EXHIBIT 1

AN ECONOMIC ASSESSMENT OF THE EXCLUSIVE CONTRACT PROHIBITION BETWEEN VERTICALLY INTEGRATED CABLE OPERATORS AND PROGRAMMERS

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About This Report

This report was commissioned by EchoStar Satellite Corporation and DIRECTV, Inc., as an independent analysis of the economic issues associated with the Federal Communications Commission's notice of proposed rulemaking as to whether to sunset the exclusive programming contract prohibition (see the Federal Communications Commission Notice of Proposed Rulemaking 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).

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The curriculum vitae for the authors are attached as Appendix 1.

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Executive Summary

- Economic theory suggests that vertical integration and exclusive contracts can be used to increase efficiency, but can also be used for anticompetitive purposes. A key determinant of whether vertical integration and exclusive contracts can be used for foreclosure is the degree of market power: anticompetitive exclusivity is possible in markets that are not fully competitive.

- Although competition in the multi-channel video programming distribution (MVPD) market has improved since the early 1990s, the Federal Communications Commission (FCC) recently stated that cable television "still is the dominant technology for the delivery of video programming to consumers in the MVPD marketplace." Despite Direct Broadcast Satellite (DBS) subscriber growth, cable firms provided service for more than 77 percent of all MVPD subscribers in July 2001. With the introduction of digital cable, DBS' traditional competitive advantage of higher quality and more channel capacity may fade and the market power of cable firms may well increase.

- One of the premises of the exclusive contract prohibition was that cable firms had significant power in the MVPD market. Despite claims that the structure of the MVPD market has changed enough to make foreclosure unprofitable, cable firms are still dominant in the market and the fundamental motivation for the prohibition therefore has not significantly changed – especially given the trend toward horizontal consolidation in the cable industry and the introduction of digital cable.

- In order to offer a viable alternative to cable firms, non-cable MVPD providers must provide the programming produced by vertically integrated cable operators. By facilitating access to this programming, the exclusive contract prohibition has bolstered competition in the MVPD market and benefited consumers. This fundamental benefit must be weighed against any potential costs. Two such costs have been cited by the cable firms in their comments: the prohibition constrains programming diversity and discourages the efficiencies that can arise from vertical integration. A closer examination of these potential costs suggests that they are very unlikely to outweigh the benefits of the prohibition for three reasons.

    - First, since the introduction of the exclusive contract prohibition, programming diversity has increased dramatically. The number of national programming channels has risen 223 percent, from 87 in 1992 to 281 in 2001. Indeed, despite the cable firms' arguments to the contrary, the DBS industry likely contributed to the significant increase in programming diversity. The historical channel capacity advantage of DBS appears to have pressured the cable firms to invest in increased channel capacity, which in turn has provided new opportunities to programmers. In addition, the DBS firms have played an important role in providing a launch platform for a number of independent programmers.

- The second reason that the benefits of the exclusive contract prohibition likely outweigh the potential costs is that most of the large cable firms are already vertically integrated. This suggests that the prohibition has not significantly discouraged vertical integration and also suggests that any internal efficiencies obtained from vertical integration may have already been largely captured.

- Finally, when exclusive arrangements are in the public interest, a mechanism already exists for such arrangements to be approved. Since 1992, six petitions have been sought for a waiver of the exclusive contract provision, and the FCC has granted two of them. This record simultaneously demonstrates that the FCC is willing to grant exemptions when exclusive contracts are in the public interest, and also that such exclusive contracts are generally not in the public interest (especially since the number approved is relatively low despite the fact that the most auspicious cases were the ones presumably filed).

- Some commentators have indicated that cable firms will have no incentive to use exclusive contracts to foreclose competition. Such a perspective, however, is inconsistent with current economic theory. It is also belied by two facts: first, when allowed to do so, cable systems have demonstrated a willingness to engage in foreclosure (e.g., Comcast's SportsNet in Philadelphia); and second, the strength of the cable industry's effort to lift the prohibition raises questions about the motivation for that effort.

- The exclusive contract prohibition currently includes a potential loophole: programming transmitted via terrestrial systems is not covered by the exclusivity clause; rather, such programming is subject to the unfair practices prohibition. From an economic perspective, such a loophole is not justified: the particular mode of transmission does not affect the competitive impact of exclusivity. Foreclosure of competition through use of the terrestrial loophole may loom larger in the future as terrestrial transmission becomes cheaper and more readily available. Indeed, the existence of the loophole itself may displace investment from other more productive uses into terrestrial systems, which could then be used to foreclose competition.

- If the MVPD market becomes more competitive and cable systems wield less market power over independent programmers and rival MVPD providers, the FCC can revisit whether the prohibition continues to be necessary. But given the current competitive structure of the market, the prohibition on exclusive contracts between vertically integrated programming and cable operators continues to be in the public interest.

I. Introduction

The Cable Television Consumer Protection and Competition Act of 1992 ("Cable Act of 1992") generally prohibits exclusive contracts for programming between vertically integrated cable programmers and operators.[1] This provision of the Cable Act of 1992 reflects congressional concern that such exclusive contracts could hamper competition in the multi-channel video programming distribution (MVPD) market, thereby harming consumers.[2] The Cable Act of 1992 sunsets the prohibition on October 5, 2002, unless the Federal Communications Commission (FCC) determines that the "prohibition continues to be necessary to preserve and protect competition and diversity in the distribution of video programming."[3]

Although competition in the MVPD market[4] has improved in the last decade (partly due to the prohibition on exclusive contracts), the market is far from fully competitive. Cable operators continue to possess significant market power and continue

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[1] Section 628(c)(2)(D) states that the FCC "shall prohibit exclusive contracts for satellite cable programming or satellite broadcast programming between a cable operator and a satellite cable programming vendor in which a cable operator has an attributable interest or a satellite broadcast programming vendor in which a cable operator has an attributable interest, unless the Commission determines... that such contract is in the public interest." See 47 U.S.C. § 548(c)(2)(D) and 47 C.F.R. § 76.1002(c)(2).

[2] *Implementation of Sections 12 and 19 of the Cable Television Protection and Competition Act of 1992: Development of Competition and Diversity in Video Programming Distribution and Carriage*, First Report and Order, 8 FCC Rcd 3359, 3366 (1993).

[3] See 47 U.S.C. § 548(c)(5) and 47 C.F.R. § 76.1002(c)(6).

