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

Applications of	)	
	)	
Adelphia Communications Corporation,	)	
	)	
Comcast Corporation	)	
	)	
and	)	MM Docket No. 05-192
	)	
Time Warner Cable Inc.,	)	
	)	
For Authority to Assign and/or Transfer	)	
Control of Various Licenses	)	

REPLY COMMENTS
OF
CONSUMER FEDERATION OF AMERICA
AND
CONSUMERS UNION
IN OPPOSITION TO THE TRANSFER OF LICENSES

Mark Cooper
Director of Research
CONSUMER FEDERATION OF AMERICA
1424 16th St., NW, Suite 604
Washington, DC 20036
(202) 387-6121

Gene Kimmelman
Senior Director for Public Policy
CONSUMERS UNION
1666 Connecticut Ave., NW, Suite 310
Washington, DC 20009
(202) 462-6262

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I. SUMMARY

A. COMMENTERS

The Consumer Federation of America (CFA) is the nation's largest consumer advocacy group, composed of two hundred and eighty state and local affiliates representing consumer, senior, citizen, low-income, labor, farm, public power and cooperative organizations, with more than fifty million individual members.[1] Consumers Union (CU), publisher of Consumer Reports, is an independent, nonprofit testing and information organization serving only consumers. CFA and CU have participated in numerous proceedings before regulatory and antitrust agencies dealing with the cable industry including merger reviews,[2] the horizontal limits proceeding,[3] and other public policy proceedings.[4]

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[1] CFA is online at www.consumerfed.org; CU is online at www.consumersunion.org;

[2] Consumer Federation of America, "Petition to Deny of Arizona Consumers Council, Association Of Independent Video And Filmmakers, CalPIRG, Center For Digital Democracy, Center For Public Representation, Chicago Consumer Coalition, Civil Rights Forum On Communications Policy, Citizen Action Of Illinois, Consumer Action, Consumer Assistance Council, Consumer Federation Of America, Consumer Fraud Watch, Consumers United/Minnesotans For Safe Food, Consumers Union, Consumers' Voice, Democratic Process Center, Empire State Consumer Association, Florida Consumer Action Network, ILPIRG (Illinois), Massachusetts Consumers Coalition, MassPIRG, Media Access Project, Mercer County Community Action, National Alliance For Media Arts And Culture, MontPIRG, New York Citizens Utility Board, NC PIRG, North Carolina Justice And Community Development Center, OsPIRG(Oregon State), Oregon Citizens Utility Board, Texas Consumer Association, Texas Watch, United Church Of Christ, Office Of Communication, Inc., US PIRG, Virginia Citizens Consumer Council, WashPIRG, Wisconsin

Consumers League, " *In the Matter of Application for Consent to the Transfer of Control of Licenses Comcast Corporation and AT&T Corporation, Transferors, to AT&T Comcast Corporation, Transferee,* April 29, 2002; "Petition to Deny of Consumer's Union, Consumer Federation of America, Media Access Project, and Center for Media Education." *In the Matter of Application of America Online Inc. and Time Warner, Inc. for Transfers of Control*, Federal Communications Commission, CS-Docket No. 0030, April 26, 2000.

[3] "Comments of the Consumer Federation of America, Consumers Union, Center for Digital Democracy, The Office of Communications of the United Church of Christ, Inc., National Association of Telecommunications Officers and Advisors, Association for Independent Video Filmmakers, National Alliance for Media Arts and Culture, and the Alliance for Community Media," *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, Review of the Commission's Regulations Governing Attribution of Broadcast and Cable/MDS Interests, Review of the Commission's Regulations and Policies Affecting Investment in the Broadcast Industry, Reexamination of the Commission's Cross-Interest Policy*, CS Docket No. 98-82, CS Docket No. 96-85, MM Docket No. 92-264, MM Docket No. 94-150, MM Docket No. 92-51, MM Docket No. 87-154; January 4, 2002; "Reply Comments of the Consumer Federation of America, Consumers Union, Center for Digital Democracy, and Media Access Project," 2003; 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, Review of the Commission's Regulations Governing Attribution of Broadcast and Cable/MDS Interests, Review of the Commission's Regulations and Policies Affecting Investment in the Broadcast Industry, Reexamination of the Commission's Cross-Interest Policy*, CS Docket No. 98-82, CS Docket No. 96-85, MM Docket No. 92-264, MM Docket No. 94-150, MM Docket No. 92-51, MM Docket No. 87-154.

[4] "Comments and Reply Comments of Consumers Union and the Consumer Federation of America," In the Matter of Comments Requested on a La Carte and Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems, before the Federal Communications Commission, MB Docket No. 04-207, July 13, 2004, August 13, 2004 "Comments of MB Docket No. 04-207; "Comments of the Consumer Federation of America," before the Federal Communications Commission, In the Matter of Implementation of Sections of the Cable Television Consumer Protection Act of 1992, MM Docket No. 92-266, January 27, 1993.

B. AN ILLEGAL MARKET DIVISION SCHEME

The petitions filed in opposition to these mergers and transactions present a comprehensive, coherent and compelling fact-based argument that these transactions are not in the public interest. This is much more than a merger. It is a series of transactions that constitute an anticompetitive market allocation agreement.[5] The number one and number two firms in the cable industry, who will constitute the number one and number two firms in the Multichannel Video Program Distribution (MVPD) industry after the merger, have proposed a complex transaction involving the assets of three of the largest players in the industry.[6] They are taking the opportunity of the bankruptcy of the number seven firm in the MVPD industry, a bankruptcy brought on not by any underlying weakness in the firm or the industry, but by the criminal activities of the founders and largest shareholders of the firm, to divide the market in a manner that will greatly increase their market power.

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[5] Declaration of J. Gregory Sidak and Hal J. Singer, in support of "Petition of TCR Sports Broadcasting Holdings, LLP, to Impose Conditions or, it he Alternative to Deny Parts of the Proposed Transaction," *In the Matter of Application of the Consent to the Assignment and/or Transfer of Control of Licenses Adelphia Communications Corporation (and Subsidiaries, debtors-in-possession), Assigners to Time Warner Cable Inc. (subsidiaries), Assignees; Adelphia Communications Corporation (and Subsidiaries, debtors-in-possession), Assigners to Comcast Corporation (subsidiaries) Assignees and Transferees; Comcast Corporation, Transferor to Time Warner, Inc., Transferee; Time Warner, Inc., Transferors to Comcast Corporation, Transferee,* MB Docket No. 05-192, July 21, 2005

[6] Federal Communications Commission, *Annual Assessment of the Status of Competition in the Market for Video Programming: Eleventh Annual Report*, February 4, 2005,Table B-3;

The merger represents an unacceptable increase in the concentration of the national video programming market, but its greatest impact will be in regional markets. If regulators accept the proposition that there are distinct product and geographic markets for certain types of regional programming, as they must given the well-documented importance of regional sports programming, then they must analyze the swaps and acquisitions entailed in these transactions as within market mergers. If they do so, they are compelled to conclude that these mergers constitute a massive and unacceptable increase in the concentration of those regional markets.

The fact that the two acquiring firms have systematically allocated the acquired assets to reinforce their control of specific markets, and sweetened the pot by throwing in and swapping additional assets that compound the concentration of markets, should be an added source of concern to regulators. Swaps of assets held prior to the merger by Comcast and Time Warner, the two parties acquiring Adelphia, constitute one quarter of the subscribers affected by the transaction.[7] Approximately 1.8 million of the 6.9 million subscribers changing hands in these transactions are pure transfers between Comcast and

[7] "Comments of DIRECTV," In the Matter of Application of the Consent to the Assignment and/or Transfer of Control of Licenses Adelphia Communications Corporation (and Subsidiaries, debtors-in-possession), Assigners to Time Warner Cable Inc. (subsidiaries), Assignees; Adelphia Communications Corporation (and Subsidiaries, debtors-in-possession), Assigners to Comcast Corporation (subsidiaries) Assignees and Transferees; Comcast Corporation, Transferor to Time Warner, Inc., Transferee; Time Warner, Inc., Transferors to Comcast Corporation, Transferee, MB Docket No. 05-192, July 21, 2005, Table 1.

Time Warner designed to allow these two firms to consolidate their control over key markets.

Magnifying these basic facts about the transaction is the fact that these two firms are joint venturors in an important programming service.[8] They are also increasing carriage of each other's programming on their systems.[9] Taken together, these facts present the makings of a full blown violation of sections 1 and 2 of the Sherman Act.

Regulators need not go that far to protect the public in this instance. They need only focus on the details of the proposed transactions and prevent their anticompetitive effects, either by rejecting the merger or by adopting specific remedies to address each of the problems raised by the merger.

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[8] "Petition to Deny of Free Press, Center for Creative Voices in Media, Office of Communications of the United Church of Christ, Inc., U.S. Public Interest Research Group, Center for Digital Democracy, CCTV, Center for Media and Democracy, Media Alliance, Hational Hispanic Media Coalition, The Benton Foundation and Reclaim the Media*," In the Matter of Application of the Consent to the Assignment and/or Transfer of Control of Licenses Adelphia Communications Corporation (and Subsidiaries, debtors-in-possession), Assigners to Time Warner Cable Inc. (subsidiaries), Assignees; Adelphia Communications Corporation (and Subsidiaries, debtors-in-possession), Assigners to Comcast Corporation (subsidiaries) Assignees and Transferees; Comcast Corporation, Transferor to Time Warner, Inc., Transferee; Time Warner, Inc., Transferors to Comcast Corporation, Transferee,* MB Docket No. 05-192, July 21, 2005,

[9] : "The America Channel LLC's Petition to Deny," In the Matter of Application of the Consent to the Assignment and/or Transfer of Control of Licenses Adelphia Communications Corporation (and Subsidiaries, debtors-in-possession), Assigners to Time Warner Cable Inc. (subsidiaries), Assignees; Adelphia Communications Corporation (and Subsidiaries, debtors-in-possession), Assigners to Comcast Corporation (subsidiaries) Assignees and Transferees; Comcast Corporation, Transferor to Time Warner, Inc., Transferee; Time Warner, Inc., Transferors to Comcast Corporation, Transferee, MB Docket No. 05-192, July 21, 2005, p. 46.

C. THE MARKET STRUCTURE

In evaluating the likely anti-competitive impact of the merger, regulators must also take the past behavior and current conditions in the industry into account. They must also recognize several unique characteristics of the industry.

Beyond the traditional analysis of market structure that must lead regulators to oppose the merger, there is a subtle story of control of marquee programming, crown jewel markets and tipping point thresholds that new entrants struggle to surpass. By solidifying the control of the critical features of the terrain of the multichannel video programming industry in the hands of the two dominant cable, multiple system operators (MSOs), the merger magnifies their market power and the threat to consumers and competitors that it entails.

