

**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 Horizontal and Vertical Ownership 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
)	

DECLARATION OF HOWARD SHELANSKI ON OPP WORKING PAPER

Introduction

1. The purpose of this declaration is to comment on the recent OPP working paper entitled “Horizontal Concentration in the Cable Television Industry: An Experimental Analysis” (“Working Paper”). I will first discuss some important ways in which the economic structure of the study’s bargaining experiments differs from the economic characteristics of the real world in which cable operators and cable networks buy and sell programming. I will then discuss why, even taking the study on its own terms, it does not

ultimately address important issues that the horizontal ownership proceeding is most concerned with.

2. My overall conclusion is that the Working Paper does not provide economic evidence relevant to the adoption of horizontal ownership rules in the cable market (nor can it properly be used as the basis for any other policy decisions or analysis of proposed transactions in the cable industry). The paper ignores consequential, economic characteristics of the market in which cable programming is sold, bought, and distributed to viewers. The study, moreover, provides no direct examination of the flow of programming to consumers or explanation for why buyer concentration is responsible for the study's results.

3. If an economic experiment is to shed light on the likely results from actual economic activity, the experiment must replicate as closely as possible the incentives, tradeoffs, and environmental forces that real-world agents face. Economic experiments, like economic models, are inevitably abstractions of real life. When properly designed, however, they can yield valuable insights despite their inability fully to mirror the real world. To be sure, even well designed economic experiments raise questions about the correspondence between behavior under laboratory conditions and behavior under similar conditions in the real world.¹ But it is not that general concern, which applies to any economic experiment, which leads me to question the Working Paper's policy relevance. Rather, it is because the Working Paper abstracts too much from the real-world markets it seeks to examine. The laboratory conditions of the study's experiments do not parallel centrally important features of the markets in which the economic activity at issue occurs. When an experiment does not or cannot sufficiently mirror essential aspects of real-world phenomena, then its results cannot be used to predict actual behavior or to make policy judgments about real economic activity. Thus, although the

¹ See, e.g., Donald W. Katzner, "The Significance, Success, and Failure of Microeconomic Theory," 24 *Journal of Post-Keynesian Economics* 41, 53-54 (2001).

Working Paper may be a somewhat interesting report of the results of a bargaining game, it provides no information useful in evaluating actual bargaining between buyers and sellers of video programming or how that bargaining affects MVPD subscribers.

I. Important Differences Between the Experimental World and the Real World

4. Although the Working Paper acknowledges the need for an experimental analysis to begin “with the creation of an experimental market that parallels the market under investigation,” (Working Paper at 9), the differences between the real world and the modeled world of the Working Paper are numerous and important. In particular:
 - The Study’s experiment never tests a market structure for MVPDs that either exists today or is reasonably foreseeable ever to exist (e.g., as a result of pending transactions). If concentration of cable ownership truly matters, the hypothesis that the study purports to test, then it would seem important for the experiments to reflect actual and potential ownership structures from the real world. Moreover, there is no apparent empirical or theoretical justification for the market shares used in the experiment;
 - The experiment addresses a hypothetical world of only 4 sellers and between 3 and 5 buyers, (Working Paper at 3, fn 6, 10, 15), not the real world in which cable operators actually purchase programming, which contains many more buyers (including not only domestic MVPDs, but also foreign buyers and buyers of programming for other media like broadcast and VHS/DVD) and more than 300 national sellers (plus numerous additional regional networks and dozens of emerging networks);

- The Working Paper does not account at all for the fact that there is competition among MVPDs for viewers. Because of this competition, a buyer's market share, as well as its absolute level of subscribers, will change depending on which programs it purchases for transmission (and depending also on the purchasing decisions made by MVPDs with which it competes). Although these considerations are critically important in shaping buyers' incentives in the real world and inevitably affect how buyers actually behave, the study ignores them;
- The "DBS" provider in the experiment is just another player in the game and is undifferentiated, except for slight differences in assumed cost structure, from those players labeled as "cable" operators. (Working Paper at 13, Table 4). The capacity and coverage differences between cable and DBS that make the latter a potent competitor to cable operators in the real world are in no way proxied in the experimental design;
- The study does nothing to account for the fact that cable networks compete with each other. If two sellers offer substitutable products, then they will compete with each other to attract a limited pool of buyers. A cable operator may believe that consumer interest does not warrant allocating more than one channel to a particular kind of content. If there are competing providers of that type of content, the bargaining process will inevitably be affected. But this real-world possibility is not factored into the experiment;
- The experimental design does not account for possible vertical integration of cable operators and program networks—or between program producers and program networks, for that matter—and the bargaining incentives that such relationships might create;

