



**NCTA**

NATIONAL CABLE & TELECOMMUNICATIONS ASSOCIATION

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June 4, 2002

**EX PARTE**

Ms. Marlene H. Dortch  
Secretary  
Federal Communications Commission  
445 12<sup>th</sup> Street, S.W.  
Room TW-A325  
Washington, DC 20554

**Re: Commercial Availability of Navigation Devices (CS Docket No. 97-80)**

Dear Ms. Dortch:

This is to notify you that on June 3, 2002, William Check, NCTA's Vice President of Science and Technology, Frank Buono of the law firm Willkie, Farr & Gallagher and I met with William Johnson, Deborah Klein, Mary Beth Murphy, Susan Mort, and Thomas Horan of the Media Bureau to discuss issues in the above-referenced docket.

Our discussion reflected positions NCTA has taken in written submissions in this docket. The attached summary describes the issues discussed.

Respectfully submitted,

**/s/ Neal M. Goldberg**

Neal M. Goldberg

NMG:gml

Attachments

cc: William H. Johnson, Deputy Chief, Media Bureau  
Deborah Klein, Chief of Staff, Media Bureau  
Mary Beth Murphy, Chief, Policy Division, Media Bureau  
Susan Mort, Attorney Advisor, Media Bureau  
Thomas Horan, Senior Legal Advisor, Media Bureau

## **THE 2005 BAN ON INTEGRATED SET-TOP BOXES SHOULD BE ELIMINATED**

### **I. The Cable Industry Has Invested Substantial Resources to Ensure Compliance with the Commission's Commercial Availability Rules and Is Firmly Committed to the Development of a Retail Market for Navigation Devices.**

- The Cable Industry Has Strong Incentives to Facilitate New Retail Distribution Channels.
  - Cable operators' core business is the sale of services, not the sale or lease of set-top boxes or other cable customer equipment. Because cable operators face vigorous competition from DBS and others, they have every incentive to maximize the equipment options for navigation devices and the number of outlets at which consumers can buy them.
  - Cable operators have a significant incentive to move the capital costs of subscriber equipment (most of which is rate capped) off their books.
  - Cable operators desire multiple suppliers of equipment wherever possible. To the extent more suppliers enter the marketplace for cable customer equipment, operators and consumers benefit from lower prices and a greater diversity of products, features, and functions.
- The Cable Industry Has Made a Major Investment and a Number of Significant Commitments to Facilitate the Retail Distribution of Navigation Devices.
  - Development of Technical Specifications. Through CableLabs' OpenCable project, cable operators achieved all milestones for implementation of the Commission's digital separate security requirement prior to the July 1, 2000 deadline. The OpenCable specifications allow manufacturers to build retail "host" products comparable in features and functions to those provided by cable operators. The OpenCable process is an open and inclusive process, in which almost 500 organizations, including consumer electronics manufacturers and retailers, participate.
  - Establishment of Relationships with Consumer Electronics Manufacturers and Retailers. Cable operators have arrangements for marketing digital cable and Internet services at hundreds of Best Buy and other retail stores. They have also established relationships with leading consumer electronics manufacturers, including Sony, Panasonic, and Pace, to produce set-top boxes that can be made available at retail.
  - Success of OpenCable's DOCSIS Initiative. CableLabs has certified over 220 cable modem products from 60 different manufacturers, and cable operators are making extensive use of retail outlets to make cable modem services and equipment more accessible to consumers.
  - The Cable Industry's OCAP "Middleware" Initiative. While not mandated by the Commission's rules, OCAP middleware will enhance the portability of OpenCable-compliant devices. The first generation OCAP specification -- OCAP 1.0 -- has been completed and was published on the OpenCable Web site on December 21, 2001. In addition, leading MSOs have formally committed to support CableLabs-certified, OCAP-enabled devices once such devices become commercially available. Further enhancements to the OCAP specification -- for example, the recently published OCAP 2.0 -- are already underway.

- The Cable Industry’s Commitment to Allow Retailers to Sell "Integrated" Set-top Boxes. Leading cable operators have voluntarily agreed to encourage set-top box suppliers (e.g., Scientific Atlanta, Motorola, Pioneer, Sony) to make integrated digital set-top boxes available at retail. In addition, the operators agreed to provision and support this equipment in their cable systems and to "buy back" integrated boxes purchased at retail from customers who are moving outside the operator’s franchise area.