We start from the premise, demonstrated below, that the MVPD market still exhibits market power at the point of sale persists. Intermodal competition between cable monopolies and a couple of satellite providers, which typifies the overwhelming majority of markets, has proven insufficient to discipline price. There is, at most, a modest effect on quality in terms of the number of channels offered, but only where satellite offers local into local. Even there cable has developed a larger bundle with anticompetitive pricing – a virtual tie between basic video and high speed Internet – that further diminishes satellite as an effective competitor.

Moreover, the bundling of programming enhances cable market power by severely reducing the elasticity of demand. Bundling of huge packages of linear

programming reinforces the power of cable operators both as sellers of video packages and buyers of video programming. Placing of programming in the big bundle becomes a make-or-break event for advertiser supported programming.

Market power at the national level is reinforced by regional market power. Clustering in the top 25 major urban markets and crown jewel local areas, like Manhattan and Hollywood, is critical to the success of programming. These two firms will dominate those markets after the merger to an unprecedented extent.

Dominance over distribution in regional clusters interacts with control of regional, "must-have" programming to create an immense amount of vertical leverage. Dominant regional firms can deny programming to competing distribution platforms either by refusing to make their programming available or by seeking exclusive arrangements for unaffiliated programming.

D. A QUALITATIVE ASSESSMENT OF THE IMPACT OF THE MERGER

At every level this merger makes things substantially worse. The anticompetitive effect is felt in both upstream and downstream markets.

1. Upstream - programming

National: Upstream in the national market, it is quite clear that post merger, Comcast and Time Warner will have unilateral make-or-break power over programming. Independent producers of video programming, who do not have guaranteed access rights, through either ownership or Congressionally legislated carriage rights, simply cannot succeed without securing carriage on both Comcast and Time Warner systems. Comcast has that power today, but it

will be substantially enhanced at the national and regional levels by these transactions, removing one of the largest cable operators not integrated into programming.

The anticompetitive conduct that is alleged and documented in the record of this proceeding includes favoring of affiliated programming and foreclosing of unaffiliated programming. The net effect as demonstrated in carriage rates is a huge disadvantage for unaffiliated programming.

Empirically, independent programmers cannot succeed without getting carriage on the systems operated by **both** of the dominant firms. Post-merger, there will not be sufficient market not controlled by these two giants to succeed without their support. This merger pushes the industry past an important tipping point. There are not enough homes to pass to succeed without securing carriage on one of these systems. As a practical matter, no one can succeed without securing it on both.

The new wrinkle added by this merger is the extensive domination of critical urban markets by these two firms. National advertisers value certain markets more highly for general programming. Programmers not only need to be in 60 million homes to survive as a national linear network, they need to be in a substantial number of the top 25 markets.

This merger increases the market share of the two dominant firms in 11 of the top 25 markets and brings the total number dominated to more than half (30) of the top 50 markets. This merger pushes the industry past a crucial tipping

point. With these mergers, the firms dominate a majority of the most important markets.

Regional: Another relatively new and important issue is the upstream market for regional programming, as opposed to national programming. There is an identifiable market for regional/local video programming. Certainly sports and news fit this category.

This programming tends to be monopolistic. Exclusive deals are made for the right to distribute the programming. Failing to get distribution dooms a producer or places that producer at a severe disadvantage.

2. Downstream – distribution

The impact of the monopolization of regional programming is also felt in the downstream market. because some of this regional programming is sufficiently "must have" or marquee to pose a threat to competition in the downstream, or distribution market. Marquee programming (sports and non-sports) is monopolized through the terrestrial loophole. Denying this programming to competitors reduces their ability to gain audience. Even when competitors get access, they are overcharged and placed at a competitive disadvantage.

The downstream threat is reinforced by other sources of market power. The large footprint of the increasingly regionally clustered systems also allows dominant regional firms to demand and receive exclusives on non-affiliated programming, further undermining competition. These regional giants also

engage in selective regulatory arbitrage, delaying entry, and selective predatory pricing against new entrants, weakening their ability to attract customers.

The ultimate effect of the increase in concentration and market power on the consumer is higher prices. The growth in the size of the dominant firms and the increase in regional clustering will result in higher prices charged to consumers. The increase will be large, 5 to 10 percent, and there are no prospects that it will be mitigated anytime soon.

E. RECOMMENDATION

The dramatic anticompetitive effects of these transactions across a range of national and local product and geographic markets makes it clear that this merger is not in the public interest. It should be rejected.

Petitioners opposing the merger uniformly call for it to be rejected, but hesitantly identify conditions to be imposed on the merger, should it be allowed to go forward. Their concern about approval with conditions is well founded. The track record on the ability of behavioral conditions to prevent harm to competition and consumers in this industry is abysmal. Enforcement is difficult; loopholes are constantly invented; and punishment for violating conditions have been inconsequential.

If conditions are to be imposed, they will have to precise, largely self-enforcing, and backed up with substantial penalties. Fines for violation of conditions should be paid to the injured parties lodging the complaint. Violations of key conditions, such as withholding of programming from competitors or denial

carriage, should trigger the divestiture of the property being wielded as an anticompetitive weapon.

Moreover, the conditions must be permanent and general, since the market power that results is so pervasive. They must address each of the major categories of leverage that the increased market power conveys.

As dominant cable operators, Comcast and Time Warner must be prevented from leveraging their control over distribution to undermine competition in the upstream programming market. Recommendations to deal with this problem range from an obligation to provide carriage on just and reasonable terms and conditions, to most favored nation treatment, to baseball arbitration, to leased access at a fixed rate that reflects the marginal value of capacity (which is presumed to be low). These conditions should apply to linear programming, but discrimination in access to the VOD space is also a concern.

As dominant cable operators, Comcast and Time Warner must be prevented from leveraging their control over distribution to undermine competition in the downstream distribution market. The should not be allowed to withhold programming that they own through the so-called terrestrial loophole. They should not be allowed to demand exclusives from programmers. Their contracts should be scrutinized to purge any such conditions.

We have treated this merger as a threat to competition and consumers in video services markets. Therefore, the predatory practice of creating a virtual tie

between basic video and high-speed Internet service, a competitive club used against satellite, should also be stopped.

II. NUTS AND BOLTS OF CABLE MARKET POWER

A. INCREASES IN MARKET CONCENTRATION

The parameters of the impact of this set of transactions on the MVPD market are staggering. The merger violates the Department of Justice/Federal Trade Commission Guidelines at every level (see Exhibit 1).

At the national level, even using the most merger friendly counts – full counting of DBS and no attribution of minority holdings in cable systems – the post merger market would be well up into the moderately concentrated range. The increase in the HHI would be just under 200 points, or twice the threshold for concern about anticompetitive impacts. Taking joint ventures into account, some petitioners estimate that the post merger national market would be highly concentrated.[10] The merger induced increase the HHI would be 200 to 300 points, four to six times the threshold.

The most dramatic impact of the merger comes at the regional/local level. These three companies are present in just under half the markets in the nation (99 market out of 210 or 47%). In 48 of those markets the post-merger market would be highly concentrated and the merger induced increase in the HHI exceeds the threshold. More importantly, against an increase of 50 points in the HHI as the threshold for concern in highly concentrated markets, the average increase in the HHI in these 48 markets is over 900 points, more than 18 times the threshold.

[10] "Opposition of Free Press, et al."

The impact of these transactions is concentrated in the largest markets in the nation. The concentration in 5 of the top 10 markets would increase by an average of over 800 points; 11 of the top 25 markets by an average of over 1000 points; 22 of the top 50 markets by almost 900 points. Thus, just under one half of the affected markets (46%) are in the largest one-quarter of the markets in the nation.

Looking at the marquee regional product markets at the regional level, the merger exceeds the threshold in 20 of the footprints of 29 regional sports networks. Eighteen of these would be highly concentrated after the merger and the average increase in the in the HHI would be almost 380 points, or more than seven times the threshold DOJ/FTC value. Two markets would be moderately concentrated post merger, with an increase averaging about 170 points.

B. PRICE INCREASES

In a market where there is a general lack of competition at the point of sale, we would expect prices to rise as a result of mergers such as these.

1. Feeble Competition at the Point-of-Sale Fails to Discipline Pricing Abuse

Econometric evidence confirms what regulators should have known all along, **head-to-head, wireline competition is the only market structure feature that significantly disciplines monopolistic pricing**. In its most recent report, the GAO finds that head-to-head, wireline competition between cable operators

lowers prices by 15 percent for basic and expanded basic service (See Exhibit 2).[11] Its earlier report had found a 17 percent difference.[12] FCC econometric models, which identified three types of head-to-head competitors (public, local exchange carriers, and other overbuilders), have consistently found large price effects from head-to-head, wireline competition.[13] Unfortunately, only about 2 percent of American households enjoy the benefit of head-to-head, wireline competition.

Overbuilding is moribund.[14] One of the great disappointments of the 1996 Telecommunications Act has been the failure of competition from alternative technologies to break down the market power of the incumbents. Congress devoted a whole section of the law to telephone competition for cable through open video systems.[15] Today, open video systems are non-existent.[16]

Overbuilders have faced vigorous efforts to prevent competition through exclusion from access to programming and regulatory tactics of incumbent cable operators.[17] Comcast has shifted some sports programming to terrestrial delivery, thereby avoiding the open access requirement of the 1992 statute. As cable operators become larger and more clustered, this strategy will become

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[11] U.S. GAO, 2003, Appendix IV.

[12] U.S. GAO, 2002.

[13] Federal Communications Commission, *Report on Cable Prices,* April 4, 2002, Attachment D-1; February 14, 2001, Attachment D-1; June 2000, Attachment D-1; May 7, 1999, C-1.

[14] Subcommittee on Antitrust, Monopolies and Business Rights, Committee on the Judiciary, United States Congress. *Competitive Issues in the Cable Television Industry.* March 17, 1988; Committee on Energy and Commerce, *Report on H.R. 4850,* Senate Committee on Commerce and Science, *Report on S12.*

[15] U.S. C. 47, Title II, part 5.

[16] Federal Communications Commission, 1998, Appendix C.

[17] *RCN Telecom Service of New York, Inc. v. Cablevision Corp., DIRECTV v. Comcast; EchoStar v. Comcast.* Problems can also occur on an event-by-event basis (see Everest, 2001, p. 4; Gemini Networks, 2001, p. 3.

increasingly attractive to them. Specific areas where such programming has been denied are Phoenix, Kansas, Philadelphia and New York. The denial of access to marquee sports programming can have a devastating effect, with satellite providers in markets where foreclosure has occurred achieving a market penetration only one-quarter of the national average.[18]

Integrated MSOs wield immense power against smaller cable companies, exploiting loopholes in the program access rules.[19] For the smaller entities, the current refusals to deal are not limited to sports programming. Other services have been denied, such as video-on-demand.[20]

Second, where the large MSOs do not have direct ownership of video services, they have obtained exclusive arrangements, thereby denying competitors and potential competitors access to programming.[21] The exclusionary tactics apply not only to head-to-head cable operators and satellite providers, but also to DSL-based providers seeking to put together a package of voice, video, and

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[18] Joint Comments, p. 14.

