reinventing the Market? Competition and Regulatory Change in Broadcasting," *Journal of Law and Society*, 1999 (26); Li, Hairong, Janice L. Bukovac, "Cognitive Impact of Banner Ad Characteristics: an Experimental Study," *Journalism & Mass Communication Quarterly*, 1999 (76); Kilborn, Richard W., "Shaping the Real," *European Journal of Communication*, 1998 (13); Blumer, Jay G. and Carolyn Martin Spicer, "Prospects for Creativity in the New Television Marketplace: Evidence form Program-Makers," *Journal of Communications*, 1990 (40), p. 78

[294] V. A. Stone, "Deregulation Felt Mainly in Large-Market Radio and Independent TV," Communicator, April, 1987, p. 12; P. Aufderheide, "After the Fairness doctrine: Controversial Broadcast Programming and the Public Interest," Journal of communication (1990), pp. 50-51; M. L. McKean and V. A. Stone, "Why Stations Don't Do News," Communicator, 1991, pp. 23-24; V. A. Stone, "New Staffs Change Little in Radio, Take Cuts in Major Markets TV, RNDA, 1988; K. L. Slattery and E. A. Kakanen, "Sensationalism Versus Public Affairs Content of Local TV News: Pennsylvania Revisited," Journal of Broadcasting and Electronic Media, 1994; J. M. Bernstein and S. Lacy, "Contextual Coverage of Government by Local Television News," Journalism Quarterly, 1992; R. L. Carrol, "Market Size and TV News Values," Journalism Quarterly, 1989; D. K. Scott and R. H. Gopbetz, "Hard News/Soft News Content of the National Broadcast Networks: 1972-1987," Journalism Quarterly, 1992; Washburn, op. cit, p. 75; Ferrall, pp. 21... 28... 30.

[295] Kathryn Olson, "Exploiting the Tension between the New Media's "Objective" and Adversarial Roles: The Role Imbalance Attach and its Use of the Implied Audience, Communications Quarterly 42: 1, 1994 (pp. 40-41); A. G. Stavitsky, "The Changing Conception of Localism in U.S. Public Radio," Journal of Broadcasting and Electronic Media, 1994.

[296] J. H. McManus, "What Kind of a Commodity is News?", Communications Research, 1992; Olson, op. cit.

[297] Bagdakian, pp. 220-221; D. L. Paletz and R. M. Entmen, Media, Power, Politics, (New York, Free Press, 1981). N. Postman, Amusing Ourselves to Death: Public Discourse in the Age of Show Business (New York Penguin Press, 1985); S. Lacy, "The Financial Commitment Approaches to News Media Competition," Journal of Media Economics, 1992.

[298] B. R. Litman, "The Television Networks, Competition and Program Diversity," Journal of Broadcasting, 1979; B. R. Litman and J. Bridges, "An Economic Analysis of Daily Newspaper Performance," Newspaper Research Journal, 1986; J. C. Buterna, "Television Station Ownership Effects on Programming and Idea Diversity: Baseline Data," Journal of Media Economics, 1988; J. Kwitny, "The High Cost of High Profits," Washington Journalism Review, 1990; A. Powers, "Competition, Conduct, and Ratings in Local Television News: Applying the Industrial Organization Model," Journal of Media Economics, 1993.

Commercialization can easily overwhelm public interest and diverse content.[299] The radio industry, which has been subject to the most unfettered process of rationalization demonstrates how local content can be homogenized off the air.[300] The growing impact of homogenization in the TV industry stimulated by the lifting of national ownership limits and restrictions on vertical integration into programming is also unmistakable.[301] Insertion of local programming is restricted or eliminated. Stories of local importance are driven out of

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[299] Rifkin, *The Age of Access,* pp. 7-9.

> More and more cutting edge-commerce in the future will involve the marketing of a vast array of cultural experiences rather than of traditional industrial-based goods and services…
>
> While the industrial era was characterized by the commodification of work, the Age of Access is about, above all else, the commodification of play – namely the marketing of cultural resources including rituals, the arts, festivals, social movements, spiritual and fraternal activities, and civic engagement in the form of paid-for personal entertainment…
>
> Imagine a world where virtually every activity outside the confines of family relations is a paid-for experience, a world in which traditional obligations and expectations – mediated by feelings of faith, empathy, and solidarity – are replaced by contractual relations in the form of paid memberships, subscriptions, admission charges, retainers and fees

[300] Fairchild, pp. 557-559,

> News programming, especially local news, which has always been the most expensive kind of programming to produce, has been rationalized almost out of existence, with a significant amount of centralization and heavy reliance on national wire services and increased use of 'information management' services of public relations companies…
>
> In Washington DC, for example, consolidation has led to one news production team providing identical new to 10 stations form a central location, personalizing each station's news break with their call letters… Staff can choose which pieces of news they will include in their own newscasts, but have no control over news content and given the economic realities created and fostered by deregulation, few may actually have the means to make these choices…
>
> It is a fairly straightforward concept: a computer system allows the station to download programming minutes or even days in advance… All possible functions of a radio station, defined in advance, are covered by one of 99 preset computer command. 'Any station joining the network 'can expect to cut operating costs by 30 to 50 percent.' The advantage of the network,' writes one business reporter, 'is that the station need not worry about selecting the music, the programming staple of most stations on the network. 'Pelmorax uses programming consultant to tailor the music and Decima Research to ensure that its formats reach the right demographics.

the high-visibility hours or off the air. Pooled news services reduce the ability of local stations to present local stories and eventually erode the capability of producing them.

2. New Media, Similar Concerns

The extremely powerful commercial thrust of the new media does not negate these concerns; rather, it reinforces the central concern of media public policy.[302] New technologies do not alter underlying economic relationships because the mass-market audience orientation of the business takes precedence and there is no reason to assume that the emergence of a different medium, like the Internet, will change behaviors of dominant firms.[303] Indeed, because the new media markets have moved quickly to vertical integration by domi-

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[301] Network Affiliated Stations Alliance, "Petition for Inquiry into Network Practices." (Federal Communications Commission, Mar. 8, 2001).

[302] Firestone and Schement, p. 45; Stempell, Guido H. III, and Thomas Hargrove, "Mass Media Audiences in a Changing Media Environment," *Journalism and Mass Communications Quarterly*, Autumn 1996; Gunther, Albert C. "The Persuasive Press Inference: Effects of Mass Media on Perceived Public Opinion," *Communications Research*, October 1998; American Civil Liberties Union v. Janet Reno, 929 F. Supp. 824 (E.D. Pa. 1996), 117 S.Ct. 2329 (1997); Iosifides, Petros, "Diversity versus Concentration in the Deregulated Mass Media Domain," *Journalism & Mass Communication Quarterly*, 1999 (76).

[303] K. C. Loudon, "Promise versus Performances of Cable," in W.H. Dutton, et al., Wired Cities: Shaping the Future of Communications (Boston, K.G. Hall, 1987). D. Le Duc, Beyond Broadcasting ((New York: Longman, 1987); T. Streeter, "The Cable Fable Revisited; Discourse, Policy, and the Making of Cable Television," Critical Studies in Mass Communications, 1987; B. Winston, "Rejecting the Jehovah's Witness Gambit," Intermedia, 1990; N. M. Sine, et al., "Current Issues in Cable Television: A Re-balancing to Protect the Consumer," Cardozo Arts & Entertainment Law Journal, 1990; V. E. Ferrall, "The Impact of Television Deregulation," Journal of Communications, 1992; R. H. Wicks and M. Kern, "Factors Influencing Decisions by Local Television News Directors to Develop New Reporting Strategies During the 1992 Political Campaign," Communications Research, 1995; Motta Massimo and Michele Polo, "Concentration and Public Policies in the Broadcasting Industry," Lubunski, Richard, "The First Amendment at the Crossroads: Free Expression and New Media Technology," *Communications Law and Policy*, Spring 1997; Chan-Olmsted, Sylvia M., Jung Suk Park, "From On-Air to Online World: Examining the Content and Structures of Broadcast TV Stations' Web Sites," *Journalism & Mass Communication Quarterly*, 2000 (77).

nant incumbents from the old media, the problems of raising capital and acquiring licenses that have afflicted the old media persist.[304]

Companies introducing technologies can identify the likely early adopters and innovators and orient their product distribution to maximize the penetration within that market segment. [305] There is a very strong base of support for the importance of income and education in the adoptions of high technology innovations like computers and telecommunications equipment.[306] The strong predictors of inclination to early adoption point directly to market segmentation strategies.[307] In other words, companies introducing technologies can identify the likely adopters and orient their product distribution to maximize the penetration within that market segment. The competitive energies of the industry are focused on the "premier" segment, with innovative offerings and consumer-friendly pricing, while the remainder of the population is ignored or suffers price increases.

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[304] Civil Rights Forum on Communications Policy, When Being No. 1 is Not Enough: The Impact of Advertising Practices on Minority-Owned and Minority Formatted Broadcast Stations (1999), asserts a bias in advertising rates. Bradford, William D., "Discrimination in Capital Markets, Broadcast/ Wireless Spectrum Service Providers and Auction Outcomes," School of Business Administration (Univ. of Washington), December 5, 2000, asserts a bias in capital markets.

[305] Sakar, Jayati, "Technological Diffusion: Alternative Theories and Historical Evidence," *Journal of Economic Surveys*, 12:2, 1998; Martinez, Evan, Yolanda Polo and Carlos Flavian, "The Acceptance and Diffusion of New Consumer Durables: Differences Between First and Last Adopters," *Journal of Consumer Marketing*, 15:4, 19998.

[306] Meeks, Carol B., Anne L. Sweaney, "Consumer's Willingness to Innovate: Ownership of Microwaves, Computers and Entertainment Products," *Journal of Consumer Studies and Home Economics*, 16, 1992; Savage, Scott Gary Madden and Michael Simpson, "Broadband Delivery of Educational Services: A Study of Subscription Intentions in Australian Provincial Centers," *Journal of Media Economics*, 10:1, 1997; Atkin, David J., Leo W. Jeffres and Kimberly A. Neuendorf, "Understanding Internet Adoption as Telecommunications Behavior," *Journal of Broadcasting and Electronic Media*, 42:4, 1998; Neuendorf, Kimbelry A., David Atkin and Leo W. Jeffres, "Understanding Adopters of Audio Information Innovations," *Journal of Broadcasting and Electronic Media*, 42:4, 1998; Lin, Carolyn, A., "Exploring Personal Computer Adoption Dynamics," *Journal of Broadcasting and Electronic Media*, 42:4, 1998.