[4] The MVPD market includes the cable industry and Direct Broadcast Satellite (DBS) services. Other available MVPD services include home satellite dishes (HSD), multi-channel multi-point distribution service (MMDS), and private cable or satellite master antenna television (SMATV) systems. See *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Seventh Annual Report, 16 FCC Rcd. 6005, 6008 (2001) ("Seventh Cable Competition Report"), at ¶ 3.

to control a significant proportion of programming, including the majority of the most popular programming networks.[5]

Given the current state of competition in the MVPD market, cable systems still have the incentive and ability to disadvantage rivals and harm competition through exclusive distribution of vertically integrated programming. The prohibition on exclusive contracts should thus be retained and not allowed to sunset in October 2002.

II. Vertical Relationships and Exclusivity Incentives

In many circumstances, vertical relationships and exclusive distribution agreements improve economic efficiency. However, such arrangements can also be exploited in a way that harms competition and consumers.

Economic theorists have developed a variety of models to examine the impact on competition from vertical relationships and exclusivity.[6] One set of models explains the incentives for vertical integration based on efficiency motivations, including the elimination of successive markups by firms with market power.[7] Another relatively

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[5] Seventh Cable Competition Report at ¶ 5, App. D, Table D-6, and App. D, Table D-7.

[6] Most economic models assume "upstream" firms that supply an input to "downstream" firms who subsequently sell a good to consumers. In this case, the programmers are the upstream firms and MVPD providers are the downstream firms.

[7] As the FCC has noted, the potential efficiencies in the MVPD marketplace arise "in the production, distribution, and marketing of video programming, and providing incentives to expand channel capacity and create new programming by lowering the risks associated with program production ventures." See Seventh Cable Competition Report at ¶ 172. Efficiency can also arise if there is market power in both the upstream and downstream markets by encouraging the combined firm to take the loss of downstream customers into account when pricing upstream products. It should be noted that this so-called double marginalization problem is also eliminated as either the upstream or downstream markets become competitive. In addition, mergers of successive monopolists in multi-product industries do not necessarily improve welfare by eliminating double marginalization. See Michael A. Salinger, "Vertical Mergers in

recent set of models examines the incentives for firms to establish exclusive vertical relationships to foreclose competition.

An earlier literature had argued that vertically integrated firms could have no anticompetitive incentives to exclude rivals and that rivals could always protect themselves by contracting with other unintegrated firms.[8] However, as Michael Riordan and Steven Salop demonstrate, this "Chicago" view that vertical integration cannot enhance market power is predicated on a number of potentially unrealistic assumptions, including an assumption that the downstream market is perfectly competitive. In the absence of these assumptions, vertical mergers "have the potential for anticompetitive effects by creating, enhancing, or facilitating the exercise of market power."[9] More recent models have developed this post-Chicago view and shown that vertical integration can harm competition and increase prices for consumers.

In a paper published in a leading economics journal, Janusz Ordover, Garth Saloner, and Steven Salop demonstrate that a downstream firm can use exclusive vertical integration with an upstream firm and deny upstream supply to downstream rivals.[10] By eliminating an upstream supplier, the downstream firm can reduce competition in the

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Multi-Product Industries and Edgeworth's Paradox of Taxation," *Journal of Industrial Economics*, September 1991, 39(5), pages 545-56.

[8] Two often cited examples are Robert H. Bork, *The Antitrust Paradox*, (New York: Basic Books, 1978) pages 222-245 and pages 299-309; and Richard A. Posner, *Antitrust Law*, (Chicago: University of Chicago Press, 1976) pages 171-184. Some cable firms have used the logic from these papers to argue that DBS providers could always replace any vertically integrated cable exclusive programming by contracting with independent programmers.

[9] Michael H. Riordan and Steven C. Salop, "Evaluating Vertical Mergers: A Post-Chicago Approach," *Antitrust Law Journal*, Volume 63, 1995, page 519.

[10] See Janusz Ordover, Garth Saloner, and Steven Salop, "Equilibrium Vertical Foreclosure," *American Economic Review*, March 1990, 80(1), pages 127-142.

upstream market, and therefore cause higher prices for unintegrated upstream supply. Assuming that the downstream providers have different characteristics, the authors find that vertical integration benefits the integrating firms – but harms consumers and competition in the downstream market. In addition, the remaining independent downstream firm will not be able to induce the remaining upstream firm to vertically integrate because it will not produce enough profit in the downstream market to compensate the upstream firm for exclusivity. Finally, the benefits of integration accruing to the integrated firm <u>increase</u> if downstream competition becomes more vigorous.[11] As the downstream firms' products become closer substitutes for each other, the benefits to the integrated firm of raising a rival's costs become more significant.[12] An application of this model to the MVPD market would suggest that cable systems (downstream firms) use exclusivity with program providers (upstream firms) in order to foreclose competing MVPD access to integrated programming. As competition between cable systems and other MVPDs intensifies, the anticompetitive effects of exclusive vertical integration become more pronounced.

Oliver Hart and Jean Tirole developed a model in which vertical integration coupled with exclusivity leads to a decline in output and social welfare (as well as a drop in profits and output for the unintegrated downstream firm).[13] In one version of their model, exclusive vertical integration eliminates the integrated downstream firm as a

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[11] Ordover, Saloner, and Salop state that "Our main conclusion is that anticompetitive foreclosure arises as an equilibrium phenomenon in a coherent model where sophisticated firms use a wide range of strategies and counterstrategies." See Ordover, Saloner, and Salop, page 140.

[12] Conversely, if the two downstream firms' products are not particularly close substitutes, raising a rival's costs does not significantly raise the integrated firm's profits (since fewer customers will be induced to switch to the integrated firm).

[13] Oliver Hart and Jean Tirole, "Vertical Integration and Market Foreclosure," *Brookings Papers: Microeconomics*, 1990, pages 205-286.

customer of the unintegrated upstream firm, and the unintegrated upstream firm therefore cannot cover its fixed costs. As a result, the unintegrated upstream firm exits the upstream market, leaving the integrated firm as a monopolist. In another version of the model, the authors assume that upstream capacity is limited. In this version, vertical integration eliminates access to the integrated upstream firm's product and can cause the independent downstream firm to exit. This again allows the integrated firm to monopolize the market. Hart and Tirole conclude:

> "According to our variants, restriction of competition is most likely to be a factor when the merging firms are efficient (have low marginal costs or investment costs) or are large (have high capacities) relative to nonmerging firms...the theory suggests that vertical mergers involving efficient or large firms should be the particular scrutiny by the antitrust authorities...a merger between an upstream and downstream firm that have had substantial dealings with outside firms is potentially more damaging than one between those that have primarily traded with each other and where the foreclosure effect on rivals will be small."[14]

In this type of model, cable systems can limit access by other MVPDs to their integrated programming, reduce competition, and thereby harm consumers. The effectiveness of this foreclosure is strongest against MVPDs that are dependent on vertically integrated cable programming and independent programmers who are dependent on cable carriage.