[19] American Cable Association, "Comments of the American Cable Association." In *The Matter of Implementation of the Cable Television Consumer Protection and Competition Act of 1992, Development of Competition and Diversity in Video Programming Distribution: Section 628 (c)(5) of the Communications Act: Sunset of Exclusive Contract Prohibition*, Federal Communications Commission, CS Dkt. No. 01-290, December 3, 2001, p. 15.

[20] "Comments of Everest Midwest Licensee LLC dba Everest Connections Corporation." In *the Matter of Implementation of the Cable Television Consumer Protection and Competition Act of 1992, Development of Competition and Diversity in Video Programming Distribution: Section 628 (c)(5) of the Communications Act: Sunset of Exclusive Contract Prohibition*, Federal Communications Commission, CS Dkt. No. 01-290, December 3. 2001, p. 6.; "Comments of Qwest Broadband Services, Inc." In *The Matter of Implementation of the Cable Television Consumer Protection and Competition Act of 1992, Development of Competition and Diversity in Video Programming Distribution: Section 628 (c)(5) of the Communications Act: Sunset of Exclusive Contract Prohibition*, Federal Communications Commission, CS Dkt. No. 01-290, December 3. 2001, p. 4.

[21] Everest, p. 6, American Cable Association, 2001, p. 15.

data products. Bundling is critical to controlling entry into the emerging digital multimedia market.[22]

Third, because the dominant MSOs are so large, they can influence important programmers not to sell to competitors or potential competitors. As the Commission noted, Ameritech and the WCA found that they were cut off from programming.[23] The list could go on and on.[24]

The problem is not simply one of complete exclusion. Dominant, vertically-integrated MSOs can inflict "discriminatory or excessively burdensome terms and conditions of programming distribution."[25] Recent comments in the program access proceeding point to an even more stark demonstration of the power of cable to engage in content discrimination.[26]

Cross-technology competition from satellite is weak as well. As shown in Exhibit 2, GAO found that in contrast to head-to-head, wireline competition, which lowers cable bills by $5 per month, competition from direct broadcast satellite (DBS) lowers bills by a mere $.15, according to the GAO.[27] The FCC's econometric analysis does not find even this small price effect. It finds a statistically significant effect in the opposite direction.[28]

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[22] Comments of the Competitive Broadband Coalition, *Implementation of the Cable Television Consumer Protection and Competition Act of 1992*, Cable Services Bureau Dkt. No. 01-290, at 10-11 [Dec. 3, 2001]), p. 11.

[23] Federal Communications Commission, 2001a, para. 28

[24] Joint Comments, 2001, p. 8.

[25] Qwest, 2001, p. 3; Dertouzos and Wildman, 1999.

[26] Joint Comments, 2001, p. 9.

[27] U.S. GAO, 2003, Appendix IV.

[28] FCC, *Report on Cable Prices,* April 4, 2002, Attachment D-1.

Confusing separate geographic markets and product market segments served by different technologies leads to an inappropriate conclusion about intermodal competition. In fact, satellite drew its subscribers from places that cable had not gone. A very substantial segment of the satellite market exists in places not served by cable. Moreover, satellite was the only digital service available for a considerable period of time. In other words, cable was not losing subscribers to satellite; satellite was expanding the market. It never competed for the bulk of cable's basic/expanded basic customer base.[29] Cable's offering of digital service is growing much faster than satellite's comparable service. The addition of high-capacity digital cable and cable modem Internet services allows cable operators to attack the high-end niche that satellite occupies.[30] Cable will be able to leapfrog satellite at the high-end of the market, particularly when it is bundled with high-speed Internet access. Satellite will be at an increasing disadvantage, as it does not have an Internet offering of equal quality and price to deliver over the same facilities.

To the extent that satellite has any competitive effect, it drives cable operators to offer a few more channels, but this effect stems from the decision of satellite to offer local programming. Where satellite offers local programming, cable operators offer about 5.4 percent more cable channels. Thus, satellite

[29] Bazinet, Jason B., *The Cable Industry.* (J.P. Morgan Securities, Inc. 2001), p. 4.

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

appears as a niche product that cannot discipline cable pricing abuse for the vast majority of cable subscribers who take only basic and expanded basic.[31]

2. Large Size and Regional Clusters Increase Market Power

Exhibit 2 also includes the econometric results of market structure characteristics beyond head-to-head competition. It shows that **bigger monopolies are worse when it comes to consumer prices.** In the GAO analysis, if a cable system is part of a large national operator, its prices are 5.4 percent higher than if it is not.[32] The GAO called this horizontal concentration. Federal Communications Commission (FCC) econometric models have been finding this to be the case for several years, with even larger effects of being part of a multiple system operator (MSO).[33] When the FCC models add in a specific variable for regional clustering, a dramatic trend in the industry, they find that clustering has an added effect of further raising price.[34] Clustering was estimated to have a 2 to 3 percent effect on price. Consumers served by one of the mega-MSOs, who have been expanding their grip on the industry through mergers and clustering, suffer higher prices by more than 5 percent and perhaps as much as 8 percent. At the Extreme, the FCC analysis suggests the total could be as high as twenty percent.

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[31] Cooper, 2002, pp. 21-32.

[32] U.S. GAO, 2003, Appendix IV.

[33] FCC, *Report on Cable Prices,* April 4, 2002, Attachment D-1; February 14, 2001, Attachment D-1; June 2000, Attachment D-1; May 7, 1999, C-1.

[34] FCC, *Report on Cable Prices,* February 14, 2001, Attachment D-1; June 2000, Attachment D-1.

The important implication is that the theory used to allow large cable operators to become larger is not supported by the empirical evidence. That theory claimed that the combination of larger, clustered systems would create efficiency-based cost savings that would be passed on to the public because one big monopolist is no worse that two, contiguous smaller ones. Since large incumbents never overbuild one-another and compete, the claim is that there was little to be lost. The econometric evidence suggests that there is, in fact, considerable harm. It turns out that large operators and clustered systems have more muscle to thwart competition and impose price increases. They can distribute programming terrestrially and extract exclusivity deals from independent programmers, thereby denying programming to competing distribution media (overbuilders and satellite). They have more leverage over local governments to obstruct the entry of overbuilders. If they knew they could not grow through mergers, they might compete by overbuilding one another.[35]

In these transactions, the two largest MSO's will become substantially larger and more clustered. All of the evidence suggests that the result will be higher prices.

C. INCREASING CASH FLOW

The recent announcement of a huge, 64 percent increase in profits by Comcast, while it has led the industry in rate increases, anecdotally reinforces the econometric results and points to the final step in this analysis, the bottom

[35] Cooper, 2002, Chapter 7.

line. Since the passage of the Telecommunications Act of 1996, monthly rates for basic and expanded basic cable have doubled (see Exhibit 3). Over that same period, the cash flow per year, per subscriber has almost doubled as well, increasing by about 90 percent. As the FCC notes in its most recent annual report, "cash flow (generally expressed as earnings before interest, taxes, depreciation and amortization or EBDITA) is often used to assess the financial position of cable firms and other companies in capital intensive industries."[36]

The fact that the bulk of the basic rate increase has been taken out as operating cash flow means that cable rate increases have been much larger than operating expenses (see Exhibit 4). In particular, the claim that rising programming costs have caused basic rate increases is false. Increases in revenues have far outstripped increases in programming costs. In fact, non-programming expenses, largely associated with high-speed Internet and digital cable offerings, have increased much faster than programming expenses. Nevertheless, even these increases have not been sufficient to hold down the tremendous rise in cash flow. Traditional video revenues, including monthly charges for basic and expanded-basic rates and local advertising revenues, have increased by over $100 per subscriber per year, which is equal to about two-thirds of the total increase in cash flow (see Exhibit 5).

[36] *11th Annual Report,* p. 19.

III. REGIONAL DISTRIBUTION COMPOUNDS THE ANTICOMPETITIVE PROBLEMS OF THESE TRANSACTIONS

A. CLUSTERING

In the cable TV industry, market power has been expanded and reinforced by control and distribution of regional programming, especially sports. Regional market power through clustering plays a critical role particularly for advertising markets. Dominating specific programming categories generates both high profits and provides leverage to undermine competitors.

The reasons offered for the importance of the large designated market areas include the attractiveness to advertisers of a high-income trend setting population, as well as the presence of the major media.

> In addition to the number of viewers, advertisers consider the markets to be important (indeed even disproportionately to their subscriber numbers) for a number of reasons including product trend-setting, higher per capita disposable income, and the presence of major press. Networks that do not substantially penetrate the top markets are at a severe disadvantage in the competition for advertising dollars relative to similar networks which do.[37]

While there are many intangible elements to this characteristic of the industry, there is one area in which it should be visible. Advertising revenue should be higher in the more highly valued markets. Exhibit 6 plots the distribution of TV households and TV ad revenue across the designated market areas, which are the standard definition of TV markets used in the industry. There is no doubt that the top markets account for a larger share of revenues

[37] TAC, Comment, p. 28.

than households. To assess the importance of this phenomenon, we have calculated the ratio of revenue to population – essentially the market-wide power ratio (see Exhibit 7).

The top eleven markets all have a substantial premium of ad revenues above TV households. These markets account for 31 percent of the TV households, but 41 percent TV ad revenue, a premium of over 33 percent. Six of the next 14 markets have a premium, but the overall premium is about the same. That is, the top 25 markets have 49 percent of TV households and 59 percent of the ad revenue.

B. DBS IS NOT A FULL COMPETITOR TO CABLE

As discussed above, it is now quite clear that DBS cannot be considered a full competitor for cable from the point of view of the consumer. The evidence shows that it does not discipline cable with respect to price.

The weakness of DBS as a distribution mechanism has been demonstrated in the behavior of the dominant DBS owner, who also happens to be the owner of one the major national broadcast networks. As the America Channel notes in its recent filing, when Fox news sought to launch a business channel, it could not rely on its DBS distribution network. As the *Wall Street Journal* noted, "people familiar with the situation say Mr. [Rupert] Murdoch didn't want to go ahead until he had an agreement with Time Warner Cable, because it controls the crucial Manhattan market."[38]

[38] Cited in TAC, p. 34.

Beyond the specific issue of the New York market, DBS continues to have a substantially different subscriber base. It is much less urban and much more rural (see Exhibit 8). The share of satellite subscribers in the top eleven DMAs is 27 percent, compared to 33 percent of cable's subscribers in those markets. The difference is substantial in terms of market value. On a simple comparison, cable has 18.4 million more subscribers than satellite in the top eleven markets. On a revenue-weighted basis, it has 22.8 million more subscribers. On a national average basis, satellite subscribers reside in designated market areas whose ad revenue is about 10 percent less than the national average, with the bulk of the difference coming in the top 11 markets.

The underlying limitation of DBS as a competitor to cable can be readily seen in the distribution of subscribers. Satellite has made its largest penetration in smaller, rural markets, which carry much less weight in the industry. Exhibit 9 underscores this point by examining markets where cable's share exceeds the level typically associated with monopoly power. This is generally put in the range of a 65 to 70 percent market share.