[307] Sultan, Fareena, "Consumer Preferences for Forthcoming Innovations: The Case of High Definition Television," *Journal of Consumer Marketing*, 16: 1999, p. 37.

Future commercialization will enhance current exclusion of certain groups. The drive to sell more subscriptions and reach a broader yet highly targeted audience advertising that caters to their individual tastes will be intense and will result in commercialization on a grander scale.[308] The resulting e-commerce will be an electronic "direct mail on steroids" pumped up by the ability of viewers to click through digitally inserted advertising for purchases.[309] The high-powered advertising will be targeted at demographically-compatible viewers identified by detailed information created by the two-way network on viewing patterns and past purchases, [310] leading to growing concerns that certain groups are not likely to have fair access to the opportunities of cyberspace.[311] The new services may be expensive to deliver because of the cost of appliances, production equipment necessary to produce programming that takes advantage of the new appliance, and also because of the infrastructure necessary to deliver interactive services. [312] The cost of services, and the targeting of marketing points to a commercial model in which high-value, high-income consumers are the ones that marketers seek to woo.

D. CONCLUSION

The animus for repeated congressional concerns about concentrated ownership of the media was a sound understanding of the relationship between ownership and diversity. Traditional concerns are not blunted by the growth of new media. As we have seen, the exer-

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[308] Morgan Stanley Dean Whitter Reynolds, *Digital Decade* (New York, 1999).
[309] Van Orden, Bob, "Top Five Interactive Digital-TV Applications," *Multichannel News*, June 21, 1999, p. 143, Kearney, Chapter 4.
[310] Menezes, Bill, "Replay, TiVo Get Cash for Consumer Push," *Multichannel News*, April 5, 1999, p. 48
[311] Cooper, "Inequality in Digital Society," *Cardozo Jounral On Media and the Arts*, forthcoming. .
[312]The cost of early HDTV equipment has been exorbitant and current prices in the range of $2,000-$4,000 "Profile with Bob Wright: The Agony Before the Ecstasy of Digital TV," *Digital Television*,

cise of market power continues unabated in the face of the existence of new media and, in many respects, it grows worse. The 30 percent limit that was well-justified—and even conservative based on economic analysis—is reinforced by consideration of diversity; it should be affirmed by the Commission.

April 1999, p. 40; Maxwell, Kim. *Residential Broadband: An Insider's Guide to the Battle for the Last Mile* (John Wile: New York: 1999); pp. 9-10.

ATTACHMENT A

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

In the Matter Of		)
		)
Implementation of the Cable Television	)	FCC 99-288,
Consumer Protection and Competition Act of 1992	)	MM Docket No. 92-264
		)
Implementation of Cable Act Reform Provisions of the	)	
Provisions of the Telecommunications Act of 1996	)	
		)
Review of the Commission's Cable Horizontal	)	
Ownership Rules		)

To: The Commission

PETITION FOR RECONSIDERATION OF

CONSUMER FEDERATION OF AMERICA, CENTER FOR MEDIA EDUCATION, ASSOCIATION OF INDEPENDENT VIDEO AND FILMAKERS AND OFFICE OF COMMUNICATION, INC. UNITED CHURCH OF CHRIST

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January 3, 1999

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

In the Matter Of	)	
	)	
Implementation of Section 11(c) of the Cable Television	)	FCC 99-289
Consumer Protection and Competition Act of 1992	)	MM Docket No. 92-264
	)	
Horizontal Ownership Limits	)	

To: The Commission

PETITION FOR RECONSIDERATION OF CONSUMER FEDERATION OF AMERICA, CENTER FOR MEDIA EDUCATION, ASSOCIATION OF INDEPENDENT VIDEO AND FILMAKERS, AND OFFICE OF COMMUNICATION, INC. UNITED CHURCH OF CHRIST

Consumer Federation of America, Center for Media Education, Association of Independent Video and Filmmakers, and Office of Communication, Inc. United Church of Christ (collectively "CFA *et al.*") respectfully seek reconsideration of the Commission's *Third Report and Order* in the above-captioned proceeding. Docket MM 92-264, FCC 99-289 (October 20, 1999) ("*Third Report & Order*").

CFA *et al.* challenge three aspects of the *Third Report & Order*:

- the inclusion of all pay-TV subscribers rather just "cable subscribers" and actual user numbers rather than cable TV "homes passed" in calculating compliance with the cable television horizontal ownership limits established by the 1992 Cable Act;
- authorization of cable operators to employ any "generally accepted" private sector data in self-reporting their ownership interests; and
- exclusion of "overbuild" systems in calculating national cable TV ownership.

SUMMARY

In Section 11(f)(1)(a) of the Cable Television Consumer Protection and Competition Act of 1992 ("1992 Cable Act"), 47 USC §611(f)(1)(a), Congress directed the Commission

> to prescribe rules and regulations on the number of cable subscribers a person is authorized to reach through cable systems owned by such person, or in which such person holds an attributable interest.

FCC rules adopted thereunder established 30% as the appropriate cap on the number of subscribers a

single owner can control.

In its October 22, 1999, *Third Report & Order*, the Commission has now reinterpreted this critical statutory provision. While purporting to adhere to the same 30% limit adopted in 1993, the Commission has actually increased the permissible level of ownership by one-fifth. The Commission accomplished this unlawful objective by making two changes not authorized by the language of the statute.

First, it improperly includes homes not capable of receiving service from a cable operator in the calculating the number of "subscribers" an operator "is authorized to reach."

Second, it reinterprets the term “cable subscriber” so as to include many people who are ***not*** cable subscribers.

This is the telecommunications equivalent of defining ketchup as a "vegetable." Allowing cable operators to acquire a larger national customer base increases "the number of cable subscribers" each operator may have. Congress wanted cable power limited, and not increased.

The increased subscriber base permitted under the new rules will actually be far greater than is immediately apparent. That is because the Commission has invited wholesale manipulation of the new rules by allowing cable operators to employ whatever privately generated data they can muster to self-report their compliance with the limits.

To afford even greater latitude to cable operators, the Commission also exempted “overbuilt” cable systems from calculation of the national ownership limits. This adjustment is as unlawful as it is unwise.

ARGUMENT

I. THE COMMISSION'S ORDER VIOLATES THE PLAIN MEANING AND LEGISLATIVE HISTORY OF §613(f).

The *Third Report & Order* superficially maintains the 30% horizontal ownership cap adopted in 1993. However, it makes two critical changes in the manner in how the it will calculate whether an MSO has exceeded the limit.

The Commission has attempted to read new meaning into Section 613(f) so that cable operators may increase their market power. Until now, operators have not been permitted to have subscribers in excess of 30% of the homes they "pass," *i.e.,* homes in communities in which they hold franchises, and are thus "authorized to serve."

The Commission's newly defined measure decreases the numerator of the Section 613(f) analysis by counting only actual users, not potential customers, in "homes passed." It increases the denominator by counting ***all pay-TV subscribers*** ("MVPD subscribers"), not just "cable subscribers."

By this method, what was once more than 36% of the market defined by Congress has been recast as being only 30%.

This construction is fundamentally at odds with the plain language of the statute, and overlooks unusually clear legislative history. It is also an irrational change which contradicts agency case law and invites wholesale evasion. Furthermore, because the Commission's calculation is a "sliding scale," it gives the potential for the largest MSOs to grow further, reducing the cable market to one large MSO or two MSOs able to act in concert. This is precisely what the Commission has itself said is contrary to the intent of the statute.

A. Counting Actual Users Rather Than "Homes Passed," and Including Non-Cable MVPD Subscribers in the Cable TV Universe Violates the Explicit Language of the §613.

Although Congress gave the Commission discretion in setting an appropriate limit on the power of cable MSOs, the statutory language was explicit and specific that the Commission must

> prescribe rules and regulations establishing reasonable limits on the number of ***cable subscribers*** a person is ***authorized to reach*** through cable systems...in which such person holds an attributable interest.

Section 613(f)(1) (emphasis added).

The Commission however has trampled over this plain language to reach an impermissible result.

"Cable subscribers" are people who have purchased cable TV service. DBS subscribers are ***not*** "cable subscribers"[1] MDS subscribers are not "cable subscribers." SMATV subscribers are not "cable subscribers." The Commission may not properly include them in its calculus.

Every home to which the cable operator can deliver service is a home which a franchised operator "is authorized to reach." Limiting the count to those who purchase the service ignores a large number of customers the operator is "is authorized to reach."

The Commission offers no explanation of how the statute could accommodate this radical revisionism. Instead, it argues why it would prefer to employ the new criteria. That, of course, is an argument which might prevail in Congress, but not one which has any proper salience at the Commission or in the courts.

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[1] A substantial number of DBS customers have historically purchased basic cable. Such customers are, of course, properly considered "cable subscribers" for the purposes of Section 613(f). The prevalence of this practice may well decline with the recent amendments to the Satellite Home Viewers Act.

B. Other Traditional Tools of Statutory Construction Also Contradict the FCC.

The structure of the statute further undermines the Commission's interpretation. Where Congress wanted the Commission to include alternate MVPDs in its calculations, it explicitly instructed the Commission to do so. For example, Congress defined "effective competition" in §3 of the 1992 Act (dealing with rate regulation) to include the entire universe of MVPDs. Had Congress intended the Commission to include all MVPDs, it would certainly have done so in a more direct fashion than by reference to "the communications market as a whole."

The legislative history also belies the Commission's reading of Section 613(f). According to the Conference report, the Conference Committee rejected the House version which would have instructed the Commission to restrict the ability of "a single multichannel video programming distributor" to control any segment of the distribution market. Conference Report at 82. Had Congress wished to include MVPD subscribers rather than cable subscribers, it would have adopted either the House measure or a variation therefore which incorporated the language addressing MVPDs generally. Instead, the Conference chose the language limiting the Commission's rulemaking discretion to cable subscribers.