Vertical integration and exclusive contracts can thus lead to anticompetitive effects that harm consumers and competitors. Christopher Snyder summarizes the models as demonstrating two effects: a commitment effect and an investment effect.

> "The *commitment* effect refers to the ability of a vertically-integrated firm to commit to restrict output to downstream competitors. Commitment comes from profit sharing: because an integrated upstream unit shares the profit of its downstream counterpart, it is harmed by increases in the output of rival downstream firms. Therefore, it has an incentive to cut

[14] Hart and Tirole, page 213.

> back input supplies to rivals of its downstream counterpart....the *investment* effect is that vertical integration may allow the integrated firm to increase its share of the surplus at the expense of rivals. If the harm to rivals is great enough, they will reduce their investment, possibly exiting the industry, leading to greater concentration."[15]

Whether vertical integration helps or harms consumers depends on whether any pro-consumer efficiencies dominate any anticompetitive effects, which itself depends on the specifics of the market under investigation.[16] A key issue is market power. For example, even Economists Incorporated (EI) notes that "...some factors that make exclusivity more or less likely to harm consumers can be illustrated by example. The key issues are market definition and market power."[17] Economists John Kwoka and Lawrence White similarly concluded, "uses of vertical practices or structure to achieve anticompetitive ends require the actual or potential presence of market power (individually or collectively)."[18] It is therefore essential to examine the specifics of the MVPD market. Before doing so, however, it is necessary to explore several other theoretical considerations.

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[15] Christopher M. Snyder, "Empirical Studies of Vertical Foreclosure," in Bob Hawkins, editor, *1995 Industry Economics Conference Papers and Proceedings* Report 95/23 (Canberra: Australian Government Publishing Service, 1995), pages 98-125 and page 107.

[16] See Michael A. Salinger, "Vertical Mergers and Market Foreclosure," *Quarterly Journal of Economics*, May 1988, 103(2), pages 345-56.

[17] Economists Incorporated, "Competition For Video Programming: Economic Effects of Exclusive Distribution Contracts," December 3, 2001, Filed with the Comments of Cablevision Systems Corp. ("EI Report"), page 10.

[18] John A. Kwoka and Lawrence J. White, editors, *The Antitrust Revolution: Economics, Competition, and Policy* (Oxford: Oxford University Press, 1999), page 331.

Exclusive vertical integration vs. exclusive contracts between independent entities

Some, but by no means all, anticompetitive effects from exclusive relationships require vertical integration, as opposed to exclusive contracts between independent entities. EI claims that if there were anticompetitive benefits to cable systems arising from exclusive relationships that were prevented by law, cable systems could have sold off their programming and then entered into exclusive contracts with the "independent" programmer (since such exclusive contracts are permitted under the Cable Act of 1992).[19] This perspective, however, assumes that exclusive vertical integration is effectively equivalent to exclusive contracts. But EI itself admits that such a perspective is misguided; arms-length contracts may not align a programmer's incentives with the interests of a cable provider since "it is too difficult to write contracts that make the outside supplier's economic incentives compatible with the incentives of the firm."[20]

The difficulty of aligning incentives in a contractual relationship, as opposed to a vertically integrated firm, affects the ability to engage in anticompetitive behavior. In particular, foreclosing competition requires specific profit-sharing schemes between the upstream and downstream firms (which EI implicitly acknowledges in its argument that exclusive vertical integration is equivalent to exclusive contracts).[21] But, as Hart and Tirole emphasize, "Profit sharing may be difficult to implement in the absence of integration, however, because independent units can divert money and misrepresent

[19] EI states that "Put differently, if cable MSOs had thought that foreclosing of MVPDs would be profitable they need only have spun off their programming interests to independent owners and entered into exclusive contracts with them back in 1992." See EI Report, page 17.
[20] EI Report, page 6.
[21] EI Report, pages 16-17.

profits. In contrast, the owner of a subordinate unit, because he or she has residual rights of control over the unit's assets, may be able to prevent diversion and enforce profit sharing."[22] Furthermore, anticompetitive behavior is less likely with exclusive contracts than with vertically integrated firms because the former is much easier for regulators to monitor.[23] Thus, exclusive contracts are not a perfect substitute for integration.[24]

MVPD programming vs. broadcast programming

The technology and structure of the MVPD market make the incentives and effects of exclusive contracts significantly different than other broadcast markets. Due to the subscription nature of MVPD consumer purchasing, denying some programming to an MVPD can cause subscribers to move from one MVPD provider to another. By contrast, exclusivity for programming on the broadcast networks (e.g., ABC, NBC, and CBS) does not require viewers to adopt the entire bundle of broadcast programming in order to view the exclusive programming.

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[22] Hart and Tirole, page 206.

[23] Arms-length transactions between independent firms are easier to police for anticompetitive effects. EI argues that a *per se* rule prohibiting exclusive contracts with integrated firms is not required when other policing actions are available: "Case-by-case antitrust remedies are far more appropriate in dealing with such issues than a blanket *per se* rule affecting all cable operators. Antitrust remedies include not only prosecutions by the Department of Justice and the Federal Trade Commission but also actions by State Attorneys General and private treble damage actions." See EI Report, page 23. EI's argument does not take into account the differential costs of monitoring and enforcing competition in an exclusive integrated setting relative to an exclusive contractual one. One way of interpreting the current prohibition is that it targets the relationships that are most difficult to police with conventional antitrust tools. In addition, as two former FCC attorneys stated in the context of the MVPD market, a regulatory approach is "less costly, far faster, and more effective than if prospective plantiffs sought similar relief under the antitrust laws. By adjudicating these claims before a single, expert agency [the FCC] – as opposed to through cases arising in a variety of jurisdictions – it is possible to achieve a consistent program access policy, and thus improve overall market performance. Moreover, because responsible telecommunications policy must be able to quickly and adequately respond to industry structure, conduct, and performance, an administrative agency with industry expertise is better equipped to analyze and react to such changes than would be a series of courts." See James Olson and Lawrence Spiwak, "Can Short-Term Limits on Strategic Vertical Restraints Improve Long-Term Cable Industry Performance?" *Cardozo Arts & Entertainment Law Journal*, 283 (1995) (footnotes omitted).

[24] Hart and Tirole, pages 208-209.

