Before the
FEDERAL COMMUNICATIONS COMMISSION

In the Matter of	)	
	)	
Applications for Consent to the	)	
Transfer of Control of Licenses	)	
	)	
General Electric Company,	)	**Docket No. MB Dkt No. 10-56**
Transforer,	)	
	)	
To	)	
	)	
Comcast, Transferee	)	

Declaration of Dr. Mark Cooper
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Fordham University

June 21, 2010

QUALIFICATIONS AND PURPOSE

My name is Mark Cooper. I am a Fellow at the Donald McGAnnon Center for Communicastions Reseearch at Fordham University. I have thirty years expeience in public policy analysis, much of it in the communications and media sectors, as my university affiliations suggest. I have testified approximately 400 times at Federal and state legislatures and regulatory agencies in forty jurisdictions in the U.S. and Canada.

I have filed a separate declaraitaion on behalf of the Consumer Federation and other public intrest groups in this docket, that demonstrtes why the Comcast-NBC Universl merger is not in the public interest based on a detailed examination of its anticompeitive impacts and the damage it would do to localism and diversity.

Because merger review is predictive, historical patterns and parallels with similar industries play an important role. Antitrust authorities are charged with evaluating what is likely to happen in a market after a merger and preventing anticompetitive outcomes or development that are not in the public interest. Historic patterns of behavior in the industry or patterns in similar industries are an important aid in understanding what could happen in the industry under review. This declaration addresses that broader historic perspective. The four studies attached to this Declaration give important perspective on the central issue raised by the Comcast NBC Universal merger – its potential impact on the emerging Internet TV market. .

THE PAST AS PROLOGUE IN MERGER REVIEW: THE RECURRING IMPORTANCE OF DISTRIBUTION BOTTLENECKS IN MEDIA MARKETS

It is frequently said that the Internet changes everything, but the change comes at different speed for different goods and services. At present, cable system operators are being confronted with the prospect that the Internet will dramatically reduce the stranglehold they have on video distribution.[1]

The proposed merger of Comcast (the nation's largest cable operator and broadband Internet access provider) and NBC Universal (one of the four dominant broadcast TV networks and a leading owner of local TV station and cable programming), coming at t this moment of great competitive promise, has shined a spotlight on the future of Internet TV and on several important past revolutions in the media sector that deeply affected media market structure and competition. Above all, the merger highlights the critical role that distribution bottlenecks play in media markets and the public interest benefits that flow from policies that prevent the exercise of market power at these important choke points in the media supply chain.

A "new" issue that has been injected into the analysis is the developments of the music industry after the growth of the commercial Internet and the advent of digital technology in the late 1990s.[2] Analysts frequently make references to the impact of technological change on the music business, which resulted in the music labels losing control over content distribution. The analysts examine ways the video business can "avoid the fate" of the music industry, and take note of Comcast's actions to do just that, but the music sector is vastly more consumer-friendly today than it was a decade ago before digital technology disintermediated the music label oligopoly.

As the largest high speed Internet access provider Comcast has been active in promoting a specific Internet business model that would extend the control of existing traditional MVPD

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[1] NBC recently stated that "[t]he Internet as a distributor of high-quality video programming has reached the tipping point." Reply Comments of NBC Universal, In the Matter of *Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, MB Docket No. 07-269, Aug. 28, 2009.

[2] Mark Cooper, "Round #1 of the Digital Intellectual Property Wars: Economic Fundamentals, no Piracy, Explain How Consumers and Artists Won in the Music Sector," Telecommunications *Policy Research Conference,* 2008

service providers over video content distribution on the Internet. NBC has been active in this space as well, although its actions have been oriented in a very different direction than Comcast's, as it has sought Internet distribution that is not dependent on existing MVPD providers. Merging these two important players would align their interests in preserving control over content distribution. Comcast has made these parallels as well stating "Whether it is music or newspapers or radio…[They] didn't have a model that protected their core business, and then, boom, here comes the Internet as this destroyer of wealth."[3]

An "old" issue that has been revived by the proposed Comcast-NBC Universal merger is the broad question of the impact of vertical integration on media product quality.[4] This issue arises because the Comcast-NBCU merger represents an unprecedented and dramatic new form of vertical integration in the video market product space. This is the first ever merger of a broadcast network with a multiple system cable operator (MSO). Since cable is the dominant means of video distribution at present and the dominant form of broadband Internet access, it calls to mind the last time such a change took place. The Fin-Syn rules had restricted the amount of programming in prime time and syndication the broadcast networks, which were the dominant means of video distribution at the time, could own. When the Financial Interest and Prime Time Syndication rules (Fin-Syn) were repealed in the early 1990s, the dominant video distributors of the time – the broadcast networks—integrated vertically in a short period of time. The swift concentration and vertical integration of video content and distribution, in less than a decade after repeal of Fin-Syn, saw independent content producers virtually banished from the most important video distribution channels. This raises questions about the impact of a new and

[3] Jeff Baumgartner, "Comcast Nears 'TV Everywhere' Launch," Light Reading, Sept. 9, 2009.
[4] Mark Cooper, and Derek Turner, "The Negative Effect of Concentration and Vertical Integration on Diversity and Quality in Video Entertainment," *Telecommunications Policy Research Conference,* 2007.

potentially more powerful form of vertical integration that would result from the Comcast-NBC Universal merger.

A second "old" issue that was raised at a Congressional hearing on the merger is the problem of discriminatory practices used by cable operators to gain competitive advantage against MVP competitors[5] and independent content producers.[6] Since this issue has been at the center of public policy debates for decades, its prominence is not surprising. The first ever merger between a major broadcast network and a large cable/ broadband Internet access service provider makes the spotlight particularly intense. Since the incentive to favor affiliated content will be greater in a combined Comcast NBC Universal and the quantity of "must have" programming controlled by the merge entity will be great, the propensity for the industry to engage in exclusionary tactics raises great concern.

IMPLICATIONS OF THE STUDIES FOR THE MERGER REVIEW

Although the historical cases may appear to be quite different, they point to one conclusion. Control of distribution is critical in the media sector and the exercise of market power through vertical integration of content and distribution or horizontal concentration in distribution can deny consumers the benefits of competition, resulting in substantial harm.

- The study of the repeal of the Fyn-Syn rule shows that vertical integration with a distribution bottleneck can cause severe harm to competition in the production of content. Repeal of Fyn-Syn allowed a distribution oligopoly to gain much greater control over content production.
- The introduction of digital distribution into the music sector teaches the same lesson from the opposite direction. Digital distribution broke the stranglehold of a distribution oligopoly over music content.
- Since deregulation, the cable industry has exhibited repeated patterns of discriminatory and exclusive practices.

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[5] Testimony of Colleen Abdullah, *House Commerce Committee,* February 4, 2010.
[6] Testimony of Jean Prewitt, *House Judiciary Committee,* March 24, 2010.

- In all cases the impact was felt in a remarkably short period, about a decade, underscoring the importance of close policy attention to this critical juncture in the supply chain.

At the heart of each of these cases of vertical leverage is a strategy of tying or bundling products together.

- Broadcasters owned/controlled one distribution channel – over-the-air-TV – and they were given quasi property rights in another (retransmission/must carry). The repeal of the Fin-Syn rules allowed them to leverage their control over distribution into a near monopoly on prime time programming. Their retransmission rights enabled them to secure carriage for bundles of services and secure a dominant position in cable TV programming. The cable operators acquiesced because they could create large bundles of programs and pass the programming costs passed through to consumers.
- The music labels bundled songs into albums and eliminated singles, forcing consumers to buy large quantities of songs they did not particularly want in order to get the songs they did want. .
- Cable has traditionally used both types of bundling to exercise its market power. It bundles content into large bundles of programs and ties content and distribution together.
- Comcast is leveraging it distribution bottleneck to add more complex layers to its bundled video product, seeking exclusives on Internet distribution and to tie traditional multi-channel video programming distribution to Internet TV distribution.

Outline

Study I presents an overview of the development of the most aggressive measure taken to date by the cable industry to throttle competition on the Internet. The study by Marvin Amori is excerpted from the original, with only the antitrust analysis section deleted, since the merger review provides a different antitrust basis for examining the practice. In testimony before the Congress, I have argued that “TV Everywhere” “is a blatant market division scheme intended to extend the cable "non-compete" regimen from physical space to cyberspace."[7] This study provides compelling evidence in support of that statement at the level of both structure and conduct.