**II. While the Cable Industry Has Dedicated Substantial Resources to the Above-described Retail Initiatives, Retailers Have Consistently Declined to Invest in -- or Commit to Purchase or Distribute -- “Host” or “Integrated” Set-top Boxes.**

- Retailers’ desire for higher profit margins is the principal impediment to the retail sale of set-top boxes.
- At least one leading manufacturer built host digital set-tops, using the OpenCable specifications, with functionality comparable to the integrated set-top devices provided by cable operators, but was unsuccessful in persuading retailers to order such devices, despite repeated attempts.
- As the record indicates, this manufacturer was told that the retailers were not interested in selling “just boxes,” a reaction consistent with press reports that have described how certain major national retailers “hope to hold out for a share of on-going service revenues” before agreeing to market digital cable boxes.<sup>1</sup>
- These reports confirm that the principal impediment to the development of a retail marketplace for set-top boxes is the retailers’ desire to extract payments from cable operators that will enable them to realize higher profit margins, at the expense of operators and consumers.
- The retailers’ desire to extract a share of cable operator service revenues may be a function of the fact that the markup on competing operator-provided customer equipment (irrespective of whether such equipment utilizes separate security or embedded security) is limited by rate regulation to 11.25%. The retailers apparently find this profit margin unattractive. Rather than seeking cost efficiencies that would improve their margin, however, they have chosen instead to manipulate the regulatory process in an effort to force cable operators to give them a share of the operators’ revenues.

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<sup>1</sup> See, e.g., “MSOs Tread Carefully Into Retail World: Retailers Want Piece of the Profits, Too,” Multichannel News, May 1, 2000 at 121; also see “Scientific Atlanta Readies for Retail of Set-Top Boxes,” The Atlanta Constitution, June 28, 2000, at E-1, 9 (quoting statement of Wachovia Securities Industry Analyst George Hunt that “[t]he first thing Circuit City wanted was a portion of the monthly cable bill”); “Bickering Delays Retail Debut of Set-Top Cable Boxes,” USA Today, July 25, 2000, at B-1 (quoting statement by RadioShack senior executive stating that “we believe that we deserve a piece of that [cable] revenue stream”); “Pricing Quandary Slows Down Retail Set-Top’s Development,” Extra/Extra, Nov. 30, 2000, at 10 (noting that major consumer electronics retailers “want to follow the DBS and cell phone business model, where the product is subsidized and the retailers get a nice slice of the monthly revenue.”).

- The reasons cited by retailers for their failure to make any investment or commitment in this area are entirely without merit.
- Adequacy of OpenCable Specifications. OpenCable specifications provide a wide variety of manufacturer options. Even without OCAP, a host device may be built that (1) provides access to premium (scrambled) digital services and call-ahead pay-per-view, and (2) using proprietary applications, may provide such services as IPPV. The manufacturer may choose what best suits its business plan. This provides the flexibility to manufacture and retail different devices tailored to the needs of different customers. Indeed, in a recent ex parte filing, CEA agreed that “sufficient standards now exist to enable the manufacture of navigation devices that could be sold at retail.”
- PHILA. Three leading set-top box manufacturers (i.e., Scientific-Atlantic, Motorola, and Pace) already have signed the PHILA. The current version of the PHILA is posted on the OpenCable Web site. Moreover, retailer complaints concerning the OpenCable specifications and PHILA do not provide any justification for their refusal to pursue the sale of integrated set-top boxes at retail, in response to the cable industry’s voluntary retail sale initiative for such devices.
- Equipment Averaging. Equipment averaging is not an unfair "subsidy," as CERC has alleged. Cable operators may only recover their costs plus 11.25%. Congress specifically authorized pooling of box costs to provide greater pricing flexibility to rate-regulated cable operators in order to facilitate deployment of advanced digital technology. This is like putting new and used boxes in the same cost pool. It has worked very well in facilitating digital deployment. CERC’s proposal to expand equipment averaging to require cable operators to subsidize the retailers’ provision of equipment to consumers represents yet another blatant attempt to improve retailer profit margins, at the expense of cable companies and consumers. This “retail subsidy” proposal is plainly outside the scope of the statute, which only allows cable operators to aggregate their costs for purposes of setting rates for the equipment they provide to subscribers. Congress clearly did not intend to extend this provision to include set-top equipment purchased and sold by retailers, who are not subject to the rate regulatory constraints imposed on cable operators that led Congress to authorize equipment averaging.