Conversely we look at markets where satellite's market share is above 30 to 35 percent. These markets contain about 16.1 million MVPD subscribers or 17 percent of the national total. Satellite's market share is above 35 percent of MVPD (indicating cable's is less than 65 percent) in markets that have 6.9 million MVPD subs, or about 7 percent of the national total. Cable's market power remains above the monopoly level in the vast majority of markets.

Exhibit 9 shows the individual markets where cable has a less than 65 percent market share. These are the 28 markets where satellite has its largest market share. We contrast this to the 28 markets where cable has its largest market share. The difference is striking, on average, cable's best markets are four times as large.

C. THE IMPACT OF THE MERGER ON KEY MARKETS

The importance of large urban markets and the weakness of satellite as a competitor, both at the point of sale and as a means of distribution for independent programming, converge in the case of Comcast. These two factors are extremely important in evaluating the market power of Comcast (see Exhibit 10).

Comcast has clustered its systems in the dominant designated market areas. About 60 percent of its subscribers reside in the top 11 DMAs. Eighty percent of its subscribers reside in the top 25 DMAs. Thus, it has a heavy premium in terms of advertising clout. This gives it greater leverage over programmers than its subscriber count would indicate.

One interesting comparison is between Comcast and the total of satellite subscribers (see Exhibit 11). Comcast owns systems that pass approximately 21.5 million subscribers. Weighted by advantage of advertising revenue in the top 11 markets, those subscribers are equal to 24.8 million. DBS serves approximately 21.3 million subscribers, but they are underrepresented in the top 11 DMAs. This disadvantage, *vis-à-vis* cable, would lower the DBS effective

count to just over 17 million. In other words, instead of being equal to Comcast in simple subscriber count, DBS would be about two-thirds the size of Comcast on an ad revenue weighted basis, if the premium on viewers in the top 11 DMAs is included.

Time Warner's pattern of holdings is somewhat different. I has an important holding in New York (Manhattan) and Houston in the top eleven and Cleveland and Minneapolis among the top 25 markets. It is quite prominent in the second 25 markets, however.

On the basis of this traditional and direct approach to merger analysis it is clear that these transactions pose a huge threat to the public interest. This threat is compounded when we examine the market structure and conduct characteristics of the cable industry and the acquiring parties. The remainder of these comments elaborate on why these anti-competitive effects, will be magnified in the MVPD industry. The analysis present empirical discussion of bundling, monopsony power and vertical leverage. These are not the main focus of anttrust practice, so the appendix briefly reviews the economic theory developed in recent years that provides the theoretical underpinning of the analysis.

IV. MARKET SHARE LEVERAGE IN THE NATIONAL VIDEO PROGRAMMING MARKET

The analysis of national market concentration shows that, at a minimum, the post-merger national market would be moderately concentrated with an

increase in the HHI of a couple of hundred points. The concern that such a change normally causes in merger review is heightened because of the characteristics of the video programming market. Simply put, the market power of the leading firms is compounded by the economic structure of the market.

A. BUNDLING

One development in the industry that has increased market power and further restricted consumer choice and programmer access is the cable industry practices of bundling programming and leveraging control of marquee programming into program suites.

Cable operators force consumers to buy large bundles of programs in order to obtain the small number of networks that they actually watch. Getting into the bundles that will be widely distributed is a make-or-break threshold for programmers. Access to these bundles is under the control of the cable operator. This practice, which has been prevalent for basic and expanded basic tiers in the past, has recently been extended to digital tiers. Similarly, large vertically integrated cable operators force suites of programs into the tiers, cluttering the dial with affiliated content to the exclusion of independent programming.

By creating the huge bundles, then controlling which programs are placed in the bundles, cable operators perpetuate their control over consumer pocketbooks and the success or failure of programming. The refusal of cable operators to allow consumers to choose which programs they want to pay for on a program-by-program basis makes it impossible for programmers to sell directly to

the public. They must sell themselves, literally and figuratively, to the handful of gatekeepers that control access to the big bundles. Advertisers, looking for national audiences, are unable to refine their message because everybody is forced to pay for everything as a result of cable's bundling strategy. Forced bundling places a premium on carriage on cable systems, in the eyes of the advertisers, rather than actual viewing by the public.

Cable offers consumers a narrow set of choices of bundled and tied channels and services (see Exhibit 12). That is, cable bundles programming into tiers, forcing consumers to purchase all the programming in the tier, if they want any of it. Cable then ties tiers together, forcing consumers to buy lower tiers, if they want to purchase upper tiers.

Households must buy basic service, with about 16 channels at a cost of about $18 per month (including equipment costs) to receive any video service. Once basic is purchased, the most popular cable programming is bundled into the "expanded basic" (or cable programming) service tier, which contains over 50 channels, at an average cost of about $27 per month. In order to access the digital tier service (including VOD), the consumer must purchase expanded basic.

Digital is not an option for consumers who do not want to pay for large packages of service. The consumer must buy expanded basic if he or she wants digital service. The digital service is also a large bundle, consisting of 30 channels, which are offered on a take-it-or-leave-it basis. It now costs more than basic service (when equipment costs are included). Digital tier service is then

tied to video on demand. The consumer must buy the digital tier in order to purchase video on demand.

In essence, cable operators force consumers to buy about 100 channels in three, large, all or nothing bites, at a total cost of over $60 per month before they even get to the point where content could bypass a program network (VOD).

In some cases cable operators have begun to offer programmers the opportunity to prove themselves on a stand-alone basis in the video-on-demand space, but this provides little real opportunity. In other words, **after the cable operators have collected about $60 per month from subscribers and chosen about 100 channels, independent programmers are offered the opportunity to compete for the scraps of discretionary income and viewer attention that might be left.**

Therefore, while increased channel capacity and video on demand could, in theory, provide the opportunity for independent distribution of programming, bundling works against realization of that potential. Bundling enables the cable operator to tightly control the flow of programming, despite the flexibility that the term "video on demand" may imply.

B. THE THRESHOLD CARRIAGE FOR SUCCESS IS VERY HIGH

Confronted with a challenge by Congress to one of the most important tools in their anti-consumer, anti-programmer arsenal--***forced bundling of programming in basic, expanded basic, and digital tiers***--the cable operators have provided data that demonstrates the severe obstacle that independent programmers face in trying to pry through the cable cartel to reach the public.

The cable operators and programmers have argued that in a world that is dominated by linear bundles – large packages of programming tiers that consumers are forced to purchase in order obtain access to the most popular programming or new digital options – a programmer must achieve carriage on systems that pass at least 50 million, and perhaps as many as 75 million, households to achieve long run viability for anything but niche market programming.

A study by Booz Allen Hamilton, commissioned by the National Cable Television Association (NCTA) as the centerpiece of economic analysis for the industry in the a *la Carte* proceeding, was emphatic about this threshold

> Historically, advertisers have been less willing to support networks with less than 50% to 70% coverage of TV households (this threshold is often applied not only to cable but to syndicated broadcast programming). Those advertisers that do support networks before they reach 50% to 70% distribution do so because they want to "get in early" and develop relationships with networks they expect to grow significantly and typically pay lower advertising rates than for established networks.[39]

The figure of 50% to 70% of TV households works out to roughly 54 to 75 million subscribers. One picture from that proceeding is worth a thousand words as an indicator of the overall market conditions. Exhibit 13 shows the advertising revenue of the most popular 62 advertiser supported networks. Well over fifty million subscribers appear to be the sharp threshold for achieving substantial advertising revenues. In the world of linear bundling, 50+ million

[39] Booz, Allen Hamilton, *The a la Carte Paradox: Higher Consumer Costs and Reduced Programming Diversity: An Economic analysis of the Implications of al la Carte Pricing on Cable Customers,* July 2004, p. 12.

subscribers is a necessary, albeit not sufficient, number of subscribers to achieve substantial revenues. Indeed, a close look at Exhibit 13 suggests that the threshold is actually in the range of 60 million households.

We have noted in earlier comments at the FCC that Bravo was struggling to reach 60 million subscribers, a level it deemed necessary to survive as a high quality mass-market offering.[40] Of course, Bravo ultimately was acquired by a broadcast network owner. The America Channel, in its opposition in this proceeding, noted the numerous other statements by cable operators and programmers that reiterate and reinforce this claim [41] A&E reiterates the central challenge identified by Bravo: "in order to attract sufficient advertising revenue to afford to pay for and provide a meaningful quantity of original programming, the network must reach approximately sixty million subscribers."[42] Crown Media Holdings directly refutes the industry claims, reiterated by the Commission, about low levels of subscribers being sufficient.

> Although the Commission has suggested that programming services may survive with a subscriber base of 15 to 20 million subscribers, that is inconsistent with Crown Media's experience in today's marketplace…

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[40] "Comments of the Consumer Federation of America, et. al, *In the Matter of Implementation of Section 11 of the Cable Television Consumer Protection and Competition Act of 1992,* p. 199.

[41] "The America Channel LLC's Petition to Deny," *In the Matter of Application of the Consent to the Assignment and/or Transfer of Control of Licenses Adelphia Communications Corporation (and Subsidiaries, debtors-in-possession), Assigners to Time Warner Cable Inc. (subsidiaries), Assignees; Adelphia Communications Corporation (and Subsidiaries, debtors-in-possession), Assigners to Comcast Corporation (subsidiaries) Assignees and Transferees; Comcast Corporation, Transferor to Time Warner, Inc., Transferee; Time Warner, Inc., Transferors to Comcast Corporation, Transferee,* MB Docket No. 05-192, July 21, 2005 (hereafter TAC Petition), Exhibit 2.

[42] Comments filed in MB Docket No. 04-207, p. 14, cited in TAC Comments, Exhibit 2.

> The Hallmark Channel's experience suggests that the more realistic plateau of meaningful advertising revenues is now approaching 50 to 60 million subscribers… Thus, these data support the conclusion that substantially greater advertising revenues are available to programming services with up to 50 to 60 million subscribers – a level of subscribership associated with a viable broad-based entertainment programming network in today's competitive marketplace.[43]

We believe that this threshold would be dramatically lowered in an *a la carte* world, because advertising could be targeted at viewers who have been able to express their willingness to pay for programming directly by exercising the choice to subscribe to specific channels. But for now, we do not live in an *a la carte* world. In the linear bundling world dictated by the cable industry practice, massive carriage is necessary to achieve viability.

By creating a marketplace that blunts the force of consumer demand and then allowing cable operators to control the terms of carriage, cable operators become gatekeepers that make or break programming. In this world, rights of carriage, through ownership of cable systems or the holding of must carry/retransmission rights, dictate success. Simply put, it is virtually impossible to succeed in reaching a mass audience without these rights of carriage.

C. DISCRIMINATION IN CARRIAGE IS WIDESPREAD

The second set of evidence that is critical GAO's clear finding that cable operators favor their own programming and discriminate against independent programming. In a rigorous econometric analysis, the GAO found that cable

[43] Comments filed in MB Docket No. 04-207, p. 6, cited in TAC, Comments, Exhibit 2.

operators were 64 percent more likely to carry their own programming.[44] They were 46 percent more likely to carry cable programming developed by broadcast network owners. These are, of course, the two entities that have carriage rights. Given how severely tilted access is against independent programmers, it is hard to imagine how they can possibly succeed.