Study II presents an analysis of the transformation of the music sector in the decade after the advent of digital distribution. It demonstrates the huge efficiency and consumer welfare benefits that resulted from digital disintermediation and shows that piracy played only a small part in the transformation of the music sector. It is an update version of an earlier academic analysis.

Study III examines the impact of the repeal of the Fin-Syn rules on the market structure and performance of the video marketplace in the decade after repeal. It shows the speed with which vertical integration and consolidation led to a tight oligopoly that pushed independent content producers out of the prime time and most lucrative distribution channels, and that quality suffered severely as a result. It is an updated version of an earlier academic analysis.

Study IV reviews the track record of the cable industry in the use of vertical leverage to achieve anticompetitive advantage, with most of the examples provided from Comcast or the firms that have been acquired by Comcast in its merger and acquisition strategy to become the largest cable operator. It then present a discussion of the problem of vertical leverage in communications networks. It concludes with a discussion of the broader concern with bottleneck control and vertical leverage in digital networks. The study combines excerpts from academic papers with an addition of a section to bring the theory directly to bear on the issue of Comcast's anticompetitive attack on Internet TV.

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[7] Mark Cooper, "Consumers, Competition and Consolidation in the Video Broadband Market" Commerce Committee, U.S. Senate, U.S. Senate, March 11, 2010

Recommendation

All of the cases suggest that the harmful effects of vertical integration and the beneficial effects of digital disintermediation can occur very swiftly. In less than a decade after deregulation, abuse of market power in the cable market led to its "reregulation." Independents were eliminated from Prime Time in less than a decade. The music industry oligopoly was routed in less than a decade. Discussions of Internet TV suggest that it could transform the video industry in a similar, even shorter time frame. The speed of developments calls for careful consideration by policymakers and these time frames are well within the predictive horizon antitrust authorities should consider in a major merger such as the Comcast NBC Universal union.

This analysis covers about a quarter of a century from the deregulation of cable in the mid 1990s to review of the Comcast NBC universal merger in 2010. Throughout the period, Congress and the FCC deregulated various aspects of the media sector in the hope that competition would improve performance. Consolidation and vertical integration increased rapidly whenever it was not explicitly restricted. Congress has re-regulated on occasion in an effort to control abuses and jump start competition, while the FCC struggled to control abuse.

Over the past quarter century there have been a few moments when a technology comes along that holds the possibility of breaking the chokehold that cable has on the multi-channel video programming market, but on each occasion policy mistakes were made that allowed the cable industry to strangle competition. This is a critical policy moment for determining whether the Internet will function as an alternative platform to compete with cable. If policymakers allow this merger to go forward without fundamental reform of the underlying industry structure, the prospects for a more competition-friendly, consumer-friendly, citizen-friendly multi-channel video marketplace will be dealt a severe setback.

Comcast's strong interest in preventing multi-channel Internet video programming distribution from competing with cable distribution, its leadership role in organizing business models to undermine that competition, its contracting practices to deny content to Internet distribution, and the incentives it has to leverage Comcast-NBC marquee content in pursuit of these anticompetitive goals requires the FCC and the Department of Justice to take action to prevent this threat to competition from materializing. Stopping the merger is part of the solution, but the Department of Justice and the FCC must also address the anticompetitive practices that exist separately from the merger.

THE 21ST CENTURY VIDEO MARKET

WHICH PAST IS PROLOGUE, CONSUMER-FRIENDLY DIGITAL DISINTERMEDIATION or CABLE DOMINATED VERTICAL INTEGRATION?

Lessons from Internet Music Sales, the Repeal of Fin-Syndication and Cable Deregulation for the Future of Internet TV and the Comcast-NBCU Merger Review and

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TV COMPETITION NOWHERE: HOW THE CABLE TV INDUSTRY IS TRYING TO KILL ONLINE TV*

Marvin Amori

***Excerpted from Marvin Amori, *TV Competition Nowhere: How the Cable TV Industry is Trying to Kill Online TV,* Free Press, January 2010.**

EXECUTIVE SUMMARY

We stand at a defining moment for the future of television and film. Existing and evolving Internet technologies may finally inject much-needed competition and choice into the TV market by enabling Americans to watch high-definition programs on the Internet from anywhere or on the family living room screen. But the big cable, satellite and phone companies, which benefit from the status quo, are trying to put down this revolution in online video.

The dominant distributors and studios have a long history of scrambling to kill online TV and trying to preserve the current market structure and prevent disruptive competition. Over the past decade, they have locked down and controlled TV set-top boxes to limit competing programming sources; they have considered imposing fees for high-capacity Internet use in ways that would discourage online TV viewing; and they have pressured programmers to keep their best content off the Internet.

In addition, these companies, which already dominate the Internet access market, have threatened to discriminate against certain online applications or already have been caught violating Network Neutrality. Indeed, the FCC issued an order in 2008 against Comcast for blocking technologies used to deliver online TV, noting the anti-competitive effect of this blocking. While it may be economically rational for cable, phone, and satellite companies to squash online competitors, the use of anti-competitive tactics is bad for American consumers and the future of a competitive media industry.

The latest method of attack aimed at online TV, however, may be the most threatening — and is also likely illegal. Competition laws aim to ensure incumbent companies fight to prevail by providing better services and changing with the times, not by using their existing dominant position and agreements to prevent new competitors from emerging.

The cable, satellite, and phone companies have apparently forged an agreement known within the industry as “TV Everywhere.” TV Everywhere, adopted after lengthy discussions among incumbents to forge an industry-wide plan, is designed to crush online competition while being marketed as a consumer-friendly feature. On Dec. 15, Comcast became the first company to launch its TV Everywhere product, under the brand Fancast Xfinity. The other dominant cable, satellite, and phone companies have announced plans to follow suit.

TV Everywhere has a simple business plan, under which TV programmers like TNT, TBS and CBS will not make content available to a user via the Internet unless the user is also a pay TV subscriber through a cable, satellite, or phone company. The obvious goal is to ensure consumers do not cancel their cable TV subscriptions. But this plan also eliminates potential competition among existing distributors. Rather than Comcast offering Xfinity to all Americans, including those living in Cox, Cablevision and Time Warner Cable regions, it is only available in Comcast regions. The other distributors will do the same, meaning that the incumbent distributors will not compete with one another outside of their “traditional” regions.

In addition, new online-only TV distributors are excluded from TV Everywhere — the “principles” of the plan, which were published by Comcast and Time Warner (a content company distinct from Time Warner Cable), clearly state that TV Everywhere is meant only for cable operators, satellite companies and phone companies. By design, this plan will exclude disruptive new entrants and result in fewer choices and higher prices for consumers.

This business plan, which transposes the existing cable TV model onto the online TV market, can only exist with collusion among competitors. As a result, TV Everywhere appears to violate several serious antitrust laws. Stripped of slick marketing, TV Everywhere consists of agreements among competitors to divide markets, raise prices, exclude new competitors, and tie products. According to published reports and the evident circumstances, TV Everywhere appears to be a textbook example of collusion. Only an immediate investigation by federal antitrust authorities and Congress can prevent incumbents from smothering nascent new competitors while giving consumers sham "benefits" that are a poor substitute for the fruits of real competition.

Building the Case

This paper has three parts. The first provides background on the current marketplace and chronicles the previous tactics of cable TV distributors to thwart online TV's disruptive potential. The second part details how the existing cable competitors forged agreements to create TV Everywhere, largely through closed-door discussions and industry conferences. The third part provides a detailed antitrust analysis.

To tell the story of how the existing providers came together to formulate "TV Everywhere," one must set aside the consumer advertisements and review the trade publications, statements by industry executives at trade shows and panels over the past year, as well as the comments those executives made to the press. Such a review shows how cable executives held discussions deliberately attempting to avoid a paper trail, crafting the plan with conversations in person, on the phone, and at trade events.

The evidence, including statements by leading cable TV executives, makes clear that, under the circumstances, TV Everywhere cannot work without collusion. Executives recognize that competitive pressures should force programmers to make more and more content available online — and to compete with one another. That is, Comcast's online Fancast should be competing online *both* with the offerings of other cable operators, like Time Warner Cable, and those of programmers like Hulu, owned (for now) by Disney, Fox, NBC and others. One Comcast executive described the online TV situation as a classic "prisoner's dilemma," in which two criminals are collectively better off colluding but worse off by following their individual self-interest.