For example, if NBC has an exclusive right to broadcast the Olympic Games, a viewer would have to watch NBC to see the events. But the viewer does not have to switch to NBC to watch all other "over-the-air" programming. By contrast, if NBC were carried on cable systems and not on DBS systems, the viewer would have to switch all programming from DBS to cable (or incur the added cost of subscribing to both DBS and cable) in order to view the Olympics.[25]

The example of Fox's entry into network programming, cited by EI as support for the view that a prohibition on exclusive contracts is unnecessary, illustrates the crucial difference between the broadcast market and the MVPD market.[26] To watch the new Fox programming, viewers were not required to forgo all programming available on other networks. Since most consumers currently subscribe to one MVPD, on the other hand, an entrant in the MVPD market would have to offer consumers an entire lineup of programming that would be more attractive than their existing programming choices. Fox only had to offer a few individual popular programs, but an MVPD must enter by offering an entire portfolio of attractive programming. Thus, if programming that is necessary to attract new subscribers is not available to all MVPD providers, an entrant is unlikely to be successful.

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[25] This example is meant to be illustrative. NBC broadcasts are also available over the air to DBS or cable consumers, so in this case the viewer would not necessarily be forced to switch MVPD providers – instead, she could view the Olympics over the air (assuming that she had the ability to receive over-the-air signals). A more precise example would involve programming that is available exclusively on MVPD systems.

[26] EI states that "It is noteworthy that it did not occur to the Commission to facilitate Fox's entry by requiring ABC, CBS and NBC to share with the new entrant all those networks' own program production." See EI Report, page 25.

III. The State of Competition in the MVPD Market

Although competition in the MVPD market has improved since the early 1990s, the FCC recently stated that cable television "still is the dominant technology for the delivery of video programming to consumers in the MVPD marketplace."[27] In particular, despite DBS subscriber growth, cable firms provided service for more than 77 percent of all MVPD subscribers in July 2001.[28]

Reflecting their growing market share, DBS firms have started to exert some pressure on cable pricing and innovation. For example, the FCC found that 2000 was the first year in which DBS providers influenced prices for cable service in a statistically significant manner.[29] Nonetheless, the effect is modest, presumably reflecting the continued dominant position of the cable firms.

Furthermore, the market power of cable firms may well increase in the future. One reason that the DBS firms have succeeded in exerting even modest pressure on cable prices is that they offer more channels, better sound, and higher picture quality than analog cable. This competitive advantage, however, is fading as cable firms introduce digital cable systems, which reduces or eliminates the historical quality and capacity advantages of DBS over analog cable and offers the possibility of bundling high-speed

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[27] Seventh Cable Competition Report at ¶ 5.

[28] See Comments of National Cable & Telecommunications Association, In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, Notice of Inquiry, CS Docket No. 01-129, (dated August 2, 2001), at ¶ 7.

[29] *Statistical Report on Average Rates for Basic Service, Cable Programming Services, and Equipment,* Report on Cable Industry Prices, FCC (2001), at ¶ 53.

Internet access, video-on-demand, and other advanced services – all of which the DBS firms currently have difficulty matching. For example, Goldman Sachs recently concluded that "We see the bundling of [cable] services as the most significant threat to DBS because of its potential not only to slow gross additions, but also to win back subscribers (seen through higher churn)."[30]

According to the National Cable and Telecommunications Association (NCTA), the number of digital cable subscribers has increased nine-fold in the past three years, rising from 1.5 million in 1998 to 13.7 million in November 2001.[31] Moreover, consumers who commit to a digital cable/cable-modem bundle may perceive fewer benefits to moving to DBS (relative to analog cable customers).[32] Therefore, at any given market share for cable providers, digital cable systems may strengthen the market power enjoyed by cable firms.

One of the premises of the exclusive contract prohibition was that cable firms had significant power in the MVPD market. Despite claims that the structure of the MVPD market has changed enough to make foreclosure unprofitable,[33] cable firms are still dominant in the market and the fundamental motivation for the prohibition therefore has

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[30] See Goldman Sachs, "Satellite Communications: DBS Operators," December 18, 2000, page 1.

[31] For data on the growth of digital cable see the NCTA website at http://www.ncta.com/industry_overview/indStats.cfm?statID=14.

[32] Goldman Sachs similarly notes that "As cable operators upgrade their networks and roll out new service, cable subscribers will have less incentive to 'churn' to DBS." See Goldman Sachs, "Satellite Communications: DBS Operators," December 18, 2000, page 33.

[33] For example, EI states that "the same changes that have made foreclosure much more expensive today than in the past have made it less profitable." See EI Report, page 11.

not significantly changed.[34] In other words, cable firms continue to have enough market power to have incentives to foreclose access to programming and harm competition and consumers.

Regardless of the concentration in the MVPD market, cable firms claim that the entry of new independent programming has significantly weakened their ability to effectively foreclose access to enough programming to have anticompetitive effects.[35] Indeed, the cable industry argues that over the past decade the percentage of vertically integrated programming services has declined from roughly half in 1992 to 26 percent in 2001.[36] But these figures are not weighted by subscribership or viewer ratings, which are the more appropriate methods of analysis. The fact remains that much of the most popular programming continues to be vertically integrated. For example, according to the FCC, four of the top six for-profit video programming networks ranked by subscribership are vertically integrated with a cable provider.[37] In addition, three out of the top five video programming networks ranked by prime-time ratings are vertically

[34] A model developed by economist Michael Riordan demonstrates that vertical integration by a dominant downstream firm into an upstream competitive market can be anticompetitive. Riordan explains that the anticompetitive effect arises because the dominant firm raises the price of the upstream input, reduces the size of the other fringe competitors in the downstream market, and thereby gains more power in the downstream market. See Michael H. Riordan, "Anticompetitive Vertical Integration by a Dominant Firm," *American Economic Review*, Vol. 88, No. 5, December 1998, pages 1232-1248.

[35] See Comments of AOL Time Warner, 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 Communications Act: Sunset of Exclusive Contract Prohibition, CS Docket No. 01-290, (dated December 3, 2001), ("AOL Time Warner Comments") at 18; Comments of AT&T, Inc., ("AT&T Comments") at 19-22; Comments of Cablevision Systems Corporation, ("Cablevision Comments") at 30-31; Comments of Comcast Corporation, ("Comcast Comments") at 7-8; and Comments of National Cable & Telecommunications Association, ("NCTA Comments") at 11-13.

[36] See NCTA Comments at 11-12.