C. The FCC's Reading is Inconsistent With All Other Parts of Section 613.

The closest the Commission comes to addressing the language of the statute is in explaining that the use of MVPD subscribers as a proxy for "cable subscribers" is "also consistent with Section 613's directive that the Commission establish limits on the number of cable subscribers a person may serve...."[2]

This is not only insupportable, but it also confuses the purpose of the law. Rather than

[2]There is no reference whatever to how abandoning "homes passed" can be reconciled with the language of the law.

explaining how the rule will limit a cable operators' monopsony power over program developers, the Commission seems to regard the statutory objective as being to promote cable investment in alternate MVPD's. Thus, it states:

> The rule will not limit the number of subscribers a ***cable operator*** may reach through alternative MVPD systems....The rule will create a sliding or adjustable cable horizontal ownership limit, under which the number of subscribers a cable operator is authorized to reach through its cable systems would decrease in proportion with any in increase in the number of subscribers that ***entity*** [*i.e.*, the cable operator] reaches through other MVPD systems. Conversely, the cable horizontal ownership limit would be higher for a ***cable operator*** that reaches fewer subscribers through other MVPD systems.

¶32.

Congress made clear that the purpose of Section 613(f) is to "enhance effective competition." It is inconceivable that assisting cable MSOs in extending their monopsony power to alternate means of delivery was what Congress meant. *See, e.g., U.S. v. Primestar*.

Rather than addressing the plain language of the statute, the Commission attempts to read new meanings into the statute by reference to §613(f)(2)(E). As the Commission states:

> We conclude that it is appropriate under Section 613 to include all MVPD subscribers in the horizontal limits calculation in order to reflect changes in the marketplace since 1993....Section 613(f)(2)(E) requires the Commission to consider "the dynamic nature of the communications market place."

¶27.

The Commission appears to have completely misunderstood the relationship between §613(f)(1)(A) and the public interest factors listed in §613(f)(2). Section 613(f)(1)(A) directs the Commission to limit "the number of cable subscribers a person is authorized to reach through cable systems" etc. As explained above, this means (1) the rules must limit the number of subscribers an MSO may ***reach***, and (2) the limit must consider ***cable*** subscribers only, not ***MVPD*** subscribers.

Congress did, however, leave the Commission discretion to fix the appropriate level of

ncentration within these parameters. The Committee reports reflect the opinion that horizontal concentration can create efficiencies and bring other positive benefits, and that the Commission must balance these benefits against the social ills of concentration.

This did not, however, give the Commission license to ignore the limitations of §613(f)(1)(A). Rather, Congress directed the Commission to address a number of public interest factors when setting the appropriate concentration level.

That the Commission places undue emphasis on §613(f)(2)(E) and reads it all out of proportion to its actual weight is demonstrated by the remaining list of public interest factors. In an unusually explicit ranking, using verbs of decreasing force, Congress detailed that the Commission must:

> (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 video programmers 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 the 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;
> (E) ***make*** such rules and regulations ***reflect*** the dynamic nature of the communications marketplace.

Section 613(f)(2)(A-E).

It is extremely relevant that the Commission is directed to ***"ensure"*** that video programming isn't impeded and that operators do not favor affiliates, but only to ***"take particular account"*** of market structure and merely to ***"make"*** its rules ***"reflect"*** the changing nature of the market. Nothing suggests that Congress, by listing these factors, intended to give the Commission *carte blanche* to

rewrite §613(f)(1)(A) or second guess Congress' policy decisions. Rather, the ranking is wholly consistent with the idea that the Commission, when setting a specific number (e.g., whether to chose 20% or 30%) in accordance with the clear language of §613(f)(1)(A), should set the number at a level which balances the listed goals.

Rather than supporting the Commission's interpretation that reference to the broader communications market as a whole gives it the authority to contravene the plain meaning of §613(f)(1)(A), the public interest factors reinforce the clear intent of Congress that the Commission's rules should limit themselves to cable subscribers that systems can reach. Thus, Congress emphasized the need for the Commission to protect consumers -- §613(f)(2)(A) -- and competing MVPD providers -- §613(f)(2)(B) -- from the ability of cable MSOs to impede the flow of programming.

II. THE ORDER IS INTERNALLY INCONSISTENT AND ILLOGICAL.

Even if the statute permitted these changes, the Commission has not offered a rational justification for their adoption.

A. The Commission Unaccountably Rejects the Use of Billing Records As A Basis to Abandon the "Homes Passed" Standard.

The Commission's explanation of its new rule is riddled with contradictory reasoning, unsupported assumptions, and red herrings. It states that shifting to from homes passed to subscribers provides a more reliable number "because homes passed calculations are based on estimates whereas subscriber numbers are based on billing records." ¶21. A few paragraphs later, however, the Commission states that MVPD subscriber count is uncertain and "some degree of estimation and double counting is involved." ¶35.

Inexplicably, while it says that estimation and the possibility of double counting do not make subscriber limits "unreliable," in the Commission's mind, it Commission rejects the homes passed criterion on the same basis: "Although homes passed might be a more stable number...it is not as

reliable as the number of subscribers because homes passed calculations are based on estimates whereas subscriber numbers are based on billing records." ¶21.

That the amount of estimation in homes passed pales in comparison to the "estimation and double counting" in subscriber estimates makes this inconsistency particularly indefensible. The homes passed estimate is based on the LFA's grant of a franchise area and the MSO's report of its build-out. Anyone may obtain at reasonable fees from publicly accessible sources the necessary information to estimate homes passed with near-perfect accuracy. By contrast, MVPD subscriber numbers can only be obtained by the voluntary release of proprietary information by interested parties to third-party reporters.[3]

This uncertainty favors cable MSOs close to (or over) the cap by making it far more difficult for interested parties to track violations of the rules. Because outside observers cannot monitor the information from publicly accessible sources, they will find it difficult to make complaints. Because the Commission allows a certifying MSO to rely on any "generally accepted industry data," any complainant will face as an initial obstacle a struggle to establish the validity of the complainants data.

In addition, an MSO approaching the limit of subscribers may under-report figures to the trade press. Alternatively, smaller companies wishing to appear more viable and attract capital may inflate their subscriber figures. Citizens have no way to verify these numbers against any objective standard.

As a general object, CFA *et al.* note that the uncertainties in the data work to create the smallest possible numerator and the largest possible denominator, favoring the largest cable MSOs and giving them the greatest opportunity to expand and exploit their market power. A MSO knows its own subscribers, and will therefore report the smallest number possible with precision. However, the Commission permits uncertainties that will inflate the total denomina

B. The *Order* Finds A 30 Percent Cap Necessary to Effectuate §613(f), But allows the Largest Cable MSOs To Grow by 20% With The Prospect of Further Increases

In its analysis of the right level for its horizontal cap, the Commission carefully examined the need for a horizontal ownership limit and why a 30 percent cap remains the appropriate level. The Commission found that the ownership limitations complement the access provisions and other protections of the 1992 Act. Furthermore, the Commission recognized the ability of cable system operators to use their monopsony power over programmers. The Commission observed that an MSO controlling a third of the cable market (as opposed to the entire MVPD market) "would pay $2.5 billion annually for programming, making it one of the largest purchasers of entertainment programming in the world." *Order* at ¶17.

For example, compare the following two contradictory paragraphs:

> To the extent cable operators have concerns regarding efficiencies of scale and competition with incumbent telephone service providers, we will permit cable operators to grow in size through overbuilding without counting subscribers reached in that manner toward an operator's horizontal limit.

¶37

> Cable operators argue that the limit should be raised so that they may compete with common carriers for the provision of Internet and telephony services....A 30% limit allows a cable operator to gain access to a substantial portion of the market to provide Internet access and telephony. ***The cable operators have presented no credible evidence that a larger size is necessary for the deployment of advanced technologies or telephony***. Moreover, we note the possibility of cooperative arrangements among operators to offer coordinated telephony services through their cable systems, so that a cable operator does not necessarily need to grow in absolute size beyond the limit in order to participate in offering of a national telephony service.

¶61.

As to the Commission's primary holding -- that it will calculate the 30% cap by reference to an

---

[3] Additional problems with using subscriber information from industry reporters are discussed *infra*.

MSO's subscribers rather than on the basis of the homes its systems pass, and will use all MVPD subscribers rather than all homes passed by cable systems -- two inconsistencies stand out as so great that they render the Commission's decision to change calculation methods arbitrary and capricious.

As the Commission noted, Congress explicitly directed the Commission to formulate rules that would prevent either one cable MSO, ***or a group of MSO working in concert,*** from exercising monopsony power over the programming market. Balancing these factors, the Commission concluded that a 30% cap achieved the goals of §613(f)(1)(A) by protecting citizens and program developers from cable monopsony power, while allowing cable MSOs to capture the efficiencies and positive benefits of size.

Incredibly, after concluding that a 30% cap represents the agency's best judgment on the appropriate size of cable MSOs, the Commission effectively ***raises*** the cap to 36.7%. Furthermore, as the Commission itself proudly maintains, the new methodology represents a sliding scale. As the number of non-cable MVPD subscribers increases, cable programmers will grow larger and larger.

The cornerstone of the Commission's decision to adopt its new methodology is an expectation that non-cable MVPDs will continue to grow rapidly. If this proves true, it will not take long for the cap to rise above 40%. Yet in this same *Order*, the Commission concluded that a cap of 40% would allow two large MSOs to dominate the cable market and collude together --either directly or tacitly-- in violation of §613(f). Indeed, under the Commission's rule, the MVPD market could become dominated by a single alternate MVPD provider and a single cable MSO. More likely, the new sliding scale will allow one or two dominant cable MSOs to grow to positions of unchallenged dominance among MVPD providers. This will happen because a ***single*** MSO may benefit from an increase in non-cable MVPD subscribership divided among ***all*** non-MVPD players. Thus, if all non-cable MVPD providers experience some growth, for a total increase of 15% in the entire non-cable

MVPD market, any single cable MSO may increase its subscriber number by 15%.

In the case of TCI, this increase would result in TCI controlling ***over 50%*** of the cable market. Even if the entire 15% migrated to one DBS provider, such as DirectTV, it could not possibly hope to match the market power of such as behemoth. As the Commission itself acknowledges in the *Order*, sheer size allows an MSO to exercise monopsony power even if competition exists. "It is reasonable to assume that an unaffiliated programmer carried on a large MSO, with all the advantages that such carriage confers, would be disinclined to alienate the MSO by seeking carriage on a competitor." *Order* at ¶59.

The Commission attempts to harmonize these inconsistencies by relying the expected growth of non-cable MVPDs. Yet the Commission utterly fails to explain how the growth of the MVPD market undercuts the Commissions many-pages of analysis demonstrating why 30% is the appropriate market cap. In a single paragraph, the Commission states that "the most significant change in the MVPD market has been the increased market share of non-cable MVPDs" and that it "agree[s] with the cable operators that the horizontal limits should take into account the non-cable MVPD's impact on the programming marketplace."