Competitive pressures should require existing cable TV distributors to meet consumer demand for online TV, rather than resisting the demand and tying programming to inflated cable TV subscriptions. Recently, when the newspapers sought to implement an industry-wide "pay wall" on the Internet, the papers sought an antitrust exemption from the Justice Department to hold talks. The cable industry did not seek such an exemption for TV Everywhere but went ahead and implemented an industry-wide agreement anyway, in apparent violation of the law.

Government oversight, antitrust law and competition policy exists to ensure a fair marketplace for all business interests to the benefit of consumers and the economy. This paper calls for congressional hearings on TV Everywhere and an immediate investigation and action by antitrust authorities at the Justice Department or Federal Trade Commission. Swift action must be taken to protect consumer choice and preserve the once-in-a-generation opportunity for emerging-competition in TV that new technologies can provide.

THE BATTLE TO CONTROL THE LIVING ROOM TELEVISION

The cable TV industry historically has not been competitive. As a result, it has long feared the Internet would create disruptive new competitors upsetting that current market structure.

This section provides background on the existing cable market structure and on how online TV would hurt dominant distributors by enabling cord-cutting, injecting competition, and increasing independence for programmers. It then discusses the incumbents' earlier tactics used to thwart online TV.

The Cable Industry's Current, Concentrated Market Structure

The cable industry consists of two cozy overlapping oligopolies — the powerful distribution companies and the powerful programming companies, which often own stakes in one another. Companies like Comcast, Time Warner Cable, Viacom, CBS and NBC Universal love the current market structure. Consumers pay a high price every month for channels chosen by the distributors, for on-demand channels, and to rent the set-top box of the distributors' choice. The powerful programmers negotiate for a cut of those huge profit margins.

The only losers in this arrangement are smaller programmers — which either can't get carried on cable TV or must give equity to a big distributor or big programmer to get carried — and smaller cable TV distributors, which have to pay through the nose for popular programming because they lack the leverage of larger distributors. The ultimate loser, however, is the U.S. consumer, stuck with rising bills, a limited choice of distributors, and an inability to watch smaller programmers that are shut out of the system.

The incumbents fear that online TV would inject competition into this stagnant, concentrated market; would democratize television by giving viewers control over what channels and programs they watch; and would return thousands of dollars to pockets of consumers. Online TV strikes at the very heart of the cozy cable model.

Distribution. In a market worth billions annually,[8] a cable operator such as Comcast, Time Warner Cable or Cox is usually the lone local cable operator, having long ago received government-backed monopolies and guaranteed returns.[9] In the 1990s, satellite operators were

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[8] One Wall Street analyst, Laura Martin of Soleil Media-Metrics, estimates the current worth of all the companies involved in television production and distribution at $300 billion. See Tim Arango, "Cable TV's Big Worry: Taming the Web," *New York Times*, June 23, 2009.

[9] Time Warner Entertainment Co., L.P. v. FCC, 56 F.3d 151, 183 (DC Cir. 1995) ("The monopolies most cable operators now enjoy resulted from exclusive franchises granted by local authorities").

able to compete more effectively, largely through regulatory changes such as a compulsory copyright license for broadcasting and program access rules requiring cable operators to make their content available to rival satellite providers.[10] This decade, after years of promises, telephone companies finally entered the cable TV business, with the benefit of regulatory changes,[11] though their deployment plans will target no more than 40 percent of U.S. homes.[12] So far, government attempts to increase competition in the cable market have resulted in only four players at most, with the local cable operator still dominant. And entry barriers are so high that additional facilities-based competitors are not expected to emerge. This limited competition and insurmountable barriers to entry have resulted in even higher prices,[13] with few advances in formats and cuts in capital investments even as the cost of technology falls.[14] Broader competition is sorely needed.

For *consumers*, the distribution market is local not national. On *average*, the local cable operator retains roughly 68 percent of the local cable TV consumer market, according to the most recent Federal Communications Commission study in 2007.[15] The satellite operators DirecTV and EchoStar roughly split most of the rest, though phone companies are making inroads.[16] More recent figures, which are not available, would likely show that Verizon's Fios product has taken some market share, though Fios is available only in few, generally wealthy, and densely populated communities.[17] These local markets are oligopolies; indeed, the cable operators' 68 percent share likely signifies monopoly power.[18]

For *programmers*, the distribution market is more national or regional; programmers can sell to more purchasers if different distributors operate, even in different towns. This national market is also highly concentrated. In 2006, four cable TV distributors, which included two satellite operators, served approximately 63 percent of all cable TV subscribers. The top 10 cable TV distributors served 87 percent of subscribers.[19] The two largest were Comcast and Time

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[10] Satellite Broadcasting and Communications Association v. FCC, 275 F.3d 337 (4th Cir. 2001).

[11] Implementation of Section 621(a)(1) of the Cable Communications Policy Act of 1984, 22 FCC Rcd 5101, 5103 (2006); Chesapeake & Potomac Tel. Co. v. United States, 42 F.3d 181, n.13 (4th Cir. 1994) (suggesting phone carriers could "easily").

[12] Comments of Free Press, (Sixth) Inquiry Concerning the Deployment of Advanced Telecommunications Capability Pursuant to Section 706, GN Docket 09-51, Sep. 4, 2009, at 50.

[13] "Statewide Video Franchising Legislation: A Comparative Study of Outcomes in Texas, California and Michigan," University of Minnesota, Prepared for the Minnesota Department of Commerce, March 2009, p. 16 (providing theories for this increase, none of which turn on increased cost).

[14] *See* Reply Comments of Free Press, (12th) Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, MB Docket No. 07-269, August 28, 2009, at 7 ("Free Press MVPD Reply"); *see also* Saul Hansell, "The Cost of Downloading All Those Videos," *New York Times Bits Blog*, April 20, 2009.

[15] 13th Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, MB Docket No. 06-189, Jan. 16, 2009 (adopted Nov. 27, 2007), at ¶¶34-41 (MVPD 2007 Report).

[16] MVPD 2007 Report; para 75 & n. 636.

[17] Stacey Higginbotham, "Is Verizon FiOS Putting the Hurt on Cable?," *GigaOm*, July 27, 2009.

[18] DOJ& FTC, Competition and Monopoly: Single Firm Conduct Under Section 2 of the Sherman Act, Sep. 2008, at 19-21(now withdrawn for other reasons).

[19] MVPD 2007 Report; Para 178.

Warner Cable.[20] While the telephone companies have taken some share, the market remains highly concentrated.

This minimal competition results in bad outcomes for consumers. Cable operators have the lowest consumer satisfaction ratings of any industry,[21] even while they soak up large profit margins and raise prices.[22] Some had predicted that the advent of competition from satellite and phone companies would decrease prices and increase quality.[23]

Programming. The programming market is also concentrated, with a few dominant programmers, both non-broadcasters and broadcasters.[24] Large non-broadcast players, whose content is available only through a cable TV subscription, include Viacom (owner of MTV Networks, Comedy Central and others) and Time Warner, a content company that split off from Time Warner Cable, and owns TBS, TNT and CNN. Broadcasters, available both on cable TV and over-the-air, for free, include ABC, NBC, CBS, and Fox.[25] Programmers have high profit margins based on adding two revenue sources — advertising and per-subscriber fees. While programmers are sometimes "cagey" about their financials, the head of NBC's cable channels stated her channels' operating profit margins "are well over 50 percent."[26]

Programming is often vertically integrated, with distributors owning programmers. In the FCC's last report in 2007 (which was before Time Warner's split from Time Warner Cable), the FCC found that of the 565 national non-broadcast channels it identified, many of the most popular were affiliated with a cable operator (84 channels total).[27] Dozens more channels were affiliated with a satellite operator.[28] At the time, five of the top seven cable operators held ownership interests in national programming networks.[29]

The industry may become more consolidated if the Comcast-NBC Universal merger is approved. Today, for example, Comcast owns E! Entertainment Television, Versus, The Golf Channel, regional sports networks, G4, and invests in The Style Network, TV One, PBS Kids

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[20] MVPD 2007 Report; n. 636.

[21] *See generally* American Customer Satisfaction Index, "Q1 2008 and Historical ACSI Scores," May 19, 2009 (ranking the cable industry tied for lowest overall at 63 in 2009, along with newspapers, and below wireless telephone companies).

[22] Regarding profit margins, see Reply Comments of Free Press, A National Broadband Plan for Our Future, GN Docket No. 09-51, July 21, 2009, at 23-24 (providing charts comparing investment and profit margins of major telecom and cable providers, and comparing the investment and margins with other capital-intensive sectors). Regarding increasing prices, see Free Press MVPD Reply, at 4-6.