[37] See Seventh Cable Competition Report, App. D, Table D-6. C-SPAN has the fifth highest number of subscribers among all programming networks, but it is not a for-profit entity. In addition, AT&T Broadband recently spun-off its stake in USA Networks, which was ranked third in the Seventh Cable Competition Report.

integrated with cable firms.[38] These top channels (e.g., TBS, USA, TNT) are critically important to DBS firms in offering a viable alternative to cable providers.[39] The lack of close substitutes for these top channels facilitates the effectiveness of anticompetitive foreclosure.[40]

Furthermore, horizontal consolidation in the cable industry increases the incentives for anticompetitive foreclosure of access to integrated programming. The intuition is simply that the costs of foreclosure are the forgone revenue from all other MVPD outlets. In particular, an integrated cable firm that denies access to its programming to a DBS firm forgoes the revenue that the DBS firm would have paid for the programming. Since the DBS firms operate on a national basis, the forgone revenue effectively covers the entire *national* subscriber base of the DBS firms. The benefit of foreclosure is that it increases relative demand for the cable package (because that package is the only avenue to view the exclusive programming). In addition to the

[38] See Seventh Cable Competition Report, App. D, Table D-7. Prime-time ratings are one measure of a network's value to subscribers. But, as noted in the text below, there is also significant value to consumers of offering a wide variety of channel choices. Ratings do not indicate the strength of a consumer's preference for a specific channel (but rather just that that channel was preferred to others). It is entirely possible that the consumer surplus associated with a network with a smaller, but extremely devoted, group of viewers may be larger than that of a network with a larger subscriber base.

[39] Economists David Waterman and Andrew Weiss stated that there was an industry consensus that "the lack of more than one or two of the well-known networks such as ESPN, USA, CNN, and HBO would seriously handicap a multichannel competitor to an established cable system." Quoted in James Olson and Lawrence Spiwak, "Can Short-Term Limits on Strategic Vertical Restraints Improve Long-Term Cable Industry Performance?" *Cardozo Arts & Entertainment Law Journal*, 283 (1995). In addition, many smaller, "niche" networks also remain affiliated with cable operators. Even if each of these networks is less crucial on a stand-alone basis than each of the top-rated networks, consumers value "more channels" and thus, these smaller channels in their totality may represent an important component of an MVPD providers' programming offering.

[40] Even EI recognizes the importance of substitutability in determining the potential anticompetitive effects of foreclosure. "It does no good for a cable operator to deny a program to a rival MVPD if the rival MVPD can readily obtain substitute programming elsewhere, through purchase or through its own vertical integration." See EI Report, page 20. In addition, EI points out that successful foreclosure would require that a significant number of cable programs be foreclosed or "alternatively the integrated firm might attempt to harm competitors by denying access to the most valuable programming." See EI Report, page 20.

potential increase in the cable system's prices, the gains from foreclosure are reflected by the number of subscribers that shift from alternatives to the vertically integrated cable system in order to view the foreclosed programming (or that remain with the cable system when they would have otherwise moved). A cable system with wider geographic coverage will gain a larger portion of the shifting subscribers (or retain a larger share of subscribers who would have otherwise switched MVPD services). In other words, the larger the size of the integrated cable firm's potential subscriber base, the larger the potential benefit from foreclosing access to programming.

The trend toward horizontal consolidation in the cable industry thus increases the returns from anticompetitive foreclosure, without increasing the costs thereof.[41] In the spring of 1995, the top ten cable systems accounted for less than 60 percent of cable subscribers nationwide.[42] Currently, the ten largest cable operators serve close to 90 percent of all U.S. cable subscribers.[43] If consummated, the recently announced purchase of AT&T Broadband by Comcast will further increase cable and program ownership concentration.[44] And this trend toward horizontal consolidation may continue; Ted

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[41] Increased horizontal consolidation can also have other anticompetitive effects that do not directly involve exclusive vertical integration and, therefore, are not examined here.

[42] See Deborah Solomon and Robert Frank, "Comcast-AT&T Broadband Deal Cements Rise of Cable Oligopoly," *Wall Street Journal*, December 21, 2001, and data from the National Cable and Television Association web site, available at http://www.ncta.com/industry_overview/indStats.cfm?statID=1.

[43] Seventh Cable Competition Report at ¶ 15.

[44] Christopher Stern, "Giant Cable Merger Planned, AT&T, Comcast Set $72 Billion Deal," *The Washington Post*, December 20, 2001. The merged entity – AT&T Comcast – would have roughly 22 million subscribers. But such a figure does not include the MVPD subscribers served by entities in which AT&T Broadband currently has an attributable interest; for example, AT&T Broadband has a 25 percent stake in Time Warner's cable systems. According to AT&T Broadband, "If [Time Warner Entertainment] and [Time Warner, Inc.] subscribers were nonetheless added to AT&T's totals, AT&T would be attributed with approximately 32,926,000 subscribers." See Letter from Douglas Garrett to Magalie Roman Salas, *Ex Parte* Submission, MM Docket No. 92-264, CS Docket No. 99-251, December 18, 2001, at 2. If attributable subscribers are thus included, the combined AT&T Comcast would have more than 40 million

Turner recently predicted that cable consolidation will "result in only two operators still standing within a year or two."[45]

IV. The Costs and Benefits of Maintaining the Exclusive Contract Prohibition

Executives at both EchoStar and DIRECTV confirm that without access to the programming available on cable systems (which could have been denied in the absence of the prohibition), the DBS firms would not have experienced dramatic subscriber growth.[46] Similarly, the FCC has noted that "the program access rules have been credited as having been a necessary factor" in the development of the DBS industry.[47] Despite the growth of DBS providers, cable firms continue to maintain significant pricing power in the MVPD market and it is therefore premature to sunset the exclusive contract prohibition – especially given the trend toward horizontal consolidation in the cable industry and the introduction of digital cable.

The cable industry argues that the exclusive contract prohibition is no longer needed because the MVPD market is fully competitive and thus foreclosure would not be a profitable strategy. The available evidence, however, suggests that the MVPD market

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subscribers – nearly 33 million AT&T subscribers and roughly 8 million Comcast subscribers – representing roughly half of all MVPD subscribers.

[45] Sallie Hofmeister, "Ted Turner Says Only 2 Cable Firms May Survive," *Los Angeles Times*, November 29, 2001.

[46] For example, in 1995, DIRECTV's marketing head stated that "without [program access], we would have been dead." See Eric Schine, "Digital TV: Advantage, Hughes," *Business Week*, March 13, 1995, at 66-67.

[47] See *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Fourth Annual Report, CS Docket No. 97-141 (1998) at ¶ 230.

is not fully competitive (see above) and that cable firms may indeed use exclusive arrangements to consolidate further their market power.