The Commission does not explain ***why*** it agrees, nor does it explain why its previous pages of analysis are rebutted by this single paragraph. This inherent contradiction without any rational explanation is not merely arbitrary; it is irrational.

C. The Commission Found That Cable MSOs Use Their Existing Market Power in an Anticompetitive Fashion in Violation of the Purpose of §613(f), But Increased the Effective Ownership Cap.

The Commission found that alternative MVPD providers and overbuilders presented credible evidence that existing cable operators ***already use their existing market power in an anticompetitive fashion in direct violation of the statute.*** As the *Order* states:

> WCA and Ameritech proffer credible evidence that indicates that MSOs have used their market power to cause unaffiliated programmers to refuse to sell their programming to other MVPDs. This evidence demonstrates another way in which MSOs can use their size and market power to impede the flow of programming to consumers in contravention of Section 613(f)(2)(A). ***It is reasonable to assume that an unaffiliated programmer carried on a large MSO, with all the advantages that such carriage confers, would be disinclined to alienate the MSO by seeking carriage.***

Order at ¶59.

Despite finding both the potential for anticompetitive behavior and actual abuses taking place in the market today, the Commission has persistently determined that it should ***raise*** the ownership cap. Worse, the "sliding scale" devised by the commission will encourage cable consolidation as competition grows. Thus, even if alternate MVPDs do continue to experience growth despite the Commission's new regulations, expanding cable MSOs will quickly choke this growth off.

III. THE COMMISSION IMPROPERLY DELEGATES AUTHORITY TO PRIVATE PUBLISHERS TO PROVIDE CRITICAL DATA.

The Commission has stated that it will permit cable operators to rely upon "generally accepted" data to report their subscribership. This is an invitation to gamesmanship, manipulation and outright trickery.

As CFA *et al*. stated above, MSOs may manipulate the subscriber information that appears in the trade press with ease. Industry reporting services have no way to check the accuracy of subscriber data -- which MSOs treat as proprietary information. Thus, nothing prevents an MSO approaching the ownership cap from reporting lower subscriber numbers than it actually possesses. Furthermore, smaller services may inflate their subscriber figures to enhance their image as viable competitors. This sort of manipulation artificially lowers the numerator of a cable MSO's percentage of the market, while inflating the denominator.

More significantly, however, industry reporters regard cable MSOs as clients. Industry

reporters must maintain the goodwill of cable MSOs, who pay for their research and who provide industry reporters with the necessary information. Thus, industry reporters have every incentive to accommodate cable MSOs in their desire to manipulate the raw data.

The Commission cannot delegate a critical government function to a private reporting agency. Not only does such a delegation fly in the face of the Commission's most basic duty to monitor and regulate the industries over which it has jurisdiction. The close relationship between private research/reporting services and the industry allow the affected industry players to appeal for a change of some inconvenient fact through back channels -- out of sight and without oversight, bereft of any public input or public interest.

The possibilities for abuse are legion. By allowing cable MSOs to use "any generally accepted industry data," the FCC invites MSOs to shop for the most favorable data. Given the number of reporting services, cable MSOs will have their pick of a wide field.

Indeed, nothing stops the cable MSOs themselves from publishing a self-serving "report" which minimizes cable subscribership and inflates non-cable MVPD subscribership. That all major cable MSOs contribute and cite the data would bootstrap it to legitimacy under the vague phrase "generally accepted industry data" employed by the Commission.

IV. THE COMMISSION IMPROPERLY EXCLUDES OVERBUILT COMMUNITIES FROM ITS CALCULATIONS.

Finally, the Commission should not limit the application of the horizontal ownership rules to "incumbent" franchises. In 1998, the Commission correctly declined to permit an "effective competition" exception on the grounds that Congress had not authorized it to create such an exception.

Indeed, limiting the horizontal ownership cap to "incumbent" systems directly violates the plain language of the statute. As discussed in Part I *supra*, the statute directs the Commission to limit "the number of cable subscribers a person is authorized to reach through cable systems" in which the person holds an attributable interest. A cable system built by an overbuilder is as much a "cable system" as an "incumbent" cable system. Subscribers to that system are "cable subscribers."

Congress could have given the Commission authority to carve out an exception to encourage overbuilding. It chose not to do so. Given the goal of the statute to limit cable monopsony power and encourage the development of alternate MVPDs, this policy choice makes perfect sense. The Commission has no authority to override Congress' policy choice as expressed in the plain language of the statute, even if it would have made a different choice.

The Commission's bald statement that creating such an exception will “encourage competition, more outlets for programming networks and more choices for consumers” remains wholly unsupported. While overbuilding by existing MSOs might create price competition, the Commission does not explain how it creates new channels for programming or choices for consumers.

Reason suggests just the opposite result should occur. As the Commission itself acknowledges, the larger an MSO in absolute size -- whatever its share of the total MVPD market -- the greater the capacity to exercise monopsony power. An MSO that expands past the subscriber limit by overbuilding will have that many more “eyeballs” with which to influence programmers.

Furthermore, the non-incumbent exception encourages overbuilding by the strong at the expense of the weak. Under the Commission's rule, the largest cable MSOs could extend their reach and use their economies of scale to overbuild and eliminate competition among weaker rivals. These new subscribers would add to the monopsony power of the largest MSOs. It would also allow the larger MSOs to extort "greenmail" from their weaker rivals.

In addition, the Commission's stated rationale for creating the “non-incumbent”exception is to address cable operators “concerns regarding efficiencies of scale and competition with incumbent telephone service providers.” ¶37. The Commission flatly contradicts this rationale in ¶61, wherein the Commission explicitly rejects the argument advanced by the cable MSOs that the Commission should raise the cap to encourage cable operators to offer Internet or telephony services. As the Commission found:

> The cable operators have presented no credible evidence that a larger size is necessary for deployment of advanced technologies or telephony. Moreover, we note the possibility of cooperative arrangements among operators to offer coordinated telephony services through their cable systems, so that a cable operator does not necessarily need to grow in absolute size beyond the limit in order to participate in offering national telephony service.

Id. ¶61.

CONCLUSION

The Commission should reverse the actions challenged here and grant all such other relief as may be just and proper.

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Date: January 3, 2000

ATTACHMENT B

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

In the Matter Of	)	
	)	
Implementation of the Cable Television	)	FCC 99-289,
Consumer Protection and Competition Act of 1992	)	MM Docket No. 92-264
	)	
Implementation of Cable Act Reform Provisions of the	)	
Provisions of the Telecommunications Act of 1996	)	
	)	
Review of the Commission's Cable Attribution Rules	)	

To: The Commission

PETITION FOR RECONSIDERATION OF

CONSUMER FEDERATION OF AMERICA, CENTER FOR MEDIA EDUCATION, ASSOCIATION OF INDEPENDENT VIDEO AND FILMAKERS AND OFFICE OF COMMUNICATION, INC. UNITED CHURCH OF CHRIST

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January 3, 1999

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Before the
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PETITION FOR RECONSIDERATION OF CONSUMER FEDERATION OF AMER-ICA, CENTER FOR MEDIA EDUCATION, ASSOCIATION OF INDEPENDENT VIDEO AND FILMAKERS AND OFFICE OF COMMUNICATION, INC. , UNITED CHURCH OF CHRIST

Consumer Federation of America, Center for Media Education, Association of Independent Video and Filmmakers, and Office of Communication, Inc. United Church of Christ (collectively "CFA, *et al.*") respectfully seek reconsideration of the Commission's *Report and Order*, FCC 99-289, MM Docket No. 92-264, released October 20, 1999 ("*Attribution Order*"), 64 FR 67193 (December 1, 1999), in which the Commission revised its cable television ownership attribution rules.

CFA *et al.* ask that the Commission reverse its decision insofar as it modified its definition of attributable interests of "insulated" limited partnerships and for directors and officers not directly involved in "video programming activities."

SUMMARY

In the "horizontal ownership" provisions set forth at Section 11(f)(1)(A) of the Cable Television and Consumer Protection Act of 1992 ("1992 Cable Act"), 47 USC §613(f)(1)(A), Congress required the Commission to place limits on direct cable system ownership as well as on "cable sytems...in which such person has an attributable interest."

Until now, the Commission has always counted, *i.e.*, "attributed," limited partners' interests as ownership interests, unless they adhere to stringent "insulation" criteria prohibiting "material

involvement" in management or operation of the partnership's "media interests." *Attribution Order* ¶57, 47 CFR 76.501 Note 2(g). Similarly, the Commission has regarded corporate officers and directors as holding "attributable" ownership unless their duties are "wholly unrelated" to the cable company's "primary business." 47 CFR 76.501 Note 2(h).

In the decision under review, the Commission has narrowed the horizontal ownership "insulation" criteria. Now, a limited partnership will be atttributable only if the limited partner is "materially involved" in managing or operating the partnership's "video-programming-related activities," rather than any of the "media interests" of the of the partnership. Attribution Order ¶64. 47 USC §613, 47 CFR §76.503.[1] Similarly, for purposes of the cable horizontal ownership rules, the Commission will, upon request, waive an otherwise attributable interest of an officer or director who promises not to participate in the "video-programming activities" of either entity. *Attribution Order* ¶68.

These amendments have created a loophole which would allow a single operator to maintain influence over cable systems serving the vast majority of American homes. The Commission's decision is incompatible with the statutory goal that cable market power be restricted. It violates clear legislative intent that the Commission employ the same stringent ownership attribution criteria historically applied to the broadcasting industry. Moreover, the Commission arbitrarily and capriciously drafted rules which are so easily evaded and unenforceable that they are arbitrary and capricious.

Even were the new rules statutorily permissible and suitably crafted, they manifest a gross abuse of agency discretion. While the Commission has maintained that they are needed to insure rapid broadband deployment, the Commission has elsewhere acknowledged that such deployment will proceed apace without sacrificing the Cable Act's ownership provisions. Moreover, the new rules

[1]The changes also apply to the companion "cable channel occupancy rules" codified at 47 CFR §504. For simplicity, the text refers only to the cable horizontal ownership rules.

will needlessly jeopardize the Commission's media diversity policies by offering a road map for evisceration of the Commission's attribution rules in broadcasting, DBS and other mass media services.