The GAO findings are consistent with the published econometric analysis that was provided in earlier comments in this proceeding. The findings are quite strong on discrimination. It provides a detailed understanding of foreclosure motivations and behaviors. Integrated owners of basic programming exclude competitors for their basic package but offer more of their own basic packages and more premium packages.[45] Owners of premium services foreclose competitors and sell more of their own programming, but offer fewer services at higher prices.[46]

In fact, the empirical evidence offered by the America Channel shows that the deck is stacked so fully against them that they are virtually doomed to failure (see Exhibit 14). Over 90 percent of the networks that have achieved carriage on systems that pass 70 million or more homes are affiliated with a multiple system operator [MSOs] or a broadcast network. Just under 90 percent of the networks that have achieved carriage on systems that pass 50 million of more homes are

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[44] U.S. General Accounting Office (U.S. GAO), *Issues Related to Competition and Subscriber Rates in the Cable Television Industry*, October 2003; *Telecommunications: Issues in Providing Cable and Satellite Television Service*, October 15, 2003, p. 30.

[45] Chipty, Tanseen, "Vertical Integration, Market Foreclosure, and Consumer Welfare in the Cable Television Industry." *American Economic Review.* Vol. 91, 2002, p. 429.

[46] Chipty, 2000, p. 429.

affiliated. Affiliated programmers are nine times as likely to gain carriage as independent programmers.

Discrimination at the top of the industry, in terms of the most frequently carried networks, starts at the bottom, in terms of carriage for newly launched networks (see Exhibit 15). Not only are affiliated launches nine times as likely to receive carriage as independent programming, they are also more likely to get better carriage on systems owned by the dominant cable operators – Comcast and Time Warner. The discrimination starts at the beginning and persists through the end, loading the dice against independent programmers.

One need not posit collusion to explain this pattern of discrimination. On the contrary, it takes place in the context of a firm with a small number of players, some of whom have an interest in favoring in their own programming and some of whom can easily exercise market leadership. In short, one can understand the outcome in the context of the theory of noncollusive games. When a small number of firms are present in an industry, parallel actions accomplish virtually all of the anticompetitive harm of collusive activity.

This pattern of discrimination This revolution in economic thinking, which added the concept of the Nash equilibrium to the arsenal of economic analysis, has permeated through a wide range of fields. Beyond collusion,[47] mutual forbearance and reciprocity can occur, as spheres of influence are recognized and

[47] Perry, Martin, K., "Vertical Integration: Determinants and Effects." In Richard Schmalensee and Robert D. Willig, eds., Handbook *of Industrial Organization* (New York: North-Holland., 1989), p. 247.

honored between and among the small number of interrelated entities in the industry.[48] The ability of large, dominant firms to look and learn about how others behave and adjust their behavior has been documented across a variety of industries. Even introductory economics texts now contain long discussions of strategic behavior and game theory, and it has become a routine part of applied policy analysis.[49]

This bears directly on the cable industry, since a small number of firms controls access to a large number of TV sets. Indeed, in the cable *a la Carte* proceeding, the fact that programmers only had to market to a handful of cable executives was touted as a huge transaction cost savings. This small number of executives has make or break power over programming, and they have used that power to favor their own programming at the expense of independent production, exactly the situation Congress intended to prevent.

The real world behavior of the dominant firms in the industry puts an end to any debate over the ability of the dominant firms to determine the fate of independent programmers (see Exhibit 16). Carriage on both Comcast and Time Warner systems is necessary to achieve the level of distribution required to achieve long run success. Not one national network has achieved even half the

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[48] Asch, Peter and Rosalind Senaca, *Government and the Marketplace* (Dryden Press, Chicago: 1985), p. 248.

[49] See, for example, Taylor, John B, *Economics* (Boston, Houghton Miflin, 2001) Chapter 11; Hasting, Justine, "Factors that Affect Prices of Refined Petroleum Products" (Washington, D.C. Federal Trade Commission Public Conference, August 2, 2001); Cooper, Mark, "Recognizing Limits of Markets, Rediscovering Public Interest in Utilities," *Natural Gas And Electric Power Industry Analysis,* Robert E. Willett, Ed. (Financial Communications Company, Houston 2003).

requisite level of carriage (25 million homes passed) without being carried on both Comcast and Time Warner systems.

Whether or not it is theoretically or mathematically possible to achieve sufficient carriage without cracking the top two is irrelevant. As a practical matter, it simply does not happen if either Comcast or Time Warner denies carriage. There are two real world processes that can account for this, beyond the simple arithmetic.

First, the transaction costs of having to negotiate with a large number of small operators create a severe disadvantage for those denied carriage by the major system owners.

Second, the behavior of the industry leaders sends a strong signal to others – "if Comcast and/or Time Warner decline to permit access to a new independent network, there is strong disincentive for other cable systems, and for competitors, to do so – as they know the survivability of such a network is in doubt."[50] The problem is that the prospects for survival of a new network that is denied access to either Comcast or Time Warner systems is so diminished that "the majority of operators, therefore, are hesitant to dedicate the channel capacity, marketing and other resources necessary to distribute a product from a programmer whose survivability is uncertain."[51]

This problem that existed before the merger will be compounded by the merger. This merger removes a large cable operator that was not vertically

[50] TAC Comments, p. 27
[51] TAC Comments, p. 27.

integrated from the market. Adelphia represents about 5 percent of the total of national subscribers. Moreover, about half of its subscribers are in the top 25 markets and bout 70 percent are in the top 50 markets. As we show below, this compounds the impact of the merger.

D. THE PRACTICAL EFFECTS OF DISCRIMINATION IN CARRIAGE

1. Affiliated Entities Dominate National Networks

No matter from what angle we view the audience, we find that a handful of entities dominate. Looking at the most popular programming, which accounts for the vast majority of cable viewing, we find that seven entities dominate (see Exhibit 17). Defining the most popular programming based on a long term series compiled by the FCC of top 20 networks in terms of subscribers and the top 15 in terms of prime time ratings, we find that seven entities completely dominate. Six of these have dominated throughout the past decade. Three were networks (ABC, CBS and NBC). Two are cable operators (Time Warner and Comcast). While Comcast had not been heavily involved in national programming, focusing instead on regional news and sports, with its recent acquisitions of large cable operators, it is now moving aggressively to expand its ownership and control of programming. One of the dominant firms (Liberty) has been spun off and pulled back various times in cable and broadcast transactions. As a result, it maintains a variety of close relationships with cable operators through carriage deals and stock ownership and with networks through stock ownership. The seventh member of the club, Fox, which has recently entered this tight circle, is a

broadcaster and now an owner of the largest DBS company. Liberty owns a substantial share of stock in News Corp., the parent of Fox.

One of the keys to proper analysis of discrimination is to pay careful attention to the actual reason for discrimination – i.e. the analyst must differentiate between programs within specific categories. Different categories of programming – such as news versus entertainment – are clearly differentiated. There is also an effort to create differentiation within program categories through branding. Hit comedies are distinct and the producers of such programs may have bargaining power. At the same time, there is a process of rivalrous imitation in the industry.[52] One of the ways these entities dominate the dial is to parlay control over marquee programming in one category into a suite of offerings across different categories (see Exhibit 18). The categories used are those that were developed in the Booz Allen Hamilton study commissioned by the NCTA for the *a la Carte* proceeding. The program suites fill the dial. That Comcast is moving aggressively to fill out its suite is also notable.

E. REGIONAL PROGRAMMING

[52] Dimmick, John, and Daniel G. McDonald, "Network Radio Oligopoly, 1926-1956: Rivalrous Imitation and Program Diversity." *Journal of Media Economics*. . Vol. 14. 2001, p. 201.

> [R]ivalry in the broadcast network television industry have been clearly mapped… patterns of imitation that might be described as rivalrous imitation among the television networks. Program types that were popular, as indexed by ratings, were more likely to be imitated, while less popular program types were not. Imitation takes the form of emulating programs with high ratings and also spin-offs of successful series. As evidenced by other studies, the result of such rivalrous imitation among television networks was a decline in program diversity.

The importance of regional programming is highlighted in the Eleventh Annual Report. Regional sports networks represent about 40% of total regional networks, while regional news networks represent another 40%.[53]

A recent FCC staff white paper on DBS-cable substitution found, "firm-specific attributes and demographic variables that influence consumer choice and switching costs that appear to affect consumers' desire to switch from one service to another." Notably, the control of regional programming affected consumers' desire to switch from cable to DBS:

> We also find that DBS penetration is lower where cable operators carry regional sports channels.
>
> This is likely due to a combination of factors discussed above. Two of the factors may involve cable operators limiting DBS operator access to regional sports networks. If this is true, cable operators may be able to offset competitive pressures from DBS, and thus may be able to impose larger price increases without losing subscribers to DBS where they are able to transmit vertically-integrated regional sports networks terrestrially, or are able to reach exclusive carriage agreements with non-vertically-integrated regional sports networks.[54]

As shown in the Eleventh Annual Report, cable operators continue to concentrate their systems regionally in "clusters" through the purchase and sales of MSOs or through "swapping." The Report found that clustering subscribers has increased in recent years.[55]

The Eleventh Annual Report also shows that small and rural areas represent distinct markets that are at a competitive disadvantage in acquiring

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[53] Eleventh Annual Report, ¶¶166-169.
[54] P. 21
[55] Eleventh Annual Report, ¶141-142

programming. Operators of small systems report that they have difficulty obtaining programming due to higher costs (programming is not available on terms similar to those received by large MSOs) and because of tying requirements by programmers.[56]

The FCC identifies fewer than 100 regional cable networks. Sports and news networks dominate the total, with about 40 percent each (see Exhibit 19). Cable operators are the most frequent owners of these networks, accounting for 44 percent. Broadcast networks account for just over 30 percent of the total regional networks. In other words, three quarters of the regional networks are dominated by the same entities that dominate national programming.

The size of the niche/regional market is extremely small compared to the national market (see Exhibit 20). Based on 2002 data, we identified 124 niche and regional networks with fewer than 20 million subscribers. Four of these have moved past 20 million (all four were affiliated). The total market of these networks is less than one-tenth the size of the national networks with 20 million or more subscribers. Moreover, affiliated networks account for just over half of all networks even in the niche/regional categories and over 70 percent of all subscribers. Even if niche/regional program is considered an outlet that mitigates the severe discrimination in the national market, the market is too small and the discrimination is still quite strong there. There is little relief for independent programmers here.

[56] Eleventh Annual Report, ¶186

To the extent that Comcast and Time Warner will have a stronger hold over these regional markets, what little prospect programmers have of success in them will be further diminished by the merger.

V. RECOMMENDATION

The dramatic anticompetitive effects of these transactions across a range of national and local product and geographic markets makes it clear that this merger is not in the public interest. It should be rejected.