One telling example of the potential dangers associated with allowing programming exclusivity in the context of vertically integrated cable systems is the experience of Comcast's SportsNet, a channel devoted to Philadelphia sports programming.[48] Survey evidence suggests that regional sports programming is critical to competition in the MVPD market. According to one recent survey, between 40 and 58 percent of cable subscribers would be less likely to subscribe to an MVPD provider if it lacked local sports.[49]

The key to the SportsNet story is a potential "loophole" in the existing exclusivity rules: programming distributed via terrestrial systems (as opposed to satellite-based delivery) is not subject to the exclusivity clause, but only to the unfair practices prohibition.[50] Since Comcast is able to distribute programming in Philadelphia entirely through terrestrial systems, it has been allowed to refuse to provide SportsNet to competing MVPDs – and has chosen to do so. As Comcast itself has stated, SportsNet "provides a significant marketing advantage against satellite and other competitors."[51]

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[48] SportsNet is a partnership between the Philadelphia Phillies and Comcast-Spectator, a division of Comcast that also owns the Philadelphia Flyers, Philadelphia 76ers, the First Union Center, and the Spectrum. See Patricia Horn, "Comcast has an Edge in Popular SportsNet," *The Philadelphia Inquirer*, October 29, 2000, ("Horn") page E01.

[49] See Comments of RCN Telecom Service, Inc., at 18.

[50] The Cable Act of 1992 prohibits "exclusive contracts for satellite cable programming or satellite broadcast programming." See 47 U.S.C. § 548(c)(2)(D) and 47 C.F.R. § 76.1002(c)(2). The FCC has interpreted this provision to mean that programming transmitted via terrestrial systems is allowed under the Cable Act of 1992. See Federal Communications Commission, *1998 Program Access Order*, CS Docket No. 97-248, (released August 6, 1998).

[51] Seventh Cable Competition Report at ¶ 186.

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As noted above, if cable firms are able to induce subscribers to commit to a digital cable/cable-modem bundle today, it may be more difficult for the DBS firms to induce the subscribers to switch to DBS in the future.[52] Therefore, if cable firms use exclusive arrangements to "lock in" customers, such arrangements can have a long-term deleterious effect on competition.[53]

Comcast's arrangement with SportsNet illustrates how cable firms can use exclusivity to gain market share, which helps to lock in subscribers and potentially harm competition in the future.[54] While many factors can influence the DBS penetration rate in a particular market, the lack of regional sports programming appears to have reduced DBS subscribership in Philadelphia. For example, Table 1 presents data from Forrester Research showing that the DBS penetration rate in Philadelphia is by far the lowest of the top 20 cities in the United States. Indeed, the DBS penetration rate in Philadelphia is just 3.9 percent, or less than half the 9.3 percent weighted average for the top 20 cities (other

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[52] See Robert D. Willig, Declaration On Behalf Of Echostar Communications Corporation, General Motors Corporation, and Hughes Electronics Corporation, *Echostar Communications Corporation, General Motors Corporation, and Hughes Electronics Corporation Seek FCC Consent For A Proposed Transfer Of Control*, CS Docket No. 01-348, (released December 21, 2001), ("Willig Declaration") at ¶ 34.

[53] If a cable firm is able to lock in subscribers, the firm increases its power to raise prices. Such pricing power can thus be used to adversely affect customers in the future.

[54] One local Philadelphia broadcast station recently contended that "Comcast uses its local sports programming to hamper competition by refusing to make SportsNet available to satellite-TV providers. SportsNet 'is a key part of their strategy to monopolize this market,' said Dave Davis, WPVI president and general manager." See Horn, page E01.

than Philadelphia).[55] DBS penetration rate data supplied to us by both EchoStar and DIRECTV are generally consistent with this finding.[56]

The Philadelphia example may be indicative of what could occur in the absence of the prohibition on exclusive contracts. Indeed, the cable operators are strongly advocating that they be permitted to enter into exclusive arrangements with their integrated programmers.[57] Yet, they have demonstrated little demand for exclusive arrangements with independent programmers. This combination of factors is not necessarily determinative of the cable firms' motivation for exclusivity, but it is at least suggestive that they are eager to use exclusive arrangements with their integrated programmers for anticompetitive purposes. That is, if the efficiency improvements from exclusivity were overwhelming, one would suspect that the cable firms would have sought to enter into such agreements with independent programmers (which are generally allowed under the Communications Act), despite the differences between such exclusive contracts and exclusive vertical integration noted above.[58]

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[55] The *Philadelphia Inquirer* reported in June 2001 that, according to Nielsen Media Research, of the 2.7 million homes with televisions in the Philadelphia region, only 3.7 percent subscribed to DIRECTV or EchoStar, compared to more than 10 percent of TV households nationwide. See Patricia Horn, "As Competition Lags for Cable TV, Prices Tend to Rise," *Philadelphia Inquirer*, June 3, 2001, page C01.

[56] As a DIRECTV spokesman was quoted describing Philadelphia, "We clearly don't have the same kind of success in getting customers in that area as we have in other similar markets, due to this issue with Comcast. These SportsNets are like local channels. They are part of a local package that is essential for us to be fully competitive with cable." See Horn, page E01.

[57] See, for example, Cablevision Comments at 15-18 and Comcast Comments at 9-11.

[58] The absence of significant efficiencies from exclusive arrangements in the MVPD market is also suggested by the relative paucity of exclusive contracts between DBS firms and independent programmers (which are also allowed under current law). For an independent programmer to be willing to enter into an exclusive contract with a MVPD firm, the MVPD firm must be willing to compensate the programmer for forgoing the revenue from all other MVPD outlets in the region covered by the contract (and there must be a creditable profit-sharing system, as noted above). Since cable firms account for nearly 80 percent of the MVPD market, it is unlikely that a non-cable MVPD provider would find it profitable to engage in such an exclusive arrangement. Indeed, even though EchoStar and DIRECTV are both allowed under FCC regulations to have exclusive contracts with programmers, DIRECTV has not signed an exclusive contract that bars non-DBS providers from access to programming. As noted by the FCC, DIRECTV has an

Table 1 Direct Broadcast Satellite Subscriber Penetration: January 2001	
City	DBS Penetration Rate
Dallas	20.2%
Houston	17.7%
Denver	14.1%
St. Louis	13.6%
Atlanta	12.4%
Phoenix	11.8%
Portland	11.2%
Minneapolis - St. Paul	10.4%
Los Angeles	10.2%
Washington	10.1%
Detroit	10.0%
Seattle	8.9%
Cleveland	7.9%
Chicago	7.7%
Pittsburgh	7.3%
San Diego	7.3%
New York	5.3%
Boston	4.9%
San Francisco	4.8%
Philadelphia	3.9%

Source: Forrester Research, Inc., Technographics Benchmark Survey, 2001

Maintaining the prohibition on exclusive contracts for video programming among vertically integrated cable firms attenuates the potential for anticompetitive behavior. This benefit must be weighed against any potential costs imposed by the prohibition. Cable firms argue that the prohibition constrains programming diversity and discourages