**III. The Commission Should Eliminate the 2005 Ban on Integrated Set-top Boxes, in Light of Changed Circumstances, in Order to Avoid Imposing Significant New Costs on Consumers and to Ensure that Cable Subscribers Have a Full Range of Equipment Options.**

- The ban would substantially increase equipment costs (and monthly lease prices) and reduce equipment options available to consumers.
- As Chairman Powell has observed, it "is contrary to good public policy to remove from the market a potentially cost-effective choice for consumers." Yet, as Chairman Powell recognized, this is precisely what the ban does.
- The D.C. Circuit has agreed with Chairman Powell: "Consumers might [choose] not to purchase retail devices for perfectly sensible economic reasons -- because, for instance, there are efficiency gains captured in the manufacture of an integrated box that lead it to cost less than the combined cost of a separate security module and a retail device, or because consumers view as too high the transaction cost of seeking a separate ancillary device at retail." General Instrument Corp. v. FCC, 213 F. 3d 724, 731 (D.C. Cir. 2000).

- There is ample record evidence showing the potential cost advantages and other benefits that integrated devices offer to customers. In particular, the record to date shows that a POD-host combination is approximately \$93 more expensive than an integrated device performing the same functions. This potentially would mean an average consumer price increase of between \$2.25 and \$3.36 per month for each leased POD-host combination (assuming both the POD and host are rate regulated), based on a five-year and three-year depreciable life, respectively. The incremental increase in monthly lease price per POD-host combination would be somewhat higher in earlier years of the depreciable life of the equipment and somewhat lower in later years. (The specific calculations for these possible monthly lease increases are set out in the Attachment.)
- The ban would force cable operators and subscribers to bear these added costs, despite the fact that the enhanced portability of such host devices provides no added value to consumers who choose to lease, rather than purchase, their set-top boxes, because those boxes stay within one operator’s cable system.
- Even if all boxes are separated into two pieces, this will not eliminate the fundamental obstacle to the retail sale of set-tops noted above, namely, retailers’ desire for higher profit margins. Retailers presumably will still be uninterested in selling “just boxes” at the same profit margins they find unattractive today. So, while maintaining the ban will surely saddle operators and consumers with significant additional costs, it is unlikely to spur retail deployment of standalone host devices.
- The ban also would have a significant adverse impact on innovation and competition.
  - Congress made clear that in implementing the commercial availability provisions, the Commission must "avoid actions which could have the effect of freezing or chilling the development of new technologies and services."
  - As Chairman Powell has observed, “[t]he decision to prohibit integrated boxes may deter innovation. The record of this proceeding shows that potential competitors to incumbent cable providers [*i.e.*, cable overbuilders] have been developing integrated boxes with unique functionalities as a way of competing. It is contrary to Section 629 and to good public policy to inhibit this development.”
  - The record shows that manufacturers in fact have developed new integrated products with innovative new features, including some products (such as Motorola’s DCP500 product line) designed specifically to meet the needs of retail customers. Yet, as Chairman Powell has further observed, the ban on integrated devices forces cable operators to make procurement and technology decisions “so as to avoid the potential for stranded investment, not on the basis of what might be best for their customers.” For this reason as well, the ban should be removed.
- The Commission’s prior rationale for the integration ban no longer applies.
  - The rationale for the ban was based on the assumption that integrated devices could continue to be available only through the cable operator. The Commission explicitly justified its decision to ban integrated devices on the basis that “[a]llowing MVPDs the advantage of being the only entity offering bundled boxes [*i.e.*, integrated boxes with embedded security] could adversely affect the development of this equipment market,”

and that accordingly “the prohibition on integrated boxes allows for equal competition in the marketplace.”