Petitioners opposing the merger uniformly call for it to be rejected, but hesitantly identify conditions to be imposed on the merger, should it be allowed to go forward. Their concern about approval with conditions is well founded. The track record on the ability of behavioral conditions to prevent harm to competition and consumers in this industry is abysmal. Enforcement is difficult; loopholes are constantly invented; and punishment for violating conditions have been inconsequential.

If conditions are to be imposed, they will have to precise, largely self-enforcing, and backed up with substantial penalties. Fines for violation of conditions should be paid to the injured parties lodging the complaint. Violations of key conditions, such as withholding of programming from competitors or denial carriage, should trigger the divestiture of the property being wielded as an anticompetitive weapon.

Moreover, the conditions must be permanent and general, since the market power that results is so pervasive. They must address each of the major categories of leverage that the increased market power conveys.

As dominant cable operators, Comcast and Time Warner must be prevented from leveraging their control over distribution to undermine

competition in the upstream programming market. Recommendations to deal with this problem range from an obligation to provide carriage on just and reasonable terms and conditions, to most favored nation treatment, to baseball arbitration, to leased access at a fixed rate that reflects the marginal value of capacity (which is presumed to be low). These conditions should apply to linear programming, but discrimination in access to the VOD space is also a concern.

As dominant cable operators, Comcast and Time Warner must be prevented from leveraging their control over distribution to undermine competition in the downstream distribution market. The should not be allowed to withhold programming that they own through the so-called terrestrial loophole. They should not be allowed to demand exclusives from programmers. Their contracts should be scrutinized to purge any such conditions.

We have treated this merger as a threat to competition and consumers in video services markets. Therefore, the predatory practice of creating a virtual tie between basic video and high-speed Internet service, a competitive club used against satellite, should also be stopped.

APPENDIX: ECONOMIC THEORY OF MONOPSONY, BUNDLING, AND VERTICAL LEVERAGE

A. MONOPSONY POWER

Given the nature of television programming, with its high first-copy costs, producers need to achieve a large audience quickly to survive. By controlling a substantial number of eyeballs, cable operators can make or break programming. Exercising monopsony power as buyers, they can squeeze programmers by holding down what they pay or by insisting on sharing the profits (demanding equity stakes). Once they become vertically integrated, their incentive to squeeze out rivals is reinforced. The fewer alternatives that are available for specialized inputs (creative producers), the easier it is to control the programming market. The public policy goal we have outlined in theory and that Congress has clearly articulated in its directives is to prevent the abuse of market power. This section develops the concept of market power.

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

The discussion of antitrust is almost always framed in terms of monopoly power – or the lack of sufficient competition to discipline sellers resulting in their

ability to set prices above costs in a market. A similar concern exists with monopsony power.

The analytic framework is established with primary reference to the work of two prominent "liberal" economists – Scherer and Ross – and two prominent "conservative" economists – Landes and Posner. The discussions are framed in terms of the Lerner index, to which earlier Notices in this proceeding referred,[57] as the central measure of market power. The decomposition of that index into the key market structure characteristics – market shares, elasticities of supply and demand – elucidates the fabric of the concept of market power.

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

The profit-maximizing firm with monopoly power will expand its output only as long as the net addition to revenue from selling an additional unit (the marginal revenue) exceeds the addition to cost from producing that unit (the marginal cost). At the monopolist's profit-maximizing output, marginal revenue equals marginal cost. But with positive output, marginal revenue is less than price, and so the monopolist's price exceeds marginal cost. This equilibrium condition for firms with monopoly power differs from that of the competitive firm.

[57] ¶ 63

For the competitor, price equals marginal cost; for the monopolist, price exceeds marginal cost.…

> [The] Figure .. illustrates one of the many possible cases in which positive monopoly profits are realized; specifically, the per-unit profit margin P_3C_3 times the number of units OX_3 sold. As long as entry into the monopolist's market is barred, there is no reason why this profitable equilibrium cannot continue indefinitely.[58]

Landes and Posner – two prominent conservative economic thinkers -- offer a similar concept, described as follows with reference to Exhibit A-2.[59]

> Our concept of market power is illustrated in [Exhibit 25] on the next page, where a monopolist is shown setting price at the point on his demand curve where marginal cost equals marginal revenue rather than, as under competition, taking the market price as given. At the profit-maximizing monopoly price, pm, price exceeds marginal cost, C', by the vertical distance between the demand and marginal cost curves at the monopolist's output, Qm; that is, by pm - C'.

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

> The mirror image of monopoly is "monopsony." A monopsonist is a monopoly buyer rather than seller. Although most antitrust litigation of market power offenses has involved monopoly sellers rather than buyers, monopsony can impose social costs on society similar to those caused by monopoly.[60]

> Monopsony is often thought of as the flip side of monopoly. A monopolist is a seller with no rivals; a monopsonist is a buyer with no rivals. A monopolist has power over price exercised by limiting

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

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

[60] Hovenkamp, Herbert, *Federal Antitrust Policy: The Law of Competition and Its Practice,* Hornbook Series (West Group, St.Paul; 1999), Footnote 13, p. 13-14.

> output. A monopsonist also has power over price, but this power is exercised by limiting aggregate purchases. Monopsony injures efficient allocation by reducing the quantity of the input product or service below the efficient level.[61]

Monopsony power has received less attention in antitrust practice for a variety of reasons. Monopoly and monopsony frequently occur together and monopoly is the more inviting antitrust target.[62] The impact of this exercise of market power, in the first instance, may be to lower prices paid by monopsonist buyers, which poses a conundrum for antitrust law, which usually focuses on price increases.[63]

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

[62] Id. at 138-139.

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

[63] Hovenkamp, at 14.

> By reducing its demand for a product, a monopsonist can force suppliers to sell to it at a lower price than would prevail in a competitive market... If the price is suppressed they will reduce output to a level that once again equals their marginal costs. In any event, both price and output will fall below the competitive level when the buyer is a monopsonist. Some productive assets will be assigned to products that would have been the supplier's second choice in a competitive market. As a result, monopsony allocates resources inefficiently just as monopoly does.
>
> The important policy implication of monopsony is that it reduces rather than increases output in the monopsonized market. Many federal judges have failed to see this. The consumer welfare principle in antitrust, or the notion that the

However, the leading antitrust texts recognize that a careful economic analysis of the abuse of monopsony power leads to the more traditional and typical anticompetitive effects.[64]

> The monopsonist reduces its buying price by reducing the amount of some input that it purchases. If the input is used in the output in fixed proportions, then the output must be reduced is well. This suggests two things: (1) the monopsony buyer that resells in a competitive market will charge the same price, but its output will be lower than if it were a competitive purchaser; (2) the monopsony buyer (or cartel) that resells in a monopolized (or cartelized) market will actually charge a higher price than if it were a competitive purchaser.[65]
>
> But antitrust attacks on monopsony abuses do occur and enforcement efforts can lead to a potentially wider interest in market power abuses of powerful buyers.
>
> For example, in addressing vertical restraints, the theoretical literature has increasingly recognized that some restraints are a product of market power in the hands of downstream dealers that buy from their suppliers. Increased public interest also followed the Federal Trade Commission's pursuit of a vertical restraints case against Toys "R" Us alleging that the powerful retail chain exercised monopsony power in preventing suppliers from selling on equal terms to other retailers.[66]

In fact, not only is monopsony power the object of traditional antitrust practice,[67] but also it has a very long-standing presence in seminal cases.

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

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central goal of antitrust policy should be low prices, has often suggested to courts that monopsony is not all that important an antitrust policy concern.

[64] Roger D. Blair and Jeffrey L. Harrison, "Antitrust Policy and Monopsony," *Cornell L. Rev.* 1991.

[65] Id. at 15.

[66] Sullivan and Grimes, at 139.

[67] John Lauck, "Toward an Agrarian Antitrust: New Direction for Agricultural Law," *N.Dak. L. Rev* 499, 1999; John J. Curtin, Daniel L. Goldberg and Daniel S. Savrin, "The EC's Rejection of the Kesko/Tuko Merger: Leading the Way to the Application of a 'Gatekeeper' Analysis of Retailer Market Power Under U.S. Antitrust Law," 40 *B.C. L. Rev.* 537 (1999).

> to monopsony power. An early example of this was the 1911 Standard Oil case, involving allegations that Standard Oil used its monopsony power over the railroads to dictate the terms by which the railroads would deal with rivals of Standard Oil. Standard Oil was by no means the sole purchaser of railroad transportation, but its substantial position in the oil industry and the relative importance of a railroad maintaining its petroleum business probably gave Standard Oil a substantial measure of monopsony power. The Justice Department directed another Section 2 attack on monopsony power at movie theater owners in United States v. Griffith. In Griffith, the defendants owned movie theaters in towns in Oklahoma, Texas and New Mexico, some of them in competition with rival theaters in the same town, others operating as the sole theater in town. The Justice Department successfully invoked Section 2 in condemning the defendants' use of their buying power to gain favorable terms from movie distributors...
>
> The unspoken premise of Griffith is that the Court will apply the same standards of proof to a monopsony claim under Section 2 that it would apply to a monopolization claim.[68]

Referring to Exhibit A-3, Hovenkamp discusses monopsony power as the monopoly power "turned upside down," but leading to the same result – higher prices – when it is combined with monopoly power.

> Consider this illustration.
>
> A monopoly manufacturer of aluminum is also a monopsony purchaser of bauxite.
>
> "Marginal outlay" refers to the total additional cost that the monopsonist incurs when it purchases one more unit. By contrast, "marginal cost" refers to the cost of the one additionally purchased unit. While the monopolist generally maximizes profits by equating marginal cost and marginal revenue, the monopolist that is also a monopsonist in an input market maximizes profits by equating marginal outlay and marginal revenue.
>
> [Exhibit A-3] illustrates. It shows the relevant demand (D), marginal revenue (MR), marginal cost (MC) and marginal outlay (MO) curves of a firm that purchases a single input in a

[68] Id. at 139.

> monopsonized market and resells this input in a monopolized market. Considering the firm simply as a monopolist in the output market, it would equate MC and MR. The monopoly price would be Pm and monopoly output would be Qm. However, if the monopolist is also a monopsonist in the market for the input and its marginal cost curve slopes upward, then its marginal outlay curve will slope upward as well, only twice as steeply. That is, the relation between marginal cost and marginal outlay is exactly the same as the relation between demand and marginal revenue, except turned upside down. The monopolist/monopsonist maximizes its profits by equating MO and MR. This yields a monopoly/monopsony price on Pmm' and an output of Qmm.[69]

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

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

> Monopsony is thought to be more likely when there are buyers of specialized products or services. For example, a sports league may exercise monopsony (or oligopsony) power in purchasing the services of professional athletes. An owner of a chain of movie theaters, some of which are the sole theaters in small towns, may have monopsony power in the purchase or lease of movies. Cable TV franchises may exercise monopsony power in purchasing television channels that will be offered to their subscribers. [70]

> At the same time, the abuse of monopsony power is more likely when the product is undifferentiated. Where products are relatively undifferentiated and capacity primarily distinguishes firms and shapes the nature of their competition, the merged firm may find it profitable unilaterally to raise price and suppress

[69] Hovenkamp, Footnote 13, p. 15.
[70] Sullivan and Grimes, p. 138.