- The experiment places the buyers and sellers under extremely stringent artificial time pressures that do not exist in the real world, requiring that contracts be negotiated in either five or six minutes rather than over a course of months (Working Paper at 76, 83, 90, 98, 105, 112);
- Actors in the experimental trials have very limited, asymmetric information about each other's payoffs from the transaction at issue, where in the actual programming market buyers and sellers are well-informed about the likely benefits each will receive from a particular bargain (Working Paper at, e.g., 73, 108 (participants not allowed to communicate); 76 (amount of third party payments to sellers unknown to buyers); 108 (sellers privy to each buyer's number of customers)). This is not to say that buyers and sellers in the real world have perfect information about each other or that an experiment need capture every nuance of the real-world information structure. There are many uncertainties in the video programming market that make it extremely difficult for a controlled, limited experiment fully to predict actual outcomes. But what is at issue here is not a nuance. The experiment assumes parties have significantly less information than real-world players are known to have about each other, and that assumption may materially affect the bargaining outcomes in the experiment;
- The players in the experiment do not learn over time about their bargaining opponents and bargains made in one period have no effect on bargaining in the next. (Working Paper at 52 (“[t]he economic experiments may not fully capture the possibility that the bargaining outcomes in successive trading periods in the actual trading market may be correlated”). Yet in the real world, parties learn about each other over time;

- Relatedly, the study does not consider how existing carriage agreements (*i.e.* the results of previous bargaining rounds) may affect current negotiations between MVPDs and program networks. Viewers do not want to lose programming to which they have become accustomed. MVPDs accordingly cannot easily threaten not to carry such programming when contracts are up for renewal. Incumbent networks thus have bargaining advantages over both the buyers of their programming and over new networks trying to get carriage for their programs;
5. The above list contains just some of the ways in which the experiment critically differs from that real-world bargaining environment of the programming market (there are numerous others as well). The Working Paper itself recognizes some of the very issues listed above. It expressly notes that the study does not replicate certain features, like learning over time, vertical integration, or the fact that bargaining in one period may be affected by the bargains struck earlier. Yet those and the other missing factors discussed above are not minor details whose omission can be ascribed to necessary stylization and simplification. It is important to recognize that the listed problems are not simple quibbles or merely inconsequential distinctions. They individually can, and together certainly do, fundamentally alter the bargaining dynamics the Working Paper purports to test. Moreover, those factors affect bargaining in different and unsystematic ways, with some omitted market characteristics favoring sellers and others favoring buyers. It is thus impossible to determine how correcting these omissions would affect the study's results.
 6. So even putting aside the more general problems with the experimental approach—*e.g.* that inexperienced students rather than experienced professionals are playing the game, that the students did not even know what product or service they were bargaining over, and that there was little real consequence to the players from their actions—the Working Paper so deviates

from the actual incentives and tradeoffs of the programming market as to provide no basis for any policy judgments about that market or about transactions among the relevant firms.

7. Professor Andrew Schotter examines the consequences of the FCC experiment's design flaws and analytical gaps in great detail in the declaration he has filed in this proceeding. Professor Schotter's principal findings are (1) that the Working Paper provides incentives and tradeoffs to the experimental subjects that differ fundamentally from those faced by real cable operators and programmers; (2) that the statistical results of the study are not robust and in some cases are driven by a single, atypical action or mistake by a student player (Professor Schotter demonstrates that the efficiency results change radically when these out-lying results are removed); and (3) that the underlying results are not tied to any underlying theory in the study and in fact find no support in current economic theory. Alternative hypotheses turn out to be more likely to explain the experimental outcomes than the market-structure explanation urged by the study. Professor Schotter demonstrates, for example, that the variation in bargaining time over the course of the experiments is a more significant factor in the results than the variation in market structure over the course of the experiments.