[23] Implementation of Section 621(a)(1) of the Cable Communications Policy Act of 1984, 22 FCC Rcd 5101, 5103 (2006) ("We believe this competition for delivery of bundled services will benefit consumers by driving down prices and improving the quality of service offerings.").

[24] *See* Mark Cooper and Derek Turner, "The Negative Effect of Concentration and Vertical Integration on Diversity and Quality in Video Entertainment," Presented at the 35th Research Conference on Communication, Information and Internet Policy (TPRC), Sept. 29, 2007.

[25] These networks own stations and then affiliate with stations across the country they do not own. The network may negotiate carriage for its affiliates. *See* Melissa Grego, "Retrans … The Bloody Battle to Save Broadcast Television," *Broadcasting & Cable*, Dec. 14, 2009.

[26] David Lieberman, "NBC Universal's Bonnie Hammer Plans to Build on Cable," *USA Today*, March 22, 2009.

[27] MVPD 2007 Report; Para 187.

[28] MVPD 2007 Report; Para 187.

[29] MVPD 2007 Report; Para 20.

Sprout,[30] Current, Driver TV, MGM Holdings, NHL Network, Music Choice, Pittsburgh Cable News Channel LLC, and the MLB (Major League Baseball) Network. If the Comcast-NBC merger is approved, then Comcast would also own MSNBC, CNBC, Bravo, USA Network, Sci-Fi, the NBC network (which affiliates with hundreds of broadcast stations), Telemundo and a minority share in broadcaster ION media, as well as more than 20 local NBC-owned-and-operated broadcast stations and a major interest in the online video service Hulu. Comcast also has disclosed its equity interests in several smaller cable programmers.[31]

In a common practice that further increases vertical integration, cable TV distributors require small programmers to give up much of their companies' equity stock to cable TV distributors just to get carried.[32] As one programmer's CEO explained, "Cable and satellite TV companies want to own you before they put you on television."[33] If true, this is illegal under communications laws.[34] Programmers have argued that distributors collectively blackball any programmer who files a carriage complaint against one distributor;[35] in addition, distributors may simply copy the programmers' format and deny carriage (or threaten to do so in negotiations).[36] In addition to the formal consolidation, a former cable executive points out "all of the executives at the top of these [cable] companies have been in and around the industry for years and have close personal and professional ties."[37] These ties facilitate discussions such as those around TV Everywhere.

Money flows: Cable TV distributors charge consumers monthly subscription fees for packages of content at generally unregulated prices far above cost.[38] With these revenues, the distributors pay programmers (their suppliers) a per-subscriber fee for every house that receives the programmers' channel. The fee may include advertising slots provided to the distributor, and it may decrease based on channel placement.[39] Cable distributors pay about a third of subscriber fees to cable programmers; these fees comprise half of the programmers' revenues, with the other half coming largely from advertising. Programmers also pay studios, which provide content for their channels.[40] These deals vary based on the market power of the programmer and the distributor.[41] Some "must-have" non-broadcast programmers, such as ESPN (which is owned by

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[30] Mike Farrell, "Is Comcast Trolling For Content?," *Multichannel News*, Sept. 9, 2009.

[31] Rafat Ali, "Comcast Units Not Part of The Deal, and Its Undisclosed Stakes," *PaidContent.org*, Dec. 4, 2009.

[32] *See* discussion in Free Press MVPD Reply, at 9-10 (quoting, from recent news reports, a consultant to many start-up programmers, Cathy Rasenberger, stating, "You need an equity partner these days among the distributors"; Nicolas Saltos, CEO of "The Horror Channel" stating, "Cable and satellite TV companies want to own you before they put you on television.").

[33] "Blacks Support Congress Bill for Fairness in Television Opportunities," *DogonVillage.com*, 2006.

[34] 47 U.S.C. § 536(a)(1).

[35] FCC Tackles Cable Programming Bundling Practices — Transcript," *Media Minutes*, Dec. 12, 2008 (Parul Desai of Media Access Project).

[36] Wealth TV Press Release, "Wealth TV Files Carriage Agreement Complaint Against Time Warner Cable, Inc.," Dec. 21, 2007.

[37] Will Richmond, "The Cable Industry Closes Ranks," *VideoNuze.com*, Nov. 12, 2008.

[38] *See* Free Press MVPD Reply.

[39] Joe Flint, "Want A Better Spot On The Dial In New York City? Open Up Your Wallet," *Los Angeles Times Blog*, July 22, 2009.

[40] Daniel Roth, "Netflix Inside, See Ya, Cable," *Wired*, Oct. 2009, at 124.

[41] Broadcasters, such as ABC (owned by Disney), have the legal benefits of "must-carry," under which they can generally require cable TV distributors to carry their broadcast channels. Turner Broad. Sys., Inc. v. FCC, 520 U.S. 180 (1997); Satellite Broad. & Commc'ns Ass'n v. FCC, 275 F.3d 337(4th Cir. 2001).

Disney) can charge large per-subscriber fees. For instance, Comcast pays ESPN's owners $2.90 per subscriber per month.[42]

Because broadcast channels (such as affiliates of ABC, NBC, Fox and CBS) are available over the air for free, cable operators historically resisted paying fees to broadcasters for carriage but would agree to carry other programming owned by the broadcaster. Today, some broadcasters have succeeded in negotiating per-subscriber fees.[43] Perhaps because their content is already available for free over the air, broadcasters like those participating in Hulu have been relatively quick to distribute content online without subscriptions in an advertiser-supported model.

Cable TV distributors' interest in Internet access providers: Cable TV distributors can attempt to use their control of Internet access in targeting online TV. All the dominant providers of high-speed Internet access are also cable TV distributors. The local cable and phone monopolies dominate residential fixed-line Internet access with 97 percent of the market.[44] The top high-speed Internet access providers include AT&T, Comcast, Verizon, Time Warner Cable, Cox and others. As a result, these cable TV distributors charge consumers twice — once for Internet access and once for a cable TV subscription. Today, cable operators make between 50 percent and 60 percent of their revenues from cable TV, and the balance from Internet access and phone services.[45]

Standardized contract terms: Negotiations for programming are often long-term, with contracts lasting as long as seven years. Moreover, these contracts, particularly among the largest distributors, generally include "most favored nation" clauses granting the distributor the benefit of any contract negotiated with a rival distributor.[46] As a result, terms of the contracts often are standardized across the cable TV industry. In addition, and of particular relevance to this paper, these contracts cover "alternative distribution methods," such as online TV delivery. These terms generally limit what content the programmer can make available online on its own Web sites and, particularly, on third-party Web sites, to ensure these online distributors cannot compete with cable TV distributors.[47]

Broadcasters can also select not to exercise "must-carry," but to negotiate for payment or other additional benefits for carriage. Most popular broadcasters elect negotiations. This is known as retransmission consent. 47 U.S.C. § 325(b).

[42] John Higgins, "Comcast Disney Fight Simmers," *Broadcasting & Cable*, March 19, 2006.

[43] *See* Mike Farrell and Linda Moss, "Operators, Broadcasters Give Peace A Chance On Retransmission Consent," *Multichannel News*, Jan 10, 2009; See Melissa Grego, "Retrans … The Bloody Battle to Save Broadcast Television," *Broadcasting & Cable*, Dec. 14, 2009.

[44] Comments of Free Press, (Sixth) Inquiry Concerning the Deployment of Advanced Telecommunications Capability Pursuant to Section 706, GN Docket 09-51, Sep. 4, 2009, at 46, 48. Satellite operators also offer Internet access, as do wireless providers, but their offerings are inferior to wireline offerings; even if these offerings are considered competitive with wireline offerings, they have minimal market share. *Id.* at 47

[45] *See, e.g.*, Comcast Corporation, Trending Schedule, 3rd Quarter, 2009.

[46] *See, e.g.*, Gil Ehrenkranz, "Mapping the 'Most Favored Nation,' " *Multichannel News*, Feb. 10, 2008.

[47] Will Richmond, "The Cable Industry Closes Ranks," *VideoNuze.com*, Nov. 12, 2008 ("I believe has closed ranks to frown heavily on the idea of cable programming, which operators pay those monthly affiliate fees for, showing up for free on the web, or worse in online aggregators' (*e.g.* Hulu, YouTube, Veoh, etc.) sites.")).