> output. The merger provides the merged firm a larger base of sales on which to enjoy the resulting price rise and also eliminates a competitor to which customers otherwise would have diverted their sales. Where the merging firms have a combined market share of at least thirty-five percent, merged firms may find it profitable to raise price and reduce joint output below the sum of their premerger outputs because the lost markups on the foregone sales may be outweighed by the resulting price increase on the merged base of sales.[71]

In some respects, video programming is differentiated, in others it may not be. Earlier notices in this proceeding discuss the question of entry by imitation in genres.[72] The development of marquis shows and strong brands suggests differentiation. The development of look-a-likes suggests a lack of differentiation.

The 35 percent figure, given for routine monopsony power concerns, is well grounded in antitrust practice in the sense that mergers have been successfully challenged at this level.[73] Similarly, a 30 percent limit is well grounded in monopsony complaints. For example, in the Toys R Us case noted above, the market controlled was "20% of the national wholesale market and up to 49% of some local markets."[74]

B. THE ANTI-CONSUMER, ANTI-COMPETITIVE POTENTIAL IN CABLE BUNDLING

[71] Merger Guidelines, Section 2.22.

[72] ¶ 17

[73] Peter Asch, *Industrial Organization and Antitrust Policy* (John Wiley, New York; 1983), Chapter 14.

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

As demonstrated in our comments filed in previous proceedings,[75] the industry practice of "bundling" is anti-competitive and has increased overall cable prices to consumers and limits access to digital tiers and VOD.

Over the past two decades, the anticompetitive potential of bundling has been explored and documented in detail. Indeed, almost immediately after the Chicago school of economic analysis tried to conclude that all bundling be deemed, *per se*, benign,[76] the potentially anticompetitive effects of bundling reemerged in the literature. This literature concluded that bundling engenders market efficiency only when the market is characterized by extreme conditions (i.e., permanent monopoly in one product, perfect competition in the other). In the more common situations, firms whose market power is neither total, nor permanent, can use bundling to defend or extend their market power, leading to further inefficiencies in the market. Under a wide range of assumptions, the dynamic[77] ability of bundling to undermine competition has been demonstrated through a number of mechanisms including inducing exit,[78] creating barriers to

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[75] CFA/CU, a *la Carte,* Initial Comments.

[76] Richard Posner *Antitrust Law: An Economic Perspective* (Chicago: University of Chicago Press, 1976), Robert Bork, (*The Antitrust Paradox: A Policy At War With Itself,* (New York: Basic Books, 1978).

[77] J. Kaplow, "Extension of Monopoly Through Bundling," *Columbia Law Review,* 85:1985; J. A. Sykes, Ordover, A. Sykes and R.D. Willig, "Nonprice Anticompetitive Behavior by Dominant Firms Toward the Producers of Complementary Products," in F.M. Fisher, ed., *Antitrust and Regulation: Essays in Memory of John J. McGowen* (Cambridge, MA, The MIT Press, 1985).

[78] M. Whinston, "Tying Foreclosure and Exclusion," *American Economic Review,* 80: 1990.

entry,[79] relaxing price competition,[80] distorting investment,[81] retarding innovation,[82] and extending market power into new markets.[83]

These concerns about the anticompetitive effects of bundling are especially relevant to the goals of public policy as expressed in the Telecommunications Act of 1996, which defined "diversity" not by the variety of programs available, but by the number of independent producers.[84] The ability of dominant firms to add programs to bundles and exclude independent firms may increase variety, but it does not contribute to diversity. Simply put, the current system lacks diversity. The Center for Creative Voices in the Media's filing makes this point nicely:

> The so-called '500 Channel Universe' provides no relief from this concentration and lack of diversity of viewpoints and voices. Evidence in the Biennial record shows that of the 91 major cable television networks each available in more than 16 million homes, fully 80 percent (73 networks) are outlets owned or co-owned by the same five media giant

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[79] O.E. Williamson, "Assessing Vertical Market Restriction: Antitrust Ramifications of the Transaction Cost Approach," *University of Pennsylvania Law Review,* 127:1979; B. Nalebuff, "Bundling as an Entry Barrier," *Quarterly Journal of Economics,* 2004, "Bundling," Manuscript, School of Management, Yale University, 1999; Y. Bakos and Eric Brynjolfsson, "Bundling and Competition on the Internet: Aggregation Strategies for Information Goods," *Marketing Science,* 19:2000.

[80] J. Carbajo, D. de Meza and D. Seidman, "A Strategic Motivation for Commodity Bundling," *Journal of Industrial Economics,* 38: 1990; Y. Chen, "Equilibrium Product Bundling," *Journal of Business,* 70: 1997.

[81] J. P. Choi and C. Stefanadis, "Tying, Investment, and the Dynamic Leverage Theory," *Rand Journal of Economics,* 32:2001.

[82] J. P. Choi, "Tying and Innovation: A Dynamic Analysis of Tying Arrangements," *The Economic Journal* 114: 2004; J. P. Choi, "Preemptive R&D, Rent Dissipation, and the 'Leverage Theory'," *Quarterly Journal of Economics,* 110:1996.

[83] D. W. Carlton, "The Strategic Use of Tying to preserve and Create Market Power in Evolving Industries," *Rand Journal of Economics,* 33:2002;

[84] This definition makes intuitive sense. As stated in the comments of the Center for Creative Voices in the Media (CCVM) comments in the *a la Carte* proceeding, pp. 4-5, "few would suggest that Chevrolet and Cadillac are separate automotive company 'viewpoints.' Rather, the 'viewpoint' is that of their conglomerate owner, General Motors. The same principle holds true in television with regard to conglomerates that own multiple distribution outlets positioned to appeal to different segments of the viewing audience, just as Chevrolet and Cadillac are positioned by GM to appeal to different segments of the car market. The 'viewpoint' is that of the owner – the conglomerate – and not of its subsidiary distribution outlet."

> conglomerates that control a 75% share of the national audience, plus Liberty Media. ... Using the principles the Commission laid down in the 2002 Biennial, the inescapable conclusion is that television today is excessively concentrated and viewpoint diversity is inadequate.[85]

The best that can be said of the current no-alternative bundles imposed on consumers is that, in a static analysis, they may expand total social surplus while reducing consumer surplus.[86] In other words, producer surplus may increase more than consumer surplus declines, increasing total surplus. Even the conclusion to this static analysis is dubious, as it is unclear whether producer surplus has increased more than consumer surplus has fallen.

Under a dynamic analysis, the enrichment of producers is not random. The current system favors a small number of dominant producers and creates barriers to entry for small, independent outlets, resulting in little diversity in ownership. Leveraging their market power through forced bundling, the large operators and dominant programmers not only reduce diversity, but also diminish competition, leading to inefficiencies in the market. Because bundling reduces competitive pressures, the total surplus is limited. When reality is injected into the theory, the cable industry argument falls apart even faster. There is no reason to believe that prices will skyrocket in an environment where consumers are allowed to choose between bundles and individual programs. In a

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[85] Center for Creative Voices in the Media, a *la Carte,* pp. 6 and 8.

[86] This observation has been well established in the economics literature for two decades. Recent works extends it to information goods in theory (Yannis Bakos and Erik Brynolfsoson, "Bundling Information Goods: Pricing Profits and Efficiency," *Management Science*, December 1999, p. 1) and cable in reality (Gregory S. Crawford, *The Discriminatory Incentives to Bundle in the Cable Television Industry,* April 2, 2004, p. 20).

more competitive, consumer-friendly environment, total surplus might well be higher.

Defenders of bundling dismiss the existence of (and, in some cases, the possible existence of) this type of anticompetitive behavior. As the Comcast-funded economist puts:

> Under a leverage motivation, a supplier uses it[s] market power with respect to one product to gain an advantage in the sale of a second product by tying sales of the two together. Leverage can take the form of driving rivals out or excluding entrants.
>
> The leverage theory clearly is irrelevant to the analysis of bundling cable programming: there is no evidence that tiers have been created to make entry by new networks or new operators more difficult. In fact, tiers have the opposite effect.[87]

This statement is contrary to empirical reality.[88] When large cable operators carry networks in which they have an ownership interest, but refuse to carry competing networks from unaffiliated programmers, they distort the marketplace. When dominant national programmers tie niche and emerging networks to their popular programming during retransmission negotiations, they leverage their market power to gain an advantage over independent, competing programming.

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[87] Katz, Michael, *Slicing and Dicing: A Realistic Examination of Regulating Cable Programming Tier Structures,* July 15, 2004, p. 26.

[88] Declaration of Robert Willig, Orszag and Ezrielev, *Regarding A La Carte Pricing,* July 15, 2004,provide a perfect example of the blind spot in the industry-funded analyses. They cite the dispute between YES and cablevision as testimony to the fact that profits are higher through widespread distribution, but ignore the fact that Cablevision was attempting to leverage it control over distribution to force YES onto a separate tier, while its own, vertically integrated competing sports programming, remained on the expanded basic tier. Our initial comments examined the YES lawsuit and dispute with Cablevision as solid evidence of discrimination and leverage, which these analysts have ignored entirely.

The record is rife with solid evidence from smaller and independent MVPD operators, independent content producers, local cable commissions and independent programmers that discrimination takes place with the largest programmers bundling to force cable operators and consumers to take networks that would not be taken in the absence of leverage.[89]

C. VERTICAL INTEGRATION AND MUST CARRY RIGHTS

Our comments on vertical integration examine the practices that cable operators use to control the flow of programming that reaches the public. With the exception of the in-house programmers who are owned in whole or in part by cable operators and large broadcast networks, whose must carry/retransmission rights give them guaranteed access to carriage, cable channels are faced with a simple take it or leave it proposition. They must acquiesce to the cable operator's

[89] Numerous examples may be found in the initial comments filed in this proceeding. For example, CCVM (page 9) quotes an Echostar press release: "Among Viacom's strong-arm tactics is the demand that the DISH Network carry Viacom-owned channels of little or no measurable appeal to viewers in exchange for the rights to carry the 16 owned-and-operated CBS stations. Viacom also threatened to withhold the Super Bowl from the DISH Network customers until a federal judge intervened." According to the Pioneer Telephone Association's filing (page 6), "Many broadcast networks have begun to demand regular monthly licensing fees for access to 'free' over-the-air broadcast signals. … One local broadcast network affiliate even went so far as to demand that our small cable system would have to agree to purchase a fixed and substantial amount of advertising on the broadcaster's station, in exchange for consent to retransmit their broadcast system. The American Cable Association's filing states (on page 30) "ACA has described the smaller cable sector's increasing concern about the use of retransmission consents by network owners and affiliate groups. The principal tactic – requiring carriage of affiliated satellite programming as a condition of access to local broadcast signals. As a result, smaller cable companies and their customers must pay for programming that they would not otherwise choose, solely to receive a free, over-the-air local broadcast station." Echostar's comments (page 1) states "MVPD's flexibility to offer a la carte and tiered services is inhibited today by many factors. First and foremost among them is the practice of large media conglomerates of bundling their must-have programming, including in particular the local network broadcast stations and the most popular cable networks, with programming that consumers do not want. Faced with widespread bundling, MVPDs currently have little choice but to offer broad *packages* [to consumers]." This is just a small sample of the myriad examples in the initial comments filed; this is not a competitive market.

demands in order to gain carriage in the expanded bundle, or starve. We have noted the econometric evidence that shows carriage rights are leveraged by cable operators and broadcasters to gain an unfair advantage over independent programmers in placing their content before the public.