II. The Working Paper Does Not Address the Flow of Programming to Consumers or Other Central Issues In the Proceeding

8. Apart from flaws in experimental design and implementation, a second reason that the Working Paper is irrelevant to rulemaking decisions or analysis of proposed transactions is that the study does not say anything directly about how increased concentration would affect the ability of cable operators to affect economic welfare, either for themselves or for consumers. First and foremost, the Working Paper does not address the flow of programming to consumers. Although the Working Paper states in footnote 2 that it is

examining the flow of programming to consumers, consumers in fact appear nowhere in the study. The Working Paper instead examines choices of transactions for some generic product among sellers and distributors of that product, and how those choices affect the total economic surplus to be divided between those parties. It never examines the flow of that product to the distributors' customers. In the MVPD context, then, the experiments could at most (assuming that real-world circumstances were properly replicated) illuminate the effects of buyer concentration on the joint welfare of MVPDs and programming networks, not the effects on subscribers. The division of economic surplus between cable networks and cable operators is at best an indirect and highly conditional measure of consumer welfare.

9. To be sure, consumers will pay most for the programs they desire most. But it is well understood that the link between program profits and the quality, amount and diversity of programming is a complex one, particularly when advertising revenues, and not just subscription revenues, are thrown into the mix.² There is, of course, the separate question of whether any of the welfare losses the study finds would have appeared had the experiment been set up to incorporate competition among buyers in the downstream MVPD market, to include larger numbers of buyers and sellers, or to account for how results of previous rounds of bargaining affect a current round of bargaining. But even accepting the study design as it is, the relationship between network/MVPD welfare and the amount and diversity of programming delivered to consumers is never spelled out in the Working Paper and under accepted theory is not a straightforward one by any means.

10. Importantly, even if one accepts the Working Paper's link between network/operator welfare and consumer welfare, the study does not make clear how it is *buyer* size that is determining the joint welfare of cable networks and MVPDs. Neither the experimental data, nor the study's analysis,

² See Bruce M. Owen and Steven S. Wildman, *Video Economics* (1992).

explain why the reported efficiency losses are the result of buyer behavior. In fact, as Professor Schotter demonstrates in his analysis of the Working Paper, the worst efficiency result is caused by the behavior of a *seller* of programming, not a buyer. So the study in the end provides no light on the ability of MVPDs to affect either their own, or consumers', welfare through their program purchase decisions.

11. Even if, as in the study, a handful of non-competing cable operators were the only buyers of the cable networks' programming, the experimental results have little bearing on how buyer size affects the programming available to MVPD subscribers in the real world. Putting aside all the other limitations of the Working Paper's experiments, the failure to recognize that consumers in each market usually have three separate choices of MVPDs, each with different mixes of programming to offer, is itself a compelling reason why the experiment is of no utility in fashioning horizontal ownership rules.
12. The study not only fails meaningfully to address consumers of video programming but also producers of that programming. The experiment confines itself to what purport to be networks and MVPDs (though the students who participated did not even know that), but it ignores the various ways in which producers of programming can ensure the delivery of their programming to consumers regardless of the outcome of *any* future negotiation between any network and any MVPD. In the real world, numerous networks are *already* ensured carriage over cable facilities, either because of de jure "must-carry" rights, the *de facto* "must-have" status of an established network, cable carriage secured through retransmission consent for a broadcast signal, or an existing long-term carriage agreement between a cable network and a cable or DBS operator. A program producer who sells to such a network will inevitably find that its programming "flows" to consumers, no matter what the result of future network-MVPD negotiations.