ARGUMENT

I. THE MODIFICATIONS TO THE INSULATION CRITERIA ARE CONTRARY TO THE PLAIN LANGUAGE OF THE STATUTE, THE INTENT OF CONGRESS, PAST COMMISSION PRECEDENT, AND ARE NOT SUPPORTED BY ADEQUATE REASONING

Over Commissioner Tristani's dissent, the *Attribution Order* contradicts the Commission's historic rationale for application of its attribution criteria, and its own findings in this docket. Until now, a limited partner could not participate in any activity that could influence or effect any "media interest" of the cable operator. This limited insulated partners to truly passive roles. Now, for purposes of the cable horizontal ownership rule, a limited partner may participate in any media interest if the partner promises to refrain from "material involvement" in the partnership's "video-programming-related activities." *1999 Attribution Order* ¶63.

Similarly, prior to the instant *Order*, cable operators could obtain a waiver of their officers' and directors' attribution only by demonstrating that their duties met the stringent criteria of being "wholly unrelated to its [the cable company's] ***primary business***." 47 CFR 501 Note 2(h) [emphasis supplied]. Now, however, the Commission will entertain waivers based solely on a certification that the officer or director "[does] not participate in the ***video programming*** activities of either entity." *Attribution Order* ¶68 [emphasis supplied].

The Commission attempted to justify this extraordinary change by claiming -- without elaboration -- that

where the MSO is not materially involved in the video-programming activities of a limited

> partnership, its investment does not extend its national programming power and the concerns of Section 613 are not implicated.

Id. ¶63.

Rather than explaining this extraordinary leap from all prior precedent, the Commission emphasized its statutorily irrelevant (and unsupported) view that

> where [video] programming is not affected, the current insulation criteria prevent investments between companies whose combination may bring benefits to the public, such as cable broad-band and telephony services and competition to the incumbent local exchange carriers on the Internet.

Id. This is not a basis upon which the Commission can ignore the language and intent of the statute.

A. The Commission's New Interpretation Of §613 Violates The Plain Language Of The Statute, The Legislative History, and Commission Precedent Interpreting The Purpose of §613

The Commission now asserts that the horizontal ownership limits of §613 exist exclusively "to address the ability of one MSO, or a group of MSOs, by virtue of their size, to affect the flow of programming from programmers to consumers." *Attribution Order* ¶63. Such an interpretation violates the plain language and legislative history of §613. Section 613(f)(1) in fact states:

> ***In order to enhance effective competition***, The Commission shall...conduct a proceeding (A) to prescribe rules and regulations establishing reasonable limits on the number of cable systems owned by such person, or in which such person has an attributable interest.

1. The Plain Language of §613(f)(1)

The Commission cannot ignore the plain language of §613(f)(1), which gives the purpose of the horizontal ownership limits as promoting "effective competition," and substitute the narrower purpose of merely protecting the video programming market. "Effective competition" has a precise

meaning, defined in terms of the number of alternative MVPDs servicing a local franchise area.[2]

As this purpose demonstrates, Congress intended the structural protection of the horizontal ownership limits to protect competition in the video marketplace ***generally***. While this includes protecting the video programming development market, it also includes promoting competition among alternative non-cable MVPDs and protecting consumers from the general exercise of market power by cable MSOs in the absence of effective competition. As discussed below, the Congressional findings and policy in Section 2 of the 1992 Cable Act, the legislative history of the horizontal ownership limits, and the Commission's previous interpretation of §613(f) are consistent with the plain language that the horizontal ownership limits are intended to promote "effective competition" in the video marketplace generally, not merely in one narrow facet such as the programming development market.

The Commission's error is in its claim that "where the MSO is not materially involved in the video-programming activities of a limited partnership, its investment does not extend its national programming power and the ***concerns*** of Section 613 are not implicated."

[2]*See* 47 USC §623(l), §613(a)(3) (defining "effective competition" with reference to §623(l)). Section 613(a)(3) refers to the MMDS/SMATV cross-ownership limits. It is, however, the only place in §613 where "effective competition" is defined.

In fact, the "concerns" of §613(f) are dramatically implicated when an MSO is "materially involved" in decisions outside of video-programming activties. As discussed above, Congress designed §613(f) to "enhance competition" in the broader video marketplace. This included concerns regarding diversity, encouraging new entrants to both the MVPD and programming marketplace, and preventing anticompetitive practices by cable MSOs.[3] Therefore, contrary to the Commission's assertion quoted above, the concerns of §613(f) are implicated any time an MSO is "materially involved" in another cable operator's "media interests."

The Commission similarly errs in finding support for its reading in §613(f)(2)(A), which instructs the Commission to "ensure that no cable operator or group of cable operators can unfairly impede...the flow of video programming to the consumer." §613(f)(2)(A). Section 613(f)(2) actually enumerates ***seven*** objectives which, "among other public interest objectives," the Commission must accomodate. §§613(f)(2)-(f)(2)(G). These include, *inter alia*, a directive to "take particular account of the market structure, ownership patterns, and other relationships of the cable marketing 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***." §613(f)(2)(C).

To be sure, the Commission has discretion in how it balances the various public interest factors it must consider. However, it cannot properly read a single objective as the ***exclusive*** purpose of §613(f)(1). To describe the national video programming market as the only competitive target of

[3]*See* §623(l) (defining "effective competition" as competition among MVPD providers); *See also Report of the Senate Committee on Commerce, Science, and Transportation*, S. Rep. No. 92, 102d Cong., 1st Sess. at 32-34 (1991) ("Senate Report"); *Report of the Committe on energy and Commerce on the Cable Television Consumer Protection and Competition Act of 1992*, H.R. Rep. No. 102-628 at 43 (1992) ("House Report").

§613(f) is an impermissible contraction of the law.

Even without Congress' explicit statement that it enacted the horizontal ownership limits to promote "effective competition," such an interpretation would be arbitrary and capricious. The Commission has discretion in how to balance the listed factors, but it must consider ***all*** of them. To explicitly consider only a single factor, and ignore both the remaining listed factors and the other public interest considerations the Commission must consider, exceeds the Commission's discretion.

2. Other Sections of the 1992 Cable Act Support CFA *et al.*'s Interpretation

In addition, other sections of the statute support CFA *at al.*'s interpretation of the purpose of the horizontal ownership limitation as designed to prevent a variety of evils attendant upon concentration of ownership in the cable market generally, not the narrow interference in video programming given by the Commission as the exclusive reason for the cable horizontal ownership limits imposed by §613(f). Congress made explicit findings that concentration of the cable industry creates "barriers to entry to new programers" and "reduce[s] the number of media voices available to consumers." 1992 Cable Act §2(a)(4). Congress stated its policy that, where cable operators are ***not*** subject to "effective competition" (which Congress stated in §613(f) it would promote through the cable horizontal ownership limits), the 1992 Act must "ensure...that consumer interests are protected" and ensure that "cable television operators do not have undue market power vis-a-vis video programmers and consumers." 1992 Cable Act, §§ 2(b)(4)-(5).

3. The Legislative History of §613(f) Indicates Congress Had Broader Concerns Than The Video Programming Market

As Commissioner Tristani observed in her dissent, the legislative history of §613(f)(1) does not support the narrow intent and purpose the Commission majority now finds applicable. Rather, "in enacting Section 613, Congress expressed many of the same competition and diversity concerns that underlie our broadcast ownership rules." *Tristani Dissent*, at 1. These concerns are not limited

to "impede[ing] the flow of video programming from programmers to consumers." *Attribution Order* ¶63. They include the concern that large cable companies "could discourage entry of new programming services, restrict competition, impact adversely on diversity, and have other undesirable effects on program quality and viewer satisfaction." House Report at 43.

4. The Purpose of Horizontal Ownership Limits Given

Finally, as Commissioner Tristani also observed, the Commission's own precedent interpreting the §613(f)(1) belies the interpretation given in the *Attribution Order*. Previously, the Commission understood the cable horizontal ownership limits as addressing the same concerns as the broadcast attribution criteria, *1993 Cable Order*, 8 FCCRcd 8565, 8581, *i.e.* "to ensure competition and diversity in the video marketplace." *1998 Cable Attribution NPRM*, 13 FCCRcd at 12993. This is far broader than the narrower purpose the Commission now ascribes to the cable horizontal ownership limits. The Commission fails, however, to explain why it has departed from its previous understanding. To modify the existing rules on the basis of this unexplained departure is arbitrary and capricious.

B. The Commission's Interpretation of §613(f) in the *Attribution Order* and Modification of the Insulation Criteria Violate the Legislative History Of the Statute and Commission Precedent Generally

Section 11(f) of the Cable Television and Consumer Protection Act of 1992 ("1992 Cable Act"), codified at 47 USC §613(f), requires the Commission to base its horizontal ownership cap on the number of cable systems owned "or in which such person has an attributable interest."

The use of the term "in which such person holds an attributable interest" was neither novel nor accidental. It adopted by explicit reference the Commission's longstanding definition of what constitutes media ownership,[4] focusing upon an entity's ability to exercise "influence" (even in the

[4]Certain cable operators have insisted that the Commission should attribute only majority stock ownership. It bears emphasis that the Commission treats ownership and investment interests as

absence of outright control) on the operation of a media outlet.[5]

This was emphasized in the unusually explicit legislative history. The Senate Report stated that the drafters of the bill intended the Commission to use the same attribution criteria as those applicable to broadcasters. Senate Report at 80. Since Congress ultimately adopted the Senate version of the ownership limits, this legislative history is especially powerful evidence of the jurisdictional committee's intent. The Commission heeded this directive in its implementation. *1993 Order*, 8 FCC Rcd at 8581 (1993) ("1993 Order")[6]

1. The Commission's 1999 *Attribution Order* Violates The Legislative Intent That the Commission Use the Broadcast Attribution Rules

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attributable without regard to nomenclature, based upon whether the interest brings with it the opportunity to influence the operation of the property. Note 1 to 47 CFR §76.501 states that "The word 'control' as used herein is not limited to majority stock ownership, but includes actual working control in whatever manner exercised."

[5]The Commission, in fact, rejected in the *Attribution Order* the "control test" proposed by the cable companies precisely because it "[did] not take into account the variety of ways that an investor may exert influence or control over a company." ¶36. Similarly, the Commission declined to raise the level of voting stock considered non-attributable above the existing 5% limit because it found that "interest holders of 5% can likely exert considerable influence on a company's management and operational decisions." ¶46.