In economics, vertical integration is a potential concern, especially when dominant firms become integrated across markets for critical inputs. CFA, et al, Initial Comments in the 2001 Further Notice describe in detail the economic theory behind limits on vertical integration.[90] The anticompetitive conduct and negative market performance result from weakened markets due to vertical concentration.

While the Eleventh Annual Report found a decrease in the percentage of vertically-owned networks,[91] the Report also shows that vertically integrated networks continue to have the largest number of subscribers[92] and are the most popular.[93]

Vertical integration can create barriers to entry. By integrating across stages of production, incumbents may force potential competitors to enter at both stages, making competition much less likely.[94] Vertical mergers can also

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[90] CFA, et al, Initial Comments, pp. 84-89

[91] Eleventh Annual Report ¶145

[92] Eleventh Annual Report ¶150

[93] Eleventh Annual Report ¶151

[94] Perry, 1989, p. 247. "[V]ertical mergers may enhance barriers to entry into the primary industry if entrants must operate at both stages in order to be competitive with existing firms and if entry at both stages is substantially more difficult than entry at one stage." Scherer and Ross, F. M., and David Ross, *Industrial Market Structure and Economic Performance* (Houghton Mifflin Company: Boston, 1990), pp. 526-527.

foreclose input or output markets to competitors.[95] Exclusive and preferential deals for the use of facilities and products compound the problem.[96] Cross-subsidization is more readily accomplished.[97] Vertical integration facilitates price squeezes and enhances price discrimination.[98]

Concerns arise that not only will the dominant firm in the industry gain leverage across input and output markets to profitably engage in anti-competitive conduct,[99] but also the dynamic processes in the industry will clearly shift toward cooperation and coordination rather than competition. Mutual forbearance and reciprocity can occur as spheres of influence are recognized and honored between and among the small number of interrelated entities in the industry.[100] The final behavioral effect is to trigger a rush to integrate and concentrate. Being a small independent firm at any stage renders a company extremely vulnerable to a variety of attacks.[101]

The vertical problem is readily identifiable in the market for video programming. A small number of firms that control distribution are integrated

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[95] ; Shepherd, William G., *The Economics of Industrial Organization* (Prentice Hall, Englewood Cliffs, N.J., 1985), pp. 289-290.

[96] Perry, 1989, p. 247; Shepherd, 1985, p. 294.

[97] Asch, Peter, and Rosalind Senaca, *Government and the Marketplace* (Chicago: Dryden Press. 1895), p. 248; Shepherd, 1985, p. 302.

[98] Scherer and Ross, 1990, p. 524.

[99] There is a growing body of theoretical and empirical analysis that has reinvigorated concerns about the anti-competitive impacts of vertical integration, particularly in the cable industry, see Krattenmaker, T.G., and S. C. Salop, 1986 "Anti-competitive Exclusion: Raising Rivals' Costs to Achieve Power Over Prices," *The Yale Law Journal*, Vol. 92; Ordover, Janusz, A. Oliver Sykes, and Robert D. Willig, "Non-price Anti-Competitive Behavior by Dominant Firms Toward the Producers of Complementary Products," In F. M. Fisher, ed, *Antitrust and Regulation* (Cambridge: MIT Press: 1985).

[100] Asch and Senaca, 1985, p. 248.

[101] Scherer and Ross, 1990, pp. 526-527; Shepherd, 1985, p. 290.

into the production of programming. As a smaller number of owners control a larger share of the market, they gain greater and greater leverage in the bargaining with independent producers. Indeed, they can make or break programming.

It is also important to recognize that complete foreclosure is not the only concern. The terms and conditions of carriage are at least as important. Vertically integrated firms defend the marquee programming in which they have a direct interest by frustrating entry and extracting rents from others.

> The power to foreclose also implies the ability to force down the license fees that an MSO pays to networks. Some anecdotal evidence suggests the possibility that larger MSOs hold significant monopsony power in the programming market.[102]

> Carriage data provide an incomplete picture of vertical integration's effects on premium networks. In particular, even if both affiliated and unaffiliated networks are carried, an integrated system might price them differently to subscribers. Personal selling and other marketing tactics offer other opportunities for system operators to favor one available network over another… For the most part, those subscribership results suggest that integrated systems also tend to favor their affiliated premium networks in pricing and promotion behavior.[103]

By forcing consumers to take large bundles and controlling the content of the bundles, cable operators control the flow of content and the access of programmers to the public. By leveraging their control of distribution, they ensure favorable treatment for their own shows.

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[102] Waterman, David, and Andrew A. Weiss, *Vertical Integration in Cable Television*. Washington, D.C.: AEI Press. 1997, p. 66.

[103] Waterman and Weiss, 1997, pp. 93…94.

D. THE CABLE FAIRY TALE: THE DANCE OF THE ENLIGHTENED ELEPHANTS

The cable industry and its experts argue that discrimination and anticompetitive conduct by cable operators as buyers in the programming market simply cannot and does not happen.[104] However, two decades of evidence from the deregulated cable industry, demonstrates that "It does happen on a regular basis."

Cable experts argue that monopsony power does not matter in the cable TV industry because of the nature of the product — i.e., video programming is a highly differentiated product with high first copy costs.[105] If products are very different from each other, the cable experts argue, they possess attributes that distinguish them in the mind of the consumer, which enables the programmers who own popular content to withhold their products and force multiple system operators (MSOs) to enter fair and efficient deals.[106] Even where the cable operators might have market power, the cable experts claim, cable operators

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[104] Ordover, Janusz, A. 2002b. "Declaration" attached to "Application and Public Interest Statement," *In The Matter of Applications for Consent to the Transfer of Control of Licenses Comcast Corporation and AT&T Corp., Transferors, To AT&T Comcast Corporation, Transferee*, February 28, 2002 (Ordover 2002b); Ordover, Janusz A., "Declaration on Behalf of AT&T," attached to "Reply to Comments and Petitions to Deny Applications for Consent to Transfer" *In The Matter of Application for Consent to the Transfer of Control of Licenses Comcast Corporation and AT&T Corporation, Transferors, to AT&T Comcast Corporation, Transferee*, MB Docket NO. 02-70, May 21. Joskow Paul, and Linda McLaughlin, "An Economic Analysis of Subscriber Limits," attached to Comments of AOL Time Warner *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 Review of the Commission's Regulations Governing Attribution Of Broadcast and Cable/MDS Interests Review of the Commission's Regulations and Policies Affecting Investment In the Broadcast Industry Reexamination of the Commission's Cross-Interest Policy*, CS Docket No. 98-82, CS Docket No. 96-85, MM Docket No. 92-264, MM Docket No. 94-150, MM Docket No. 92-51, MM Docket No. 87-154. January 3., 2002c; Rosston and Shelanski, 2002.

[105] Ordover, 2002c, para. 13, 26.

[106] Ordover, 2002a, p. 36; 2002c, para. 15, 35, 36.

realize that they share a strong interest with programmers to ensure the flow of quality programming, so they treat programmers fairly.

In order to make this analysis plausible, cable industry experts must assume away key facts about the cable market. The resulting picture they paint bears no relationship to reality. They assume no ability to price discriminate,[107] no market power for the buyers,[108] a lack of specialized inputs,[109] fair competition for the sellers[110] and highly differentiated products.[111] With the most challenging problems assumed away, the cable company experts have reduced the entire analysis to a battle over rents between cable operators and major programmers, which they assume can have no basis in public policy.[112] But in this proceeding it is the independent programmers who are the victims that Congress intended for the Commission to protect from unfair treatment.

In order to put a reasonable face on the "bargaining" that results, the cable experts must assume what is essentially a marketplace of huge and powerful programmers, some of whom are vertically integrated, facing off against huge and powerful MSOs, some of whom are integrated.[113] In addition to being vertically integrated, other strategies that might help programmers survive are to have large portfolios of programs[114] or to sell in foreign markets.[115]

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[107] Ordover, 2002a, p. 34; 2002c, para 29.
[108] Ordover, 2002a, p. 37.
[109] Joskow and McLaughlin, 2002, p. 9.
[110] Ordover, 2002a, p. 35; Ordover, 2002c, para. 30.
[111] Ordover, 2002c, para. 15; Joskow and McLaughlin, 2002, p. 10.
[112] Ordover, 2002a, pp. 17, p. 36; 2002c, para. 43.
[113] Ordover, 2002c, para. 87.
[114] Ordover, 2002a, pp. 16, 21; 2002c, paras. 11, 74.

The most dramatic demonstration of the gatekeeping function of carriage can be found in the claim that MSOs ask programmers for an equity stake in their channels or desire exclusive arrangements to lower the programmer's risks or increase profits. Equity is not the problem that programmers must overcome, however. The stumbling block for programmers is not raising capital or assembling talent to create programming. The only thing they lack is carriage. Programmers do not ask MSOs to take equity stakes or seek benefits in deals that prevent them from making their shows available to all means of distribution; MSOs extort equity or exclusive arrangements from programmers by withholding carriage. The MSOs control the programming market and undermine competing distribution systems with their anticompetitive and discriminatory practices.

The dance of the elephants tramples the mice (independent producers) and the grass (consumers). There is little room for independent, modestly sized, domestic producers of programming in this dance. Therefore, in the hypothetical cable world, small independent entities depend on the enlightened self-interest of the cable operators to protect them. They need not fear in this fantasy world because cable operators behave well. Indeed, the bigger the cable operator, we are told, the better they treat the small independent producers because they have too much to lose.[116] The facts show that this is not the case. The larger

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[115] Ordover, 2002a, pp. 29-30; 2002c, paras. 74-75.

[116] Ordover, 2002a, p. 40; 2002c, para. 35; Joskow and McLaughlin, 2002, p. 15.

operators, who own their own programming, favor themselves at the expense of independents.

Do the assumptions underlying the theory properly reflect economic reality? In the case of the cable commenters, the answer is no. Cable operators discriminate and use other anticompetitive practices by leveraging their control of distribution to defend their franchise product. Evidence of these problems is both qualitative and quantitative and it comes from both integrated and nonintegrated entities.[117]

[117] Ahn, Hoekyun, and Barry R. Litman, "Vertical Integration and Consumer Welfare in the Cable Industry." *Journal of Broadcasting and Electronic Media.* Vol. 41. 1997.