13. More generally, the study cannot be taken to provide any valid conclusions about the effect of market concentration in the cable market. There is no generally accepted economic theory that predicts that increased concentration will lead to decreased bargaining efficiency. To be sure, economists well understand how concentration among producing firms may lead to inefficient prices and output levels. But that is a very different question from whether concentration in the industries on one side or the other of a bargaining relationship affects the efficiency of that bargaining. Such concentration may well affect the *division* of the pie among bargaining parties, but there is no theoretical basis for assuming that concentration affects the *size* of the pie through bargaining. Yet this assumption is precisely the one the Working Paper makes. The study simply asserts that its volatile and idiosyncratic inefficiency outcomes are the result of concentration.

14. I do not mean to suggest that no result can be real without first having a well-understood theory. I do not here question that the Study's experiments in fact showed some modest changes in bargaining efficiency across trial transactions in the study's stylized world. The issue is not the result itself, but the Working Paper's explanation for that result. Concentration is not the only possible explanation for the reduced efficiency yielded by the high-concentration trials. The study, however, never tests alternative hypotheses for the results. As Professor Schotter shows, had the study tested alternative explanations (such as bargaining time), it would have found them much more powerful than the concentration explanation the study advocates. The study never considers, for example, how the information structure of the game that the student subjects play might drive bargaining strategies and outcomes. It is well understood by economists that lack of information in bargaining leads to inefficient results. The very limited and asymmetric information that buyers and sellers were allowed to have in the study's experiments is a more likely explanation for any inefficiencies than concentration. *See* Declaration of Andrew Schotter,

Comments of AT&T Corp., CS Docket No. 98-82, at ¶¶ 10, 34, 45-49 (filed July 18, 2002).

15. There is no economic basis for arguing, as the study does (at pp. 23-24), that oligopoly and monopoly are predictable sources of inefficiency in a market like the one in the experiment. Concentration causes inefficiency when a seller must charge all buyers the same price and cannot price discriminate among buyers. In such cases, prices above marginal cost eliminate transactions with consumers willing to pay marginal costs. In the experiment, however, transactions are matched and independent, and the seller can sell at a low price to one buyer and not lose its ability to sell at a higher price to other buyers. Concentration at the buyer level will therefore not induce inefficiency in such a market. Indeed, the study itself acknowledges in Appendix A that traditional oligopoly and oligopsony models do not apply in the experimental setting (p.54). Yet the study supplies no other theory for why concentration explains the experimental results. The Working Paper's unsupported assertions to the contrary, concentration is most likely not responsible for the study's reported outcomes. As Professor Schotter's analysis clearly and convincingly demonstrates, other features of the experimental design are the much more likely motivators of the results.

16. Finally, the Working Paper does not address any of the theoretical arguments that Professor Ordover and I have made in our separate submissions early in this proceeding, or in the AT&T Comcast merger proceeding, explaining why larger MVPDs would not have buying power in the programming market. Indeed, to the extent the study is relevant to our testimony, it supports our conclusions. The study finds that there is no increase in bargaining power when a firm goes from a 27 percent to a 51 percent share of the MVPD market. Although the actual efficiency levels generated by the Study's experiments are likely incorrect and too low, as Professor Schotter explains, the lack of change in that efficiency level as market share increases is

consistent with my and Professor Ordovery's findings. Importantly, when properly analyzed, none of the Working Paper's experimental results challenge the record testimony Professor Ordovery and I have filed in both proceedings.

17. In sum, the Study's experiment in no way reflects the structure, incentives, tradeoffs, or economic environment in which cable operators actually bargain with cable networks for programming. For that reason, its results apply to a world quite different from the real one and thus provide no basis upon which any regulatory judgments can be made in this rulemaking or in any other related context. Moreover, the Working Paper does not directly address how its bargaining results affect consumers or why buyer concentration is the true cause of the study's efficiency results. Therefore, even if one accepts the experimental parameters as valid, it is unclear how the study's results bear on the issues central to this proceeding.

Verification

I, HOWARD A. SHELANSKI, declare under penalty of perjury that the foregoing is true and correct. Executed this 16 th day of July, 2002.

A handwritten signature in cursive script, reading "Howard A. Shelanski", is written over a horizontal line.

Howard Shelanski