[6]Its 1992 notice of proposed rulemaking articulated appropriate attribution criteria. *Cable Attribution Notice*, 8 FCC Rcd. 210, 217 (1992) ("*1992 NPRM*"). *See also*, *Cable Attribution Rules*, 13 FCCRcd 12990, 12993 (1998)("*1998 Cable Attribution NPRM*"); *Cable Attribution Reconsideration and FNPR*, 13 FCC Rcd 14462, 14490-91 (1998) ("*1998 Order*").

The legislative history directs the Commission to employ the broadcast attribution criteria in crafting cable attribution standards. It has not done so here. Instead, it has created a loophole in the attribution criteria so great that it swallows the whole.

The Commission has failed to explain why it departed from the broadcast criteria. Indeed, the remainder of the *Attribution Order* contradicts this reasoning, as well as 15 years of Commission precedent in the area of attribution generally and precedent on cable horizontal ownership limits since their inception.

In adopting the broadcast attribution criteria when implementing §613, the Commission recognized that "the legislative history of the 1992 Cable Act supports the use of the broadcast attribution criteria." *1993 Order*, 8 FCCRcd at 8581. The Commission reaffirmed this interpretation in the instant *Order*, stating:

> the cable operators have not presented a valid basis for a radical departure from our attribution rules framework, ***a framework that Congress found appropriate*** for the Commission to consider for the horizontal ownership rules.

Attribution Order ¶33.

Despite this acknowledgment of the jurisdictional committee's intent, and despite the determination that the cable operators failed to present a "valid basis for a radical departure" from the broadcast-type rules, the Commission makes exactly such a radical departure in the *Attribution Order*. The Commission does not explain this contradiction and departure from the legislative intent.

The Commission has an especially high burden to meet in adopting a more expansive standard where Congress so clearly considered the issue and expressed an intent that cable ownership be carefully delimited. While the Senate Report recognized that the agency should have some flexibility, by allowing it to employ "other criteria the FCC may deem appropriate," this language does not give the Commission license simply to ignore the Senate Report's expressed preference for the broadcast

attribution criteria. Rather, the quoted language imposes a duty to present a powerful justification for permitting greater latitude for cable operators.

As explained below, the Commission has failed to justify the changes by any standard, let alone under the heightened standard imposed by the legislative history and Commission precedent interpreting that history.[7]

The Commission's determination to vary from its past interpretation of the legislative history without proper explanation is both arbitrary and capricious. This error is compounded by the Commission's own acknowledgment in this very *Order* of the legislative intent and the failure of the cable operators to justify any significant change. On reconsideration, the Commission should reverse the new insulation criteria to the horizontal ownership attribution criteria.

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[7]Because Congress enacted the cable horizontal ownership limits to constrain the power of cable MSOs and enhance effective competition, 47 USC §613(f)(1), the Commission has a far higher burden in applying more liberal criteria than for tightening them. Thus, for example, while the Commission's elimination of the single majority shareholder exemption, *Attribution Order* ¶81, departs from the broadcast attribution criteria, the Commission adequately met the burden imposed by the legislative history and justified this departure. As the *Attribution Order* stated, the single majority shareholder rule makes little sense as applied to cable in light of the Commission's determination that even minority shareholders may exercise considerable influence or control of an entity. *Id*. Accordingly, the exemption should be eliminated in both services. Because the use of this provision has been widespread in the broadcasting industry, the Commission more plausibly points to the difficulties of eliminating it in that service. By contrast, no one has taken advantage of this exemption in the cable service, or indicated an intention to do so. *Id.*

C. The Commission's *Attribution Order* Breaks With Established Precedent Without Adequate Explanation and In Contradiction With the General Conclusions Of The Order

The *Attribution Order* is inconsistent with its own reasoning and with past precedent in both the cable and broadcasting services. The Commission should therefore reconsider this arbitrary decision and reverse the changes to the insulation criteria. In the instant *Order*, the Commission radically departs from its previous decisions on appropriate "insulation" criteria for limited partners, officers, and directors. The 1999 *Attribution Order* eliminates the previously strict requirement that a limited partner refrain from even indirectly influencing the "media interests" of a partnership and instead requires forbearance from participating in "video-programming related activities." Similarly, the even stricter restrictions on officers and directors -- that their duties be "wholly unrelated" to the cable company's business -- has been replaced with a requirement to refrain from "video-programming related activities."

The Commission purported to base these changes on a new understanding of the purpose behind the horizontal ownership rules. Yet only a few paragraphs previously, the Commission found that cable operators had failed to provide any reason for altering the attribution criteria used in determining the cable horizontal ownership limit:

> The cable operators focus their arguments on the attribution rules applicable to the horizontal ownership rules. However, the cable operators have not presented a valid basis for a radical departure from our attribution rules framework, a framework that Congress found appropriate for the Commission to consider for the horizontal ownership rules. The cable operators have not shown differences in ownership, financing or management structures between cable and broadcast industries that would warrant creating such a different type of attribution standard for the cable horizontal ownership or other cable rules.

Attribution Order ¶33.

The Commission also determined that "we find no basis to alter our conclusion that...our limited partnership insulation criteria are necessary to identify partnership interests that confer influence or control." *Id.* ¶61. As the Commission noted, "the insulation criteria are designed to

identify situations in within which it is safe to presume that a limited partner will not be materially involved in the media management and operations of the partnership." *Id.* Accordingly, the Commission rejected the request by cable MSOs to loosen the attribution criteria generally. *Id.* ¶¶61-62.

The Commission's decision to alter the attribution criteria in the cable horizontal ownership limits, despite the its finding that cable operators had failed to make the case for any such "radical departure" and the Commission's defense of the underlying principles of the attribution criteria and the attribution criteria generally, is utterly irrational, arbitrary and capricious.

The Commission cannot claim that altering the insulation criteria from prohibiting involvement in "media interests" to prohibiting involvement in "video-programming-related activities" is a minor change rather than a radical departure. Indeed, the Commission's past precedent belies such a claim; furthermore, the Commission's departure from this precedent without adequate explanation underscores the irrational and arbitrary nature of the changes wrought by the instant *Attribution Order*.

1. History Of The Insulation Criteria

The Commission did not choose to apply (and the Senate Committee did not endorse using) the broadcast attribution criteria to the cable horizontal ownership limits by chance or by reflex.

As an initial matter, it is worth noting that these rules were developed with cable systems in mind, and applied to cable system owners to the extent applicable under the existing rules. *1998 Cable Attribution NPRM*, 13 FCCRcd at 12992; *Corporate Ownership Reporting and Disclosure By Broadcast Licensee*s, 97 FCC2d 997, 998 (1984) ("*1984 Attribution Order*") (*Report and Order* "comprehensively review[s] and revise[s] the standards for attributing interests in broadcast, ***cable television***, and newspaper properties.")

The Commission developed the attribution criteria, and their very limited exceptions, with due

deliberation -- balancing the need to ensure the independence of the licensee with the need to assure licensees access to needed capital. *See generally id., reconsideration granted in part, denied in part,* 58 R.R.2d 604 (1985) ("*1985 Attribution Recon*"), *clarified* 1 FCCRcd 802 (1986) ("*1986 Attribution Clarification*"). Yet the Commission departs from this history without explanation, failing to explain why safeguards previously found necessary are no longer needed.

Prior to the *1984 Attribution Order*, the Commission attributed the media interests of a partnership to all parties in the partnership. *1984 Attribution Order*, 97 FCC2d at 1022. In the *1984 Attribution Order*, the Commission altered its policy in recognition of the fact that a truly passive investment through a limited partnership that conferred "no influence or control over the licensee" could serve valuable public purposes. Specifically the Commission recognized limited partnerships "provide[] another source of capital for the industry without inherently affecting the distribution or concentration of control within the industry." *Id.* at 1022-23.

The Commission therefore sought to establish "some means ...to verify appropriate insulation of the general partner from ***any possibility*** of control or influence by the limited partners." *Id.* at 1023 (emphasis added). Accordingly, the Commission held that:

> [a]ny limited partner relieved of attribution by these provisions may not be involved in any material respect in the management or operation of the broadcast, cable television, or newspaper entity concerned.

Id.

On reconsideration in 1985, the Commission provided the strict criteria for insulation set forth in 47 CFR 73.3555 Note 2. The Commission defended its "no material involvement" standard and the insulation criteria as:

> provid[ing] an appropriate mechanism to enable the Commission to verify that limited partners who are relieved from attribution will lack the ability to influence or control partnership affairs.

1985 Attribution Recon, 58 RR2d ¶43.

The Commission has explicitly rejected suggestions that any significant involvement in the operations of the partnership can be neatly partitioned. For example, in 1986, the Commission rejected a request that it clarify that rendering legal services was not "material involvement" in media activities; the Commission found that:

> A partner whose contribution is in the form of personal services and expertise rather than in the form of a financial investment is the antithesis of a passive investor. Indeed, ***it is virtually inevitable that such a partner will become involved in partnership affairs.***

1986 Attribution Clarification, 1 FCCRcd at 804.

The Commission again reaffirmed these general conclusions in August 1999 -- only two months before issuing the instant *Attribution Order*. *See Review of the Commission Regulations Governing Attribution of Broadcast and Cable/MMDS Interests*, 14 FCCRcd 12559 (1999).

Significantly, the Commission has imposed ***even stricter*** insulation criteria for officers or directors. The Commission will only consider a request for a waiver of attribution for an officer or director where the officer or director's "duties and responsibilities are ***wholly unrelated*** to [the cable operator's] primary business." 47 CFR 501 Note 2(h). This follows logically from the Commission's conclusion that it is "virtually inevitable" that someone involved in one aspect of the partnership will become generally involved in all partnership affairs, and cannot help but influence decisions outside the officer's or directors defined duties.

Indeed, the Commission created the insulation criteria for officer and directors in 1984 for the extremely narrow purpose of "provid[ing] attribution relief" for officers in large corporations "where these individuals' duties and responsibilities are neither directly nor indirectly related to the activities of any broadcast licensee in which their corporation has a cognizable interest." *1984 Attribution Order*, 97 FCC2d at 1025. As the Commission stressed, however:

> The scope of our intention in this regard is narrow, however, for we do not intend to permit officers or directors to disclaim their interests as a matter of course....Generally, the influence over a licensee wielded by these individuals is significant and should be cognizant if the

purposes of our multiple ownership rules are to be properly vindicated.

Id.

2. The Commission's Application Of The Insulation Criteria of the Attribution Criteria to Cable Horizontal Ownership Limits Has Always Reflected the Historic Purpose Prohibiting Any Material Involvement By the Insulated Partner.