Set-top boxes: Cable TV distributors also derive revenue from leasing set-top boxes to consumers. These boxes are often needed for on-demand and high-definition offerings and frequently include DVR capabilities. The incumbents can generate huge fees from renting these boxes because they dominate the market for them and have made it difficult for consumers to purchase independent boxes.[48]

The Technologies and Potential of Online TV

Based on new technologies, companies can deliver TV content through an Internet connection (or, as they say in the industry, "over the top"[49] of an Internet connection) and deliver that content to the TV screen. Online TV distribution includes a range of business models, including subscription, per-episode fees, advertiser-supported, or some combination. Distributors include Hulu, which already has 40 million monthly viewers and hundreds of advertisers.[50] Companies like Miro, Vuze and Joost, have offered high-definition video.[51] Apple's iTunes sells movies and shows, charging per program,[52] though Apple is now trying to assemble a disruptive monthly subscription TV service.[53] YouTube is adding full-length films to its user-generated content and splitting the resulting ad revenue with the content owners.[54] Some niche start-ups offer specialized content; for example, one company caters to aviation and air-show enthusiasts with high-definition video.[55]

Users are also now streaming online TV content to more screens — to the computer, the mobile handheld, and the television set. Consumers use simple technological connections like inexpensive cords or more convenient methods like set-top box devices (Apple TV, Roku, Vudu), and gaming consoles (Sony's Playstation 3 and Microsoft's Xbox), BluRay players, and Wi-Fi enabled televisions. Apple TV is a device retailing at a few hundred dollars that connects a TV screen to an Internet connection and gives users the ability, using a remote control, to purchase and watch high-definition movies and TV shows from the iTunes store, listen to music, and view photos.[56] Roku, designed and then spun off by Netflix, sells a device for under $100 that streams TV content from Netflix, Amazon VOD (offering 45,000 movies and TV shows[57]), and Major League Baseball's site.[58] Vudu similarly enables online TV viewing on a television screen through a box. The Playstation and XBox are popular gaming consoles that also function as home entertainment centers, particularly when beaming online TV to television screens.

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[48] Cecilia Kang, "Consumer Electronics Group Calls for Broad FCC Set Top Box Review," *Washington Post*, Nov. 24, 2009; Matthew Lasar, "Sneak Peek at FCC National Broadband Plan Gets Mixed Reviews," *Ars Technica*, Dec. 17, 2009.
[49] Leslie Ellis, "Get Ready For Over-the-Top Video," *Translation-Please*, July 11 2005.
[50] Brian Stelter, "Web-TV Divide Is Back in Focus With NBC Sale," *New York Times*, Dec. 3, 2009; Mike Farrell, "Hulu Partners Eye Subscription Model," *Multichannel News*, Sept. 15, 2009.
[51] Juha Saarinen, "Vuze challenges Joost," *The Techsploder* Blog, April 10, 2009.
[52] "iTunes Sells 200 Million TV Shows, Adds New HD TV Lineup," *AppleInsider.com*, Oct. 16, 2008.
[53] Sam Schechner and Yukari Iwatni Kane, "Apple TV-Service Proposal Gets Some Nibbles," *Wall Street Journal*, December 22, 2009.
[54] Jacqui Cheng, "YouTube launching premium section with movies, TV shows," *Ars Technica*, April 16, 2009.
[55] Ben Griffiths, "Superfly Guys: Three Enthusiasts Believe Online TV Can Revolutionise Air-Shows," *City A.M.*, Sept. 8, 2009.
[56] Apple TV, http://www.apple.com/appletv/.
[57] Daniel Roth, "Netflix Inside, See Ya, Cable," *Wired*, Oct. 2009, at 122.
[58] "Roku," *Wikipedia*, http://en.wikipedia.org/wiki/Roku (visited Sep. 2, 2009).

Xboxes offer high-definition movies through Netflix.[59] BluRay players, now the industry standard for high-definition DVD, often have online TV capabilities, including Netflix capability. BluRay players are "pretty much open platforms, and anyone can deliver a Web streaming service directly using it."[60]

Boxee is software that enables users to explore online content from CBS.com, Comedy Central and other sites using a device like Apple TV, a computer, a television's built-in Internet connection,[61] game consoles or BluRay players.[62] In December 2009, Boxee unveiled its plan for set-top box pre-loaded with Boxee software.[63] The *New York Times* has reported that Boxee's software has a "well-organized directory,"[64] unlike the "increasingly long and convoluted channel directories on most cable and satellite systems," made by companies that are "clearly not experts at creating elegant interfaces or simple remote controls."[65] Boxee also embeds social networking features enabling users to view, rate, and recommend content through its interface.[66] Boxee has raised millions from investors.[67]

One of the most popular online TV offerings is Netflix, a company known initially for offering DVDs through the mail for monthly subscription fees. Netflix now offers television through the Internet. It has 9 million subscribers and offers programming to numerous devices, having embedded its software in nearly 10 million TVs, DVD players, game consoles like Microsoft's Xbox 360, and laptops.[68] Microsoft incorporated the service in its Windows Media Center software, so everyone with Microsoft Vista can stream Netflix service to their television.[69] As a result, Netflix "routs around" the cable TV distributors. In so doing, Netflix acted "surreptitiously" to avoid "the wrath of the [cable] giants."[70] Netflix has partnered with device makers and with programmers to provide access for subscribers to thousands of its titles online.[71]

The Incumbents' Fears of Online TV

The availability and popularity of these devices and technologies causes three main fears for the cable TV distributors — cord-cutting, competition and losing marker power over programmers.

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[59] Chris Albrecht, Netflix HD Streams Coming to Xbox," *NewTeeVee.com*, Oct. 29, 2008.
[60] "Research Firm Sees Blu-ray As Key Over-the-Top Drive," *ScreenPlaysMag.com*, Nov. 25, 2009 (discussion analysis of Colin Dixon of the Diffusion Group).
[61] "Web Video Deal Making Intensifies Race to the TV," *ScreenPlays Magazine*, Aug. 27, 2009.
[62] Chloe Albanesius, "Boxee Lands Deal for Set-Top 'Boxee Box,' " *PCMag.com*, Nov. 12, 2009.
[63] Chloe Albanesius, "Boxee Lands Deal for Set-Top 'Boxee Box'"; Avner Ronen, "A Boxee Box?" *Boxee Blog*, Jan. 16, 2009.
[64] Brad Stone, "Boxee, Used to View Web on TV, Generates Buzz," *New York Times*, Jan. 16, 2009.
[65] Brad Stone, "Boxee, Used."
[66] Brad Stone, "Boxee, Used."
[67] Brad Stone, "Boxee, Used"; Robin Wauters, "Boxee Raises $4 Million for Socially Networked Media Center," *TechCrunch*, Nov. 18, 2008; Brad Stone, "Boxee Raises Another $6 Million for Assault on Big Media," *New York Times Bits Blog*, Aug. 13, 2009.
[68] Daniel Roth, "Netflix Inside," at 120, 124.
[69] Daniel Roth, "Netflix Inside," at 120, 124.
[70] Daniel Roth, "Netflix Inside," at 124.
[71] Rose Major, "Netflix Strikes Sony Deal," *Rapid TV News*, Dec. 7, 2009.

Cord-cutting

"Cord-cutting" refers to cancelling a cable TV subscription. As one cable trade publication noted, cord-cutting is "becoming easier than ever" since consumers can watch television through the Internet, supplemented by over-the-air digital broadcasts.[72] By April 2009, 8 percent of consumers had already hooked up their televisions to the Internet.[73] Publications often feature families cutting the cord and saving hundreds or thousands of dollars a year.[74]

One publication quoted a user who canceled cable and uses Apple TV: "It's hard to justify paying $100 a month for TV programming when so much is available online."[75] Another publication noted Boxee's fans think Boxee is "a way to euthanize that costly $100-a-month cable or satellite connection,"[76] and quoted one Boxee user saying, "Most people my age would like to just pay for the channels they want, but cable refuses to give us that option."[77] And the CEO of Roku has publicly stated, "Our goal is to have everyone cancel their cable subscription."[78] Roku provides 10 channels to its box; as one reporter noted, if "some bigger names in content — Hulu, are you listening? — were to sign on and make channels," then Roku "would be truly be an excellent replacement for cable."[79]