- Given that the cable industry has now committed to allow integrated devices to be made available to consumers through independent retail outlets, applying the Commission’s own reasoning, the prohibition can no longer be justified, particularly given the significant added costs which maintenance of the ban would impose on consumers.
- Indeed, the ability of retailers to purchase and sell the very same integrated devices that are provided by cable operators means that cable operators should now be treated like DBS operators, who operate under this same model and who are exempt from the ban.
- The rationale for the ban is further undermined by the cable industry’s (1) demonstrated and ongoing commitment to OpenCable’s POD-host and middleware initiatives, and (2) increasingly strong economic incentives (in the vigorously competitive MVPD marketplace) to develop retail distribution channels for the equipment used to access their services.
- Neither retailers nor consumer electronics manufacturers would be disadvantaged by the continued provision of integrated set-tops by cable operators.
  - The cable industry’s commitment to support the retail sale of integrated devices answers the retailers’ claim that operator-leased integrated devices are superior to digital host devices with separate security, by allowing retailers to sell integrated devices that are identical to those the operator leases. This commitment also addresses objections raised with regard to the copy protection and certification terms of the PHILA, which are inapplicable, since there is no POD interface in these integrated devices requiring the signing of the PHILA. In addition, the plan provides subscribers who purchase integrated devices at retail with "virtual portability," as a result of the "buy-back" provisions of the plan, thereby addressing retailer concerns in this area as well.
  - Retailers and consumer electronics manufacturers seeking to build and market host devices also have significant opportunities to achieve integration efficiencies, in the form of reduced costs and/or increased functionality, by incorporating host navigation device functions into other consumer electronics equipment (e.g., TVs, DVDs, VCRs), which may make such products appealing to consumers.
  - Retailers can achieve additional efficiencies and further enhance the commercial viability of their product offerings through joint marketing and bundled pricing (e.g., offering a free DVD player as an inducement to purchase a digital TV and set-top box).
- The best policy is to ensure that consumers can choose the option that best fits their preferences. While some consumers may prefer the particular features in an integrated device, which might be offered by a cable operator or a retailer, others may prefer the different features offered in a host device, which also might be offered either by a cable operator or a retailer. This is why Chairman Powell has said that the market should be allowed to play this out.

## ATTACHMENT

### Calculation of Potential Monthly Consumer Price Increase for POD-Host Combination

#### Assuming Five-Year Depreciable Life

- Acquisition cost = \$93 (i.e., cost of POD (\$78) + cost of host interface (\$15))
- 15% cost of capital (i.e., 11.25% rate of return + tax gross up)
- \$18.60 depreciation expense (i.e.,  $\$93 \div 5$  years)
- \$55.80 net rate base at beginning of Year 3 (i.e., \$93 acquisition cost - \$37.20 depreciation expense for first 2 years)
  - **NOTE:** For purposes of illustration, we have assumed the beginning of Year 3 for the net investment. The incremental increase in net rate base and monthly lease price per POD-host combination would be somewhat higher in Years 1 and 2 and somewhat lower in Years 4 and 5.
- \$26.97 annual capital costs (i.e., \$55.80 net rate base x 15% cost of capital + \$18.60 depreciation expense)
- **\$2.25** possible monthly price increase in Year 3 (i.e.,  $\$26.97 \div 12$ )

#### Assuming Three-Year Depreciable Life

- Acquisition cost = \$93 (i.e., cost of POD (\$78) + cost of host interface (\$15))
- 15% cost of capital (i.e., 11.25% rate of return + tax gross up)
- \$31 depreciation expense (i.e.,  $\$93 \div 3$  years)
- \$62 net rate base at beginning of Year 2 (i.e., \$93 acquisition cost - \$31 depreciation expense)
  - **NOTE:** For purposes of illustration, we have assumed the beginning of Year 2 for the net investment. The incremental increase in net rate base and monthly lease price per POD-host combination would be somewhat higher in Year 1 and somewhat lower in Year 3.
- \$40.30 annual capital costs (i.e., \$62 net rate base x 15% cost of capital + \$31 depreciation expense for first year)
- **\$3.36** possible monthly price increase in Year 2 (i.e.,  $\$40.30 \div 12$ )