Earlier in this proceeding, in the *1993 Report and Order* adopting the attribution criteria for cable horizontal ownership limits, the Commission explicitly rejected cable industry requests to adopt attribution criteria permitting greater involvement by limited partners or other non-attributable interest holders in the affairs of the partnership or licensee. The Commission rejected the claim that the purposes of Section 613 required different attribution criteria than those employed in broadcasting. As the Commission reasoned at the time:

> In employing the [broadcast attribution] criteria for this purpose, ***we note that the objectives of the broadcast attribution model are consistent with our goals in establishing ownership standards for subscriber limits.*** In this regard, the broadcast attribution rules focus on thresholds that enable a broadcast licensee to influence or control management or programming decisions. ***We believe these same issues are relevant to addressing the concerns at issue in this proceeding relating to the ability of cable operators to unduly influence the programming marketplace.***

1993 Order, 8 FCCRcd at 8581.

Indeed, the only question which troubled the Commission was whether the broadcast attribution criteria were ***sufficient*** to effectuate the purposes of the horizontal ownership limits, or whether to impose stricter standards to ensure "competition and diversity in the video marketplace."

1998 Cable Attribution NPRM, 13 FCCRcd at 12993.

By contrast, the Commission stated in the 1999 *Attribution Order*:

> where the MSO is not materially involved in the video-programming activities of a limited partnership, its investment does not extend its national programming power and the concerns of Section 613 are not implicated.

Attribution Order ¶63.

Despite this direct contradiction between the two Orders, the 1999 *Attribution Order* is

stunningly bereft of any explanation as to why it modified its 1993 conclusion that "the objectives of the broadcast attribution model are consistent with our goals in establishing ownership standards for subscriber limits." It does not explain why it is no longer true that "the same issues are relevant to addressing the concerns at issue in this proceeding relating to the ability of cable operators to unduly influence the programming marketplace."[8]

The Commission's failure to justify these departures from precedent are magnified by the legislative history, which directs the Commission to apply the broadcast attribution rules to §613 unless it justifies some other standard as appropriate. Senate Report at 80. The Commission recognized this legislative imperative in its 1993 Order adopting the attribution rules applicable to Section 613, *1993 Order*, 8 FCCRcd at 8581, reaffirmed this understanding in 1998, *1998 Cable Attribution NPRM*, 13 FCCRcd at 12993, and acknowledged it again in the instant *Attribution Order*. *Attribution Order* ¶33. Yet the Commission does nothing to meet this burden or explain why its past interpretation was in error.

CFA *et al*. cannot state the Commission's failure better than Commissioner Tristani has already done in her dissent:

> The Commission has repeatedly recognized that it is one entity's ability to influence or control the management ***or*** programming decisions of another entity that implicate the concerns of Section 613. [emphasis in original] The majority, however, acts as if it were writing on a blank slate by ignoring the ability to influence or control a partnership's management and focusing only on programming-related decisions. The majority does not claim that the broadcast criteria, affirmed by the Commission only two months ago, are wrong. But nor does the majority attempt to explain why our prior precedent is wrong - i.e. why the broadcast attribution criteria do not really address the same issues here. Indeed, the majority

[8]Nor, in reference to the exception for officers and directors, does the Commission explain why it has deviated from its previous reasoning that "it is virtually inevitable" that one involved in any single material aspect of the partnership's affairs "will become involved in the partnership's affairs" generally.

> would find any such attempt difficult, since, in enacting Section 613, Congress expressed many of the same competition and diversity concerns that underlie our broadcast ownership rules.

Tristani Dissent at 1 [emphasis added, footnote omitted].

3. The Commission's Determination To Modify the Insulation Criteria For Officers and Directors Deviates Precipitously From Past Precedent

The Commission departs in a similarly arbitrary manner in altering the insulation criteria for officers and directors. The Commission in 1984 considered and rejected an argument similar to that embraced by the Commission in the *1999 Attribution Order* -- that a licensee's desire for expert officers and directors should trump the public interest in seeing the attribution criteria properly employed.

In 1999, the Commission held that it should permit insulation of officers and directors so that multiple cable companies may benefit from this expertise. "Permitting directors or officers who have knowledge and expertise in areas other than video programming...will benefit the cable company as technologies converge." *1999 Attribution Order* ¶68.

By contrast, the Commission in 1984 was far more concerned with protecting the public interest than "benefit[ing] the cable company." The *1984 Attribution Order* found:

> We recognize, as various parties contend, that this approach may impose constraints on the availability to interested corporations of officers and directors with "media expertise" because it restricts the limited number of such individuals from serving in these capacities on behalf of multiple corporate licensees. It is, however, ***precisely the ability of an officer or director***, particularly one with "media expertise," ***to influence multiple licensees that our ownership rules are intended to detect and limit***, and properly so.

1984 Attribution Order, 97 FCC2d at 1025.

II. THE MODIFICATIONS DO NOT WORK IN THE REAL WORLD, ARE IMPOSSIBLE TO ENFORCE, AND RENDER THE ATTRIBUTION CRITERIA A NULLITY

The irrationality of the Commission's decision alone requires its reversal.

The attribution criteria have always recognized the important truth that a person or entity can

exercise influence or control over a licensee without formal control. Here, for the first time, the Commission has allowed form to take precedence over substance under the attribution criteria -- rules designed precisely for the purpose of insuring that the substance of influence and control are constrained by reality rather than corporate form.

Departing from its precedents on attribution generally and its consistent precedent under the 1992 Cable Act, the Commission announced it will modify the insulation criteria for limited partners, officers and directors. No longer will the Commission require a limited partner to refrain from any "material involvement" in a license's "media interests." Nor will the Commission require that an officer's or director's duties be "wholly unrelated" to the licensee's primary business as a condition of considering a waiver request. Instead, for purposes of the cable horizontal ownership limits, the Commission will no longer count an interest properly attributable in exchange for a promise not to interfere with "video-programming related activities."

As Commissioner Tristani pointed out in her dissent, however, these rules simply will not work in the real world. The Commission cannot realistically expect that partners, officers and directors can neatly "cordon off" (in the words of Commissioner Tristani) video-related activities from other concerns. Nor can the Commission pretend, in the face of its own experience, that formal separation of functions will prevent a limited partner, officer or director from exerting influence over the video-related decisions of the partnership as a whole.

For years, the Commission has recognized -- and all in all other respects continues to recognize -- that "influence" takes many forms, open and pernicious. Because the Commission's rules act to safeguard vital First Amendment principles of diversity, in addition to protecting new entrants and encouraging economic competition, the Commission has always imposed clear, bright line attribution criteria that safeguard the public interest.

In the context of the cable horizontal ownership limits, the Commission has recognized that

Congress imposed these rules to create structural safeguards protecting consumers and non-cable multi-video programming distributors (MVPDs) from the power over programming exercised by large MSOs. *Cable Horizontal Ownership Limits, Third Report & Order* ¶¶15-16 (rel. October 22, 1999) ("*Horizontal Ownership Third Report & Order*). Until now, the Commission had always understood that Congress created these structural rules "to ensure competition and diversity in the video marketplace." *1998 Cable Attribution NPRM*, 13 FCCRcd at 12993. By weakening the cable horizontal ownership attribution criteria, the Commission has eroded these important structural safeguards and jeopardized "competition and diversity in the video marketplace."

A. The New Rules Elevate Form Over Substance By Creating Distinctions On Paper That Do Not Exist In The Real World

The downward departure from the traditional strict standards for insulation previously imposed by the Commission undercuts the entire purpose of the attribution criteria, to "focus on ownership thresholds that enable a...licensee to influence or control management or programming decisions." *1993 Attribution Order*, 8 FCCRcd at 8581.[9] Even where paper separations exist, the supposedly "independent" officers or entities cannot help but know of and be influenced by the video-programming issues that affect the partnership as a whole. The Commission has already observed this phenomenon in the context of AT&T's (referred to as TCI's) arrangements with other "independent" cable companies in which it has attributable interests.[10]

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[9] As Commissioner Tristani observed in her dissent: "The majority's belief that 'programming activities' can be neatly cordoned off from other management functions is illusory. In the real world, the ability to influence a partnership's core business activities inevitably involves the ability to at least indirectly affect the various activities, such as programming, in which the partnership is involved. Until today, the Commission has always recognized this common sense proposition. *Tristani Dissent* at 2.

[10] Attachment C of the *Attribution Order* documents AT&T's web of relationships, prompting the Commission to observe: "[AT&T's] relationships with its partners demonstrates the influence that an investor can have over an entity, even if the investor does not have actual, operational control over

an entity's programming. Each of [AT&T's] partners may take advantage of [AT&T's] industry alliances, even if it is not required to do so." *Attribution Order* ¶37.

1. The Convergence of Cable and Other Communications Media The Commission Intends to Promote Will Only Increase the Ability of "Insulated" Parties To Interfere In Video Programming Decisions

The intertwined cross-marketing and technical issues associated with convergence of cable and other communications technologies -- the very convergence the Commission purports to promote by loosening the attribution criteria -- can only cause the incidence of intersections between "video-programming" and "non-video-programming" to increase. The Commission therefore cannot realistically expect that partnerships formed or officers and directors employed for the purposes of Internet deployment or telephony will not "directly or ***indirectly***" control or influence the video-programming related activities of the cable company in question.

The Commission's rules fly in the face of the very goals of the Commission in loosening the insulation criteria: to promote convergence of cable and other communications services. In this very proceeding the Commission has heard how cable MSOs can influence the video-programming decisions of entities that on paper appear independent. To ignore these facts and loosen the insulation criteria is irrational, arbitrary and capricious.

2. The Commission's Decision to Accept Artificial Separations Is Particularly Irrational and Dangerous In the Case of Officers and Directors

The Commission's willingness to grant waivers of attribution freely for officers and directors who pledge to "not participate in the video programming activities of either entity"is particularly irrational and arbitrary.[11] Because officers and directors participate in the important decisions

[11]As Commissioner Tristani stated in her dissent: "In particular, the Commission has always recognized that the potential influence of officers and directors is significant, and should be attributable to a broadcaster or cable operator whenever these individual's duties relate to the media activities of the company." *Tristani Dissent* at 2.

governing the policies and operations of both the licensee's and the "insulated entity's" business, the Commission has always been extremely reluctant to grant officers and directors attribution relief. Officers and directors cannot help but be aware of, and be influenced by, the interests of the companies that appoint them, pay their salaries, and in which they may have a significant financial interest.