A recent article in the *New York Times* described one family's use of an inexpensive mini computer, an Xbox (which was not even "absolutely necessary"), Boxee, Hulu and Netflix to cancel their monthly $140 cable subscription and save $1,600 a year.[80] Thirty-five percent of respondents in a recent survey said they would consider canceling their cable TV subscription within the next five years to watch TV exclusively on the Internet.[81] Americans already could watch a third of their television hours without a cable TV subscription on over-the-air standard- and high-definition digital channels available with an antenna for free.[82] While clearly not all Americans will cancel their subscriptions in the short term, millions of households could. As one financial analyst observed, "People are starting to wonder, do we even need the cable connections?"[83]

Whether consumers will actually cut the cord, clearly cable providers fear the possibility. "We are starting to see the beginning of cord cutting," said Glenn Britt, the chief executive of

[72] Todd Spangler, "Breaking Free," *Multichannel News*, Nov. 2, 2008.
[73] Mary Madden, "The Audience for Online Video-Sharing Sites Shoots Up," Pew Internet & American Life Project, July 2009.
[74] Nick Bilton, "Cable Freedom is a Click Away," *New York Times*, Dec. 10, 2009. *See also* Marguerite Reardon, "You Don't Need Satellite TV When Times Get Tough," *Cnet.com*, Dec. 19, 2008.
[75] Spangler, "Breaking Free."
[76] Brad Stone, "Boxee, Used."
[77] Brad Stone, "Boxee, Used."
[78] As *Wired* noted, cable TV distributors and programmers are "some of the most powerful incumbents in media," and they "have successfully stymied or co-opted all previous entrepreneurial efforts." Daniel Roth, "Netflix Inside," at 124.
[79] Chris Foresman, "First Look: Roku Channel Store Expands Connected Set-Top Box," *Ars Technica*, Nov. 23, 2009.
[80] Nick Bilton, "Cable Freedom is a Click Away," *New York Times*, Dec. 10, 2009. *See also* Marguerite Reardon, "You Don't Need Satellite TV When Times Get Tough," *Cnet.com*, Dec. 19, 2008 (discussing a family saving $93 a month).
[81] "Cable TV Follows Its Subscribers to the Internet," *Knowledge@Wharton*, Aug. 26, 2009.
[82] Wayne Friedman, "Cable Share Grows, Broadcast Recedes," *Media Post News*, Dec. 9, 2009.
[83] Dawn C. Chmielewski and Meg James, "Hulu's Tug of War with TV," *Los Angeles Times*, May 11, 2009 (quoting Bobby Tulsiani, Forrester Research media analyst).

Time Warner Cable in February 2009. "People will choose not to buy subscription video if they can get the same stuff for free."[84] According to a senior vice president at Cablevision-owned Rainbow Media Holdings, which owns channels like AMC and IFC, "My biggest fear would be not so much people cutting the cord, but the younger generation coming up and never buying into [cable TV]."[85] A recent report by the firm SNL Kagan concludes that "videos over the Internet will continue to erode the subscriber base from the multichannel services vendors in the United States," though perhaps less than cable TV distributors fear.[86]

While cord-cutting is likely further in the future for most Americans, many Americans may turn to existing devices and services — like Netflix and Hulu — instead of paying a few dollars for a TV show on-demand or a monthly fee to rent a cable DVR. As the cable industry would like to preserve and expand DVR and on-demand revenues, this is a real threat to them. Cable TV distributors do not like this picture. They would rather charge consumers twice — for cable TV *and* for Internet service. These operators "worry that the proliferation of free video on the Web — and downloadable shows on Apple iTunes — may be harming the $60-billion-a-year subscription video business by allowing people to unplug their cable services."[87] As Professor Jonathan Taplin noted, cable TV distributors "would rather" you not cancel your cable TV subscription and "that you pay them 70 bucks a month for maybe a lot of channels you don't use."[88]

Cable distributors fear, in short, "cannibalizing" their existing cable TV subscriptions with their Internet subscriptions.[89] The idea of consumers watching online TV on the television "terrifies television networks and distributors"[90] and represents a "potentially dangerous idea for the TV industry."[91] As a result, according to press reports, "some [cable TV distributors] are

[84] Deborah Yao, "Cable Companies See Customers Cutting Back: 'The Beginning Of Cord Cutting,' " *Associated Press*, Feb. 8, 2009.

[85] Steve Donohue, "Cisco: Set-Top Data Could Boost 'TV Everywhere,' " Nov. 19, 2009.

[86] Mike Robuck, "Report: OTT Eating Into Video Market Share Pie," *CedMagazine.com*, Oct. 9, 2009.

[87] Brad Stone and Brian Stelter, "Some Online Shows Could Go Subscription Only," *New York Times*, March 20, 2009.

[88] Laura Sydell, "Hooking Up PC To TV Could Be Near," *All Things Considered*, March 12, 2009. Cable operators note this reality themselves when discussing the benefits of moving to switched digital video. Comcast CTO Tony Werner: "It's clear that the last 200 to 300 channels are watched such a small fraction of the time ... if you never have more than 40 streams watched out of 200." Leslie Ellis, "How Sexy is HFC? (Answer: Plenty)," *CED Magazine*, May 1, 2007. The FCC has confirmed that cable service prices continue to rise out of pace with inflation or investment. Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992, 21 FCC Rcd 15087,15088 (2006).

[89] Brad Stone and Brian Stelter, "Some Online Shows Could Go Subscription Only," *New York Times*, March 20, 2009.

[90] Brad Stone and Brian Stelter, "Some Online Shows Could Go Subscription Only."

[91] Brad Stone, "Boxee Raises Another $6 Million for Assault on Big Media," *New York Times Bits Blog*, Aug. 13, 2009 ("The more free Web video that makes its way to the television, the fewer reasons people have to pay those hefty monthly bills to the cable and satellite companies, which split revenue with" the cable programmers).

trying to make sure people have a reason to keep paying hefty cable bills"[92]; TV Everywhere, which ties online TV to cable subscriptions, is meant to be such a reason.[93]

Competition.

Online TV could disrupt the cable industry's oligopoly markets, injecting long-sought competition in markets like subscription and on-demand viewing. The entry costs for building an entire network — like the cable or phone networks, built under government-sanctioned monopolies — or launching a satellite are very high. Because of the economics of Internet distribution, online TV distributors have low costs of entry. As a result, new competitors like Roku could enter and take some market share, while cable TV distributors will likely have to lower their cable TV prices or provide higher quality — in short, *to compete* — to the benefit of consumers.

With online competition, companies like Comcast and Cox would be forced to compete nationally with one another and with programmers. Today, Comcast and Cox have local cable monopolies that do not overlap. In the online space, all these distributors could compete with one another through Internet delivery, even if Comcast does not have a cable network in a traditional Cox market like San Diego. Programmers like the owners of Hulu also could become direct competitors to Comcast and Cox. Finally, new entrant programmers could use the Internet to reach consumers, forcing existing programmers to lower their prices to consumers (*e.g.*, through fewer ads) or to provide greater value, perhaps through innovation.[94]

Control Over Programming and Talent

With competition from online TV, cable TV distributors could lose some of their market power with smaller programmers. Today, powerful distributors have incredible power over smaller programmers. Being able to decide whether a programmer can succeed, the distributors often pay little to carry smaller programmers or can demand an equity stake in exchange for carriage. A large online TV market could subvert that dynamic. Programmers could go directly to consumers without cutting a deal with the cable TV distributor. As a result, programmers would have greater leverage in negotiating with the cable TV distributor, as programmers could reach an audience without being wholly dependent on a few powerful distributors. In addition, if

[92] Brad Stone and Brian Stelter, "Some Online Shows Could Go Subscription Only."

[93] According to the *New York Times*, "leading the charge" against online TV "are the cable and satellite companies." Brad Stone and Brian Stelter, "Some Online Shows Could Go Subscription Only." The fear of online TV is one reason "why they are engaged in efforts like TV Everywhere." (Brad Stone, "Boxee Raises Another $6 Million.") According to NBC's president of digital distribution, cutting the cord "will become more easily doable" with the available television sets that have built-in Internet connections, but he "pointed out that efforts like TV Everywhere could dissuade subscribers from cutting the cord on cable." Steve Donohue, "Cisco: Set-Top Data Could Boost 'TV Everywhere,' " Nov. 19, 2009 (quoting Jean-Briac Perette, of NBC).

[94] Time Warner acknowledges that after it spins off its AOL online unit, 70 percent of its profits will come from its cable deals, and the company sees that dependence increasing as broadcast TV continues to lose viewers and ad revenue. Industry analysts looking at Hulu and other current sites warn that ad revenues from online video will never match those of broadcast and cable television, amplifying fears over losing cable programming fees. Steve Donohue, "Online Distribution Threatens TV Ad Revenue," *Contentinople*, June 5, 2009.

there are more distributors to negotiate with, both online and offline, smaller programmers could negotiate for better terms with distributors.