"exclusive arrangement with the National Football League (NFL) to make available to subscribers a substantial package of NFL games each Sunday." See Federal Communications Commission, *In The Matter of Implementation of the Cable Television Consumer Protection Act of 1992*, FCC 01-307 (released October 18, 2001) at ¶ 10. But the agreement between DIRECTV and the NFL is not truly exclusive, since it does not apply to agreements between the NFL and cable companies or other non-DBS MVPD providers (e.g., C-band satellite distributors). See Comments of DIRECTV, Inc., ("DIRECTV Comments") at 7. To the extent that EchoStar's subsidiary Kelly Broadcasting Systems, Inc. ("Kelly") has obtained exclusive distribution rights for certain foreign language networks (e.g., Greek, Russian, Arabic), it did so through arm's length negotiations with foreign programmers, not through acquisition of control over these programmers. Furthermore, those rights mean only that other U.S. distributors must deal with Kelly (as opposed to the foreign content providers) with respect to this programming.

the efficiencies that can arise from vertical integration.[59] A closer examination of these potential costs, however, suggests that they are very unlikely to outweigh the benefits of the prohibition for three reasons.

First, it is important to recognize that programming diversity has increased dramatically since the introduction of the prohibition on exclusive contracts. Since 1992, the number of national programming channels has increased 223 percent, from 87 in 1992 to 281 in 2001.[60] Despite the cable firms' arguments to the contrary, the DBS industry likely contributed to the significant increase in programming diversity.

A number of commentators argued that the DBS industry obtained a "free ride" through the exclusive contract prohibition, which in turn has reduced the incentives of both vertically integrated cable operators and DBS firms to create new programming.[61] But this perspective ignores the dynamic impact the exclusive contract prohibition has had on bolstering competition and programming diversity in the MVPD market. In particular, DBS has historically held an advantage relative to analog cable in terms of channel capacity, and consumers have indicated a strong preference for such capacity. For example, a recent survey of new DBS subscribers found that the leading reason for switching to DBS was "more channels."[62] That revealed preference, in turn, has

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[59] See AT&T Comments at 7-8; Cablevision Comments at 8-9; Comcast Comments at 13, and NCTA Comments at 16-17.
[60] NCTA Comments at 12.
[61] See AT&T Comments at 8 & 12; Cablevision Comments at 9 & 16; and NCTA Comments at 16.
[62] According to a survey by The Yankee Group, the top five reasons for people switching to DBS were more channels (79 percent), greater movie selection (69 percent), clearer picture and sound (66 percent), dissatisfied with cable (46 percent), and cable was too expensive (44 percent). See Satellite Broadcasting & Communications Association Press Release, "Study Shows Satellite TV Increasing Urban Penetration," August 14, 2000.

pressured the cable firms to invest in increased channel capacity. As NCTA President and CEO Robert Sachs stated, "Being digital from the start, and having the advantage of substantially greater channel capacity, DBS spurred cable operators to replace hundreds of thousands of miles of coaxial cable with fiber optics so that they too could offer consumers hundreds of channels of digital video and audio services."[63] The channel capacity advantage of DBS thus appears to have pressured the cable firms to invest in increased channel capacity, which in turn has provided new opportunities to programmers.

In addition, the DBS firms have played an important role in providing a launch platform for independent programmers;[64] as the NCTA stated in its comments, "The allure of DBS coverage for new networks, vertically or non-vertically integrated, is also strong. Unlike the variety of channel positions and system configurations involved in cable system launching, a deal with a DBS provider means immediate nation-wide reach to millions of homes in the same channel."[65] EchoStar's recent announcement of an agreement with Vivendi Universal illustrates how an MVPD provider can facilitate the entry of new programming on a non-exclusive basis.[66] As part of the agreement, Vivendi Universal will develop five new programming channels and EchoStar has agreed to carry

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[63] See Robert Sachs, Testimony Before Subcommittee on Antitrust, Business Rights, and Competition, Committee on the Judiciary, United States Senate, April 4, 2001, pages 2-3.

[64] As DIRECTV notes in its comments, "more than a dozen programming channels have been launched on DIRECTV... and more are on the way." See DIRECTV Comments at 6. EchoStar programming executives add that programmers use DBS carriage to improve their bargaining position with cable systems. The programmers assume that DBS carriage will improve their chances, and price, for carriage on cable systems, not that DBS carriage alone will make the new programming profitable.

[65] NCTA Comments at 15.

[66] See EchoStar Press Release, "EchoStar, Vivendi Universal Form Strategic Alliance to Offer New Programming, Interactive Television Services for Consumers," December 14, 2001.

them.[67] While EchoStar and Vivendi Universal could legally enter into an exclusive contract, it is important to note that the new programming under the agreement will be distributed on a non-exclusive basis: that is, the programming will be available to all other MVPD providers. Indeed, incentives are built into the agreement to encourage Vivendi Universal to distribute the new programming to other MVPD providers.

Looking to the future, the proposed merger between EchoStar and DIRECTV will allow the new EchoStar to play an even more important role in expanding programming diversity through increased channel capacity. The proposed merger of EchoStar and DIRECTV could eventually "free up" roughly half the current spectrum used by the individual firms, thus allowing the new EchoStar to increase the number (and diversity) of channels offered to subscribers.[68] Given the preference of MVPD subscribers for "more channels," such an expansion of channel capacity will likely force cable systems to continue to upgrade their program offerings. With more channel capacity on both DBS and cable, programming diversity will likely expand.

While the evidence appears to suggest that the DBS firms contributed to increased programming diversity, a body of empirical literature suggests that vertically integrated cable systems have favored their own programming and excluded similar non-integrated programming. As the FCC noted, cable providers "with large programming interests may

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[67] EchoStar and Vivendi Universal will also "work together on a new programming initiative to develop new satellite-delivered broadband channels featuring interactive games, movies, sports, education, and music to be launched within a 3-year period following the consummation of the agreement." See EchoStar Press Release, "EchoStar, Vivendi Universal Form Strategic Alliance to Offer New Programming, Interactive Television Services for Consumers," December 14, 2001.
[68] See Willig Declaration at ¶ 21.

unfairly favor affiliated programming over unaffiliated programming."[69] One recent empirical study of cable system program choices showed that vertically integrated cable systems exclude rival services.[70] The author noted that "TCI [now AT&T Broadband] and Comcast, two operators who own the basic shopping service QVC, are less likely to carry rival shopping service Home Shopping Network (HSN), and they are less likely to carry both QVC and HSN."[71] More broadly, the author concluded that "vertical integration between cable operators and premium program services results in the exclusion of rival services."[72] Previous studies have reached similar conclusions. For example, David Waterman and Andrew Weiss conclude, "The weight of evidence thus supports the conclusion that majority ownership relationships do influence cable systems to 'favor' their affiliated pay networks, both with respect to carriage decisions and overall marketing behavior."[73]

The second reason that the benefits of the exclusive contract prohibition likely outweigh the potential costs is that most of the large cable firms are already vertically integrated. This suggests that the prohibition has not significantly discouraged vertical

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[69] Federal Communications Commission, *In the Matter of Implementation of Section 11 of the Cable Television Consumer Protection and Competition Act of 1992, Implementation of Cable Act Reform Provisions of the Telecommunications Act of 1996, The Commission's Cable Horizontal and Vertical Ownership Limits and Attribution Rules,* Further Notice of Proposed Rulemaking, CS Docket No. 01-263, (released September 21, 2001), at ¶ 29.