Furthermore, officers and directors are in the best position to exert influence or control over the cable operator. Thus, officers and directors are uniquely placed to coordinate the activities of cable MSOs in an anticompetitive fashion and to, directly or indirectly, influence the decision-making process of the licensee. The Commission recognized in 1984, when formulating the "narrow" insulation criteria for officers and directors and imposing the previous strict regime, that paper separations cannot prevent the reality that officers and directors influence policy beyond the scope of their official duties.[12]

3. The Acceptance of Paper Assurances In The Face of Reality Is Contrary To The Commission's Other Recent Actions In Attribution

The Commission's refusal to recognize relationships that convey influence or control in the real world in preference to paper assurances of independence runs counter to the Commissions other recent actions in attribution. For example, the Commission's adoption of the equity-plus-debt (EDP) rule in this *Order, Attribution Order* ¶¶82-92, and in the August 1999 *Broadcast Attribution Order*, 14 FCC Rcd 12559 (1999), recognize the reality that, in the words of Chairman Kennard, "debt instruments can be a source of influence over a licensee." 14 FCCRcd at 12659.[13]

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[12]As the Commission stated: It is "precisely the ability of an officer or director...to influence multiple licensees that our ownership rules are intended detect and limit, and properly so." *1984 Attribution Order* 97 FCC2d at 2025.

[13]Similarly, in the August 1999 *Broadcast Attribution Order*, the Commission found that limited marketing agreements (LMAs) -- a device through which a broadcast licensee sells substantially all of its time to another licensee -- constitutes an attributable interest. The Commission took this step because it found that, despite maintaining the independence of the licensee on paper, the LMA

conferred "a degree of influence and control that warrants ownership attribution." In the words of Chairman Kennard, unattributed LMAs "represent a kind of artifice," a means to "circumvent our ownership limits" and evade the Commissions rules.

It is therefore utterly inconsistent of the Commission to create a new "artifice" to "circumvent our ownership limits" by loosening the attribution criteria. The Commission should undo the loophole it has created and restore the insulation criteria to their previous state.

B. The New Insulation Criteria Are Unenforceable

The Commission has no mechanism in place to enforce an insulated partner's, officer's or director's pledge not to interfere, directly or indirectly, with the video-programming related activities of the cable company in question. Nor can injured parties or citizens groups monitor what happens in a company's corridors or conference rooms, where violations will take place. Even if the Commission intended to conduct random audits of MSOs, or permit complainants to depose possible violators on a monthly basis, violations of the promise to avoid involvement in video programming would remain undetectable.

In addition, the attribution criteria have always recognized that the ability to influence a corporations activities goes well beyond any overt power or expression of preference. As discussed above, if a director or limited partner has well-known programming interests, other directors or partners will not knowingly act against those interests. This chilling effect is not something that can be enforced against a company that has certified that such interference will not happen. No paper trail will ever reveal itself to any audit or discovery, no matter how intrusive.

The attribution criteria have always recognized this basic fact. As the Commission noted in 1984, when it rejected case-by-case adjudication in favor of bright-line benchmarks:

> For reports required on a regular basis, the determinations would have to be made repeatedly due to slightly changing circumstances from one report to the next. If reports were not required regularly, the Commission would be entirely dependent on the haphazard notification that would result only when it occurred to an outside party that certain multiple interests might violate the rules and that the Commission should be advised.

1984 Attribution Order, 97 FCC2d at 1010.

The certainty that violations will take place, coupled with the inability to prove these

violations or enforce the rules, renders the attribution criteria a nullity. To pretend to preserve the integrity of the rules, while modifying them in such a way as to make them unenforceable and therefore useless, is at best irrational and at worst hypocritical. In either case, the Commission should reverse itself on reconsideration and restore the previous criteria.

C. Reliance On Case By Case Adjudication Defies Commission Precedent In Attribution and the Commission's Recent Statements Disfavoring Waivers

The *1999 Cable Attribution Order* invites waiver applications for officers and directors seeking to insulate themselves under the newly announced insulation criteria. *1999 Attribution Order* ¶68. Although the old rules had also required a party seeking an exemption from attribution to apply for a waiver, the Commission's strict criteria and adherence to the principles behind the attribution rule discouraged waiver applications. Now, the Commission has actively encouraged them and invited a new regime of case-by-case adjudication.

1. The Commission Has Traditionally Rejected The Case-By-Case Approach

Since 1984, the Commission has attempted to eliminate case-by-case determinations in favor of bright line rules. As the Commission explained in its *1984 Attribution Order*:

> Finally, the Commission will not return to the us of *ad hoc* determinations for attributing ownership....Such a procedure would be virtually impossible to administer, if only for the sheer volume of determinations that would have to be made.... Furthermore, such a procedure would inevitably lead to unpredictable and inconsistent results, even if specific criteria...were employed....Even under existing, specific attribution criteria, the Commission is called upon to make innumerable individual judgements in the context of waiver requests and situations not contemplated by the rules.

1984 Attribution Order, 97 FCC2d at 1010.

Indeed, in the instant *Attribution Order*, the Commission rejected several requests by cable operators for case-by-case determinations. For example, the Commission rejected the proposal for case-by-case determinations of control, *1999 Cable Attribution Order* ¶38, stock benchmarks, *id.* ¶45, and equity-plus-debt. *Id.* ¶92. Similarly, the Commission eliminated its long-standing cross-

interest policy to reduce the number of individual determinations made under the attribution rules. *1999 Broadcast Attribution Order*, 14 FCCRcd at 12609. As the Commission found, such case-by-case determinations involve too many variables. Furthermore, critical variables are subject to change over time, which would either require ongoing monitoring or would permit entities to acquire influence over licensees over time.

In addition, the Commission found that case-by-case determinations create regulatory uncertainty, potentially chilling investment, and increase the administrative burden on both the agency and on applicants.

The Commission's decision to embrace and encourage case-by-case determinations in the context of the cable horizontal ownership limits, while rejecting them emphatically in all other contexts, is both arbitrary and ill-advised. Notably, the Commission does not explain ***why*** the reasons for rejecting case-by-case determinations and waivers do not apply in this context.

2. Liberal Waiver Policies Have Proven Unsuccessful

Only a few months ago, the Commission recognized the error of encouraging, in the words of Chairman Kennard "administration by waiver, not by rule." *1999 Broadcast Attribution Order*, 14 FCCRcd at 12658. As part of its revision the Commission determined it would consider LMAs for more than 15% of a station's time an attributable interest. *Id*. at 12597. In separate statements, the majority of the Commissioners expressed their regret that the Commission had granted extensive waiver relief. As Commissioner Ness stated:

> I have long felt that our rules were susceptible to "gaming." We have been too willing to permit through the back door what we would not countenance through the front....As a consequence, we have penalized those who most dilligently followed the letter and spirit of our rules, and rewarded those who "pushed the envelope" most aggressively.

Id. at 12661.

Yet, only a few months later, the Commission invites precisely the sort of "gaming" condem-

ned by Chairman Kennard and Commissioner Ness. CFA *et al.* warn the Commission that, unless it reconsiders its decision, it will come to regret the its decision to "administ[er] by waiver, not by rule."

III. THE MODIFICATIONS ARE NOT NECESSARY TO EFFECTUATE THE COMMISSIONS GOALS AND CREATE BAD PRECEDENT

Capping the irrationality of the Commission's action, the Commission itself has recognized that it need not do such violence to its rules to encourage the deployment of Internet and telephony services.[14] In the *Horizontal Ownership Order*, released the same day as the *Attribution Order*, the Commission observed that cable MSOs have a variety of permissible relationships at their disposal through which to offer Internet and telephony services; they need not acquire new ownership interests to provide nationwide service. *Horizontal Ownership Third Report & Order*, ¶61. The Commission also found evidence that ample capital is available to the cable industry to finance deployment of advanced services, even under the current attribution criteria. *1999 Attribution Order* ¶51.

Finally, CFA *et al.* observe that the Commission's bad policy choices in the cable attribution criteria will inevitably poison the attribution criteria in other services as well. Now that the Commission has shown its willingness to ease the insulation criteria and invited case-by-case waivers, it should expect merger applicants in other services to request similar special treatment.

Furthermore, the Commission will face similar arguments for attribution relief as it encourages other services to deploy Internet and other communications services. For example, the Commission has recently expressed its expectation that digital television licensees will provide multiple services in addition to broadcasting. *See Public Interest Obligations of Broadcast Licensee*, FCC 99-390 (released December 20, 1999). It is inevitable that digital licensees will press the

[14]When AT&T acquired TCI, for example, the Commission found compelling that AT&T's expensive investment would drive it to deploy new services ***in the absence of any other incentive.*** *Applications for Consent to the Transfer of Control of Licenses and Section 214 Authorizations from Tele-Communications, Inc. to AT&T Corp.*, 14 FCCRcd 3160, 3230 (1999).

Commission to loosen the insulation criteria so that they, like the cable MSOs, can "bring benefits to the public, such as []broadband and telephony services." *1999 Attribution Order* ¶63. The Commission will no doubt receive similar requests from MMDS licensees, DBS providers, and others who would arguably "benefit from an inventor's experience" in advanced communications. *Id.*

If the Commission hopes to maintain the integrity of the attribution rules, it should not embark on this slippery slope. Once an exception is made, it becomes that much easier to make -- and more difficult to resist pressure to make -- further exceptions. If the Commission does not wish to see over fifty years of jurisprudence in the area of attribution become a nullity, it should reconsider the decision to loosen the insulation criteria and reverse itself.

CONCLUSION

For decades, the Commission has recognized the basic principle that relationships that fall short of outright control on paper convey sufficient influence to allow an entity to directly or indirectly influence a licensee. The Commission has wisely treated these relationships as equivalent to ownership, and attributed them to entities as a necessary means of effectuating the Commission's ownership rules. Based on the long success of this attribution practice, Congress directed the Commission to limit the number of cable systems a person may own "or in which such person holds an attributable interest." In using the words "attributable interest," the Congress intended that the Commission use traditional principles and rules of attribution that had served the Commission in the broadcast services.

Now, chasing the chimera of convergence, the Commission has adopted new insulation criteria that contradict the intent of Congress, past Commission precedent, current Commission practice in all other respects under the attribution rules, and common sense. The new rules are arbitrary and capricious, and the Commission should reverse the modifications to the insulation criteria, as applied to the horizontal ownership rules, on reconsideration.

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