Widespread online TV also could give unions, such as screenwriters, more bargaining power to negotiate more favorable deals with cable TV programmers.[95] Such talent would have the option of working for more programmers, as smaller programmers succeed. The talent would also have the ability to distribute content directly to consumers online, becoming programmers themselves.

Earlier Actions to Attack Online TV

Since the advent of high-speed Internet access service, cable TV distributors have used at least four main tactics to undermine television over the Internet before the unveiling of TV Everywhere. All have been famously unpopular and controversial, and they have prompted investigations, legal action, legislation and regulations.

Network Neutrality Violations

Cable TV distributors have targeted and blocked online software enabling high-definition online TV. As early as the 1990s, the operators made "efforts to block or otherwise impair a user's ability" to access streaming video longer than 10 minutes,[96] fearing that Internet access would undermine cable TV revenues.[97] The CEO of AT&T Broadband and Internet Services (then a cable operator) explained AT&T would not "allow others to freely transmit movies and TV shows" over AT&T's Internet access connections because "AT&T didn't spend $56 billion to get into the cable business 'to have the blood sucked out of our vein' " by online TV.[98]

A more high-profile and recent example is Comcast's degradation of peer-to-peer applications used to distribute, among other things, high-definition online TV from providers such as Vuze, Miro, BitTorrent.com and ABC.com.[99] In the Federal Communications Commission's *Free Press-Comcast Order* directing Comcast to stop blocking these technologies, the FCC noted Comcast's clear anti-competitive motives: "Peer-to-peer applications … have become a competitive threat to cable operators such as Comcast because Internet users have the opportunity to view high-quality video with BitTorrent that they might

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[95] Dante Atkins, "The WGA Strike, the Internet and Media Decentralization," *FlowTV.org*, May 22, 2008.

[96] "Excite@Home Keeps a Video Collar," *ZDNet.com*, Nov. 1, 1999 (noting that the other major cable ISP, similarly a joint venture including cable operators, called Road Runner, limited 10 minute streaming videos created particularly for its service).

[97] "Excite@Home Keeps a Video Collar." ("Part of the genesis of the 10 minute restriction was from the concern that folks would start watching streaming media on the computer instead of going to the core cable business and watching TV shows," said Gary Arlen, a Maryland-based consultant, adding that the cable companies were concerned "that video on the Net would take away from the core business and maybe make customers not watch what the advertising supported cable programming side was offering." David Card, senior analyst for Jupiter Communications, puts a fine edge on the reason for the restriction: "They don't want the cable modem business to cannibalize their basic core business, which is delivering filmed entertainment, news and sports.")

[98] David Lieberman, "Media Giants' Net Change Establish Strong Foothold Online," *USA Today*, Dec. 14, 1999.

[99] "BitTorrent Firms: Comcast Throttling is Anti-competitive," *CNet News*, Feb. 14, 2008.

otherwise watch (and pay for) on cable television."[100] Other carriers also engage in questionable conduct.[101]

The distributors' "technical" defenses of these practices are questionable. Internet networking experts have maintained that increases in capacity to meet increased usage are economical.[102] While carriers initially claimed they could not handle the peer-to-peer or video traffic,[103] the largest carriers are "flush with cash, enough to upgrade and expand their broadband networks on their own" without government subsidies.[104] They also now hope to carry increased amounts of online TV — their own — through the TV Everywhere initiative.[105]

Moreover, these Network Neutrality violations have resulted in thousands of consumer complaints, several bills proposed in Congress, two FCC enforcement actions, and an imminent FCC rulemaking.[106]

Targeted Cap-and-Metered Pricing

Cable and phone companies have proposed cap-and-metered pricing for Internet service that appears to target online TV.[107] Unlike the current all-you-can-eat monthly fee-plans, cap-and-metered pricing would charge users based on the capacity used. As a result, downloading or streaming large files will be more expensive than smaller files. In March 2009, Time Warner Cable announced metered pricing trials in four cities that would have made watching online TV cost-prohibitive.[108] AT&T is testing a metering plan on its wireline U-verse service with hopes

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[100] In re Formal Complaint of Free Press and Public Knowledge Against Comcast Corporation for Secretly Degrading Peer-to-Peer Applications, 23 FCC Rcd. 13028, 13030 (2008).

[101] Cox Communications trialed a system to prioritize supposedly "time-sensitive" Internet applications, excluding peer-to-peer services from its category, even for streaming TV, phone or video conferencing. (Todd Spangler, "Cox To Test Bandwidth-Throttling System," *Multichannel News*, Jan. 28, 2009.) AT&T Wireless specifically prohibits any P2P file sharing and redirecting television signals. (Lynnette Luna, "AT&T revises data usage rules," *Fierce Broadband Wireless*, May 3, 2009.) AT&T Wireless has an exclusive deal with Apple for the iPhone to encourage Apple to reject BitTorrent, SlingPlayer and other video applications. AT&T cited network burdens and un-adjudicated copyright infringement as justifications. (David Kravets, "Apple Rejects iPhone BitTorrent App," *Wired Threat Level Blog*, May 11, 2009; Dan Moran, "AT&T Defends SlingPlayer's Wi-Fi Limit," PC World, May 13, 2009.)

[102] Testimony of Gary R. Bachula, Internet2, Net Neutrality: Hearing before the United States Senate Committee on Commerce, Science and Transportation, 109th Cong. (2005), Feb. 7, 2006.

[103] *See, e.g.*, Comments of Free Press et al., Broadband Practices NOI, WC Docket No. 07-52, Feb. 13, 2008; Reply Comments of Free Press et al., Broadband Practices NOI, WC Docket No. 07-52, Feb. 28, 2008.

[104] Cecilia Kang, "Major Carriers Shun Broadband Stimulus," *Washington Post*, Aug. 14, 2009.

[105] Similarly, AT&T made a deal with Major League Baseball to carry the MLB's television channel on the iPhone, providing customers with live games streamed over the 3G network for a single $9.99 application charge. (Jordan Golson, "MLB iPhone App to Live-Stream Games Over 3G; Still No Sling," *GigaOm.com*, June 18, 2009). Time Warner CEO Bewkes predicted that TV Everywhere would exceed the popularity of YouTube and Hulu: "This will be by far the highest amount of online video watched in the United States." (Todd Spangler, "Pay TV's Internet Acid Test," *Multichannel News*, July 6, 2009.)

[106] Preserving The Open Internet Broadband Industry Practices, 2009 WL 3413028 (F.C.C., Oct. 22, 2009).

[107] S. Derek Turner, "Blocking or Metering: A False Choice," Free Press, August 2008.

[108] Time Warner Cable offerings started at only 5 GB for a month, with $1 charges for each GB of overage. Meanwhile, downloading a single high-definition movie often requires 8 GB. Stacey Higginbotham, "The Twilight Problem: Why Metered Broadband Could Suck," *Gigaom.com*, April 14, 2009.

for national expansion.[109] Even under generous allowances for bandwidth, users could not watch high-definition programming for many hours a day.[110]

In response to trials by Time Warner Cable, a House bill was introduced in Congress, and Time Warner Cable dropped its immediate plans under consumer pressure.[111] The company stated the plans would be reintroduced following a "customer education process."[112]

Control Over Set-Top Boxes

While many devices can put online TV programming onto TV screens, the cable operators have made it nearly impossible to attach independent devices to the cable TV connection or, in doing so, to integrate online TV content and cable TV content through the same convenient interface.[113]

Third-party box makers have little to no hope of penetrating the set-top box market for delivering cable TV programming (including video-on-demand). Cable operators have spent almost two decades actively thwarting congressional and FCC efforts meant to ensure consumers can attach devices to the network. In 1992 and again in 1996, Congress passed laws to ensure the commercial availability of third-party cable devices,[114] and the FCC has sought to implement Congress' directive, if somewhat unevenly, sometimes half-heartedly, and often incompetently.[115] As a result, the set-top box is not subject to competition or innovation (many boxes consist of very old technology[116]), and cable operators rent boxes to users at very high monthly prices. As a *Wired* author noted, "The set-top box has proven to be a closed and well-guarded fortress against a world of clouds and openness," and the incumbents "work strenuously to keep it that way."[117]

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[109] John Timmer, "Sorry, Beaumont! AT&T Brings (More) Bandwidth Caps to Texas," *Ars Technica*, Dec. 2, 2008.

[110] Brian Mahoney, "Comparing Hybrid OTT/Pay TV Solutions on Opposite Sides of the Pond: TV Everywhere and Project Canvas," *Trender Research*, November 4, 2009 ("If my math is correct, Comcast's 250 GB cap is good for about 1 hour of HD content viewing per day. Most consumers would not even come close to that right now, but what about "cord-cutters" wanting to replace the 8+ hours of TV viewing common to U.S. households?

[111] *See* "Time Warner Cable Charts a New Course on Consumption Based Billing," *PR-Inside,* April 16, 2009); Saul Hansell, "Time Warner Cable Profits Will Grow With Broadband Caps," *New York Times Bits Blog*, April 8, 2009. TWC is also moving ahead with trials of the revised plan in Beaumont, Texas. (Nate Anderson, "Time Warner Tries Again, Fails to Justify Caps and Charges," *Ars Technica*, April 10, 2009).

[112] Nate Anderson, "Time Warner Tries Again."

[113] This process already revolutionized online music: Though few consumers would have switched to the iPod from compact discs based merely on the legal digital content then available, many users moved quickly to the iPod because it permitted users also to listen to their existing libraries. This created a larger market for digital downloads, making a CD-free life feasible for millions. Because of the strategies of cable operators, however, "Apple has largely failed to ignite the same fire in the video and TV markets as the audio market." (Alex Salkever, "Three Reasons Why Verizon's App Store Doesn't Threaten Apple," *Daily Finance*, July 15, 2009.)

[114] 47 U.S.C. § 549.

[115] Reply Comments of Free Press, (12th) Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, MB Docket No. 07-269, Aug. 28, 2009, at 6-8.

[116] The cable industry supplies tens of millions of consumers with "old set-top boxes that have limited memory and processing capabilities"; the chief software architect for Comcast admits that the "lowest end set-top box [still supplied by Comcast] is the equivalent of a Mac II from 1991." Saul Hansell, "Like Apple, TV Explores Must-Have Applications," *New York Times*, Sept. 6, 2009.

[117] Daniel Roth, "Netflix Inside, See Ya, Cable," *Wired*, October 2009, at 120, 124.

The FCC admits its policies have failed. In late 2009, the FCC concluded that "set-top box competition has not emerged, limiting innovation."[118] In 2008, there were only 14 set-top boxes on the market, including those leased by cable TV distributors; by contrast, there are 900 mobile phone and handheld devices on the market.[119] The Consumer Electronics Association, which represents thousands of companies, has fought for years to open up the set-top box market. As their vice president recently concluded, "It's been a long slog. … Cable operators have been loath to give up control."[120]

Device-makers can, however, attach boxes to the *Internet* connection through, for example, an ethernet jack.[121] This has resulted in devices like Apple TV, Roku, Vudu and Boxee's announced device — as well as the ability to connect televisions, gaming consoles, computers and BluRay players.

But in a move that drastically reduces the consumer-friendliness of these boxes, the cable industry forbids outside boxes from integrating cable TV offerings within the same interface used for navigating online TV.[122] For example, Boxee's popularity rests on it being a user-friendly interface that displays, in one place, TV content from users' hard drives and multiple sites across the Internet.[123] As a result of this restriction, users cannot easily "change channels" among online and cable TV programs.[124] While public TV distributors in Europe have moved to incorporate online and cable TV into one interface,[125] the cable industry lobbying association has recently argued that enabling integrated interfaces could result in a cable industry rushing to the government for subsidies to survive.[126]

While these issues are independent of TV Everywhere, we can expect cable TV distributors to tie TV Everywhere to their controlled set-top boxes: An executive of Comcast's

[118] FCC, "FCC Identifies Critical Gaps in Path to Future Universal Broadband," Nov. 18, 2009.

[119] Cecilia Kang, "Consumer Electronics Group Calls for Broad FCC Set Top Box Review," *Washington Post*, Nov. 24, 2009.

[120] Cecilia Kang, "Consumer Electronics Group Calls for Broad FCC Set Top Box Review," *Washington Post*, Nov. 24, 2009.

[121] Implementation of Section 304 of the Telecommunications Act of 1996 Commercial Availability of Navigation Devices, 13 FCC Rcd 14775, 14778 (1993).

[122] *See e.g.* Memorandum of Understanding Among Cable Operators and Consumer Electronics Adopters Regarding Interactive Digital Cable Ready Products, April 25, 2008, at 8-10, *available at* http://fjallfoss.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=6520013345.

[123] Boxee is a "New York-based start-up [that] makes elegant software that cobbles together offerings from all of those services [Hulu and Netflix], plus many more — with whatever media you have stored on your hard drive — and serves it up to you on your big screen, with a minimum of fuss." Peter Kafka, "Boxee: WebTV That Makes Sense. Is that Good or Bad for Big Cable?" *All Things Digital Blog*, Jan. 12, 2009.

[124] Even the Supreme Court has noted that consumers prefer not to switch between cable TV offerings and non-integrated offerings. Turner Broadcasting System, Inc. v. FCC, 520 U.S. 180, 219-21 (1997).

[125] Brian Mahoney, "Comparing Hybrid OTT/Pay TV Solutions on Opposite Sides of the Pond: TV Everywhere and Project Canvas," *Trender Research*, Nov. 4, 2009 ("Project Canvas [in the UK, led by BBC] is also tackling the hybrid interface challenge head-on by providing an integrated electronic program guide").

[126] Comments of the National Cable & Telecommunications Association on NBP Public Notice #27, A National Broadband Plan for Our Future, GN Dkt No. 09-51, December 22, 2009, at v, 9, 11-12.

subsidiary online technology, called "ThePlatform," has stated Comcast will be "downloading authentication devices into users' set-top boxes" for TV Everywhere.[127]

Content Lockout

Before launching TV Everywhere, cable operators pressured programmers "to keep as much content offline as possible."[128] Some cable TV distributors "have gone so far as to stipulate that cable networks limit the number of episodes they make available online. Others have imposed an outright ban."[129] Executives at an unnamed, major programmer (which requested confidentiality for fear of retribution by cable TV distributors) confirmed that it would not put its programming online, based on the demands of cable TV distributors.[130] The distributors generally threaten to pay lower per-subscriber fees on the cable TV platform if programmers make content available online: "The message is loud and clear to programmers," said one observer. "You'll be jeopardizing those monthly affiliate fees come renewal time if your crown jewels leak out; worse, you'll be subverting the entire cable business model."[131]

Historically, incumbent distributors have tried to stifle emerging competitors by denying them content, almost invariably requiring government action to protect competition. In the 1910s, publishers of sheet music tried to deprive manufacturers of piano rolls and records;[132] in the 1930s, song performers tried to deprive over-the-air radio of songs.[133] In the 1970s, the incumbent TV broadcasters (like NBC and CBS) tried to kill cable operators — then a new entrant — by denying access to broadcast TV content. Without access to that incumbent content, cable operators would have been unable to gain initial subscribers; without initial subscribers, the cable operators would not have had the revenue and the audience to then create their own programming content, like HBO.[134] Years later, cable operators attempted to deny content to emerging satellite operators.[135]

Recently, cable operators have deprived phone companies of premium local sports content. A new TV entrant's need for content is so powerful that AT&T had to run to the FCC to file a complaint about access to San Diego Padres games, which Cox, the local cable operator, refused to license to AT&T. Notably, Cox licensed the games to other cable operators that did

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[127] "ThePlatform" also serves Cablevision, Cox, and Time Warner Cable. (Mike Robuck, "ThePlatform Powers TV Everywhere on Programmers' Sites," *CED Magazine*, Nov. 18, 2009.) From September to November, as TV Everywhere is about to launch, ThePlatform signed up 20 programmers, including E!, Style, Travel Channel, and regional Fox and Comcast sports. (Todd Spangler, "ThePlatform Wants to Handle 'TV Everywhere' for Everyone," *Multichannel News*, Nov. 18, 2009.)

[128] Dan Frommer, "Why Comcast Has To Worry About Hulu," *Silicon Alley Insider*, May 4, 2009. Another noted, "Believing that they should have exclusivity because their [per-subscriber] payments support the enormous cost of producing TV shows, [cable TV distributors] have been pushing back against the Hulu freebies." (Dawn C. Chmielewski and Meg James, "