[70] Tasneem Chipty, "Vertical Integration, Market Foreclosure, and Consumer Welfare in the Cable Television Industry," *American Economic Review*, June 2001, 91(3), pages 428-453. It is important to note that the author also finds that there may be offsetting efficiency benefits from vertical integration, because, for example, "integrated operators are better at promoting their products than are unintegrated operators." See Chipty, page 450. The article's arguments and results with regard to efficiency benefits, however, apply to vertical integration – and not directly to the presence or absence of exclusivity in that vertical relationship.

[71] Ibid, page 429. AT&T Broadband no longer has a stake in QVC, but Comcast owns 57 percent of the network.

[72] Ibid, page 450.

[73] David Waterman, and Andrew Weiss, "The Effects of Vertical Integration Between Cable Television Systems and Pay Cable Networks," *Journal of Econometrics*, May/June 1996, 72(1996), page 391.

integration and also suggests that internal efficiencies obtained from vertical integration may have already been largely captured. Indeed, if the merger between AT&T Broadband and Comcast is consummated, three of the top four cable firms – accounting for roughly half of all cable subscribers – will be vertically integrated.[74] The extent of vertical integration in the cable industry today limits the degree to which eliminating the prohibition would produce internal efficiencies through further vertical integration, while exacerbating the anticompetitive dangers. Furthermore, the prohibition on exclusivity among vertically integrated cable firms is not inherently a disincentive to efficiency-improving vertical integration.[75]

Finally, when exclusive arrangements are in the public interest, a mechanism already exists for such arrangements to be approved. The FCC has the authority to waive the prohibition on the basis of five factors, including the effect of the exclusive contract on competition and the effect of the exclusive contract on programming diversity. Since 1992, six petitions have been sought for a waiver of the exclusive contract provision, and the FCC has granted two of them.[76] This record simultaneously demonstrates that the FCC is willing to grant exemptions when exclusive contracts are in the public interest, and also that such exclusive contracts are generally not in the public interest (especially

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[74] See Seventh Cable Competition Report at ¶ App. C, Table C-3,.

[75] Economists William Baumol, Janusz Ordover, and Robert Willig have shown that the efficient outcome could be produced by a prohibition on exclusivity combined with an appropriate pricing standard. See William J. Baumol, Janusz A. Ordover, and Robert D. Willig, "Parity Pricing and Its Critics: A Necessary Condition for Efficiency in the Provision of Bottleneck Services to Competitors," *Yale Journal of Regulation*, Vol. 14, No. 1, Winter 1997, pages 145-164.

[76] See, for example, Federal Communications Commission, In the Matter of Time Warner Cable, 9 FCC Rcd 3221 (1994); In the Matter of New England Cable News, 9 FCC Rcd 3231 (1994); In the Matter of Newschannel, 10 FCC Rcd 691 (1994); In the Matter of Cablevision Industries Corp., 10 FCC Rcd 9786 (1995); and In the Matter of: Outdoor Life Network and Speedvision Network, 13 FCC Rcd 12,226 (1998).

since the number approved is relatively low despite the fact that the most auspicious cases were the ones presumably filed).

V. Economic Rationale for Terrestrial Loophole

As noted above, the exclusive contract prohibition currently includes a potential loophole: programming transmitted via terrestrial systems is not covered by the exclusivity clause; such programming is subject to the unfair practices prohibition. From an economic perspective, such a loophole is not justified. The particular mode of transmission used to deliver programming does not affect the underlying competitive impact of exclusive contracts between vertically integrated programmers and cable operators. Viewers make no distinction between video delivery methods to MVPDs; the competitive effects of foreclosure are the same whether the signal is delivered by satellite or fiber cable to the cable system facilities. The example of SportsNet in Philadelphia shows that this terrestrial loophole has been used by a cable operator to foreclose competitors' access to essential programming, which has reduced competitive pressures in the local market. Foreclosure of competition through use of the terrestrial loophole may loom larger in the future as terrestrial transmission becomes cheaper and more readily available. Indeed, the existence of the loophole itself may displace investment from other more productive uses into terrestrial systems, which could then be used to foreclose competition.

VI. Conclusion

Economic theory suggests that vertical integration and exclusive contracts can be used to increase efficiency, but can also be used for anticompetitive purposes. A key determinant of whether vertical integration and exclusive contracts can be used for foreclosure is the level of market power: anticompetitive exclusivity is possible in markets that are not fully competitive.

Cable systems continue to hold an overwhelming share of MVPD subscribers. Thus, in the absence of the prohibition on exclusive contracts, cable operators would still have the incentive and ability to harm consumers by foreclosing access to vertically integrated programming to competing MVPD providers. By not allowing rivals to provide a broad range of programming, integrated cable systems will be able to raise prices to consumers and slow the growth of competitors. Some commentators have indicated that cable firms will not use exclusive contracts to foreclose competition. Such a perspective, however, is belied by two facts: first, when allowed to do so, cable systems have demonstrated a willingness to engage in foreclosure; and second, the strength of the cable industry's effort to lift the prohibition raises questions about the motivation for that effort.

If the MVPD market becomes more competitive and cable systems wield less market power over independent programmers and rival MVPD providers, the FCC can revisit whether the prohibition continues to be necessary. But given the current competitive structure of the market, the prohibition on exclusive contracts between vertically integrated programming and cable operators continues to be in the public interest.

VERIFICATION

I, Jonathan M. Orszag, declare under penalty of perjury that the foregoing declaration is true and correct. Executed on January 4, 2002.

Jonathan M. Orszag

I, Peter R. Orszag, declare under penalty of perjury that the foregoing declaration is true and correct. Executed on January 5, 2002.

Peter R. Orszag

I, John M. Gale, declare under penalty of perjury that the foregoing declaration is true and correct. Executed on January 7, 2002.

John M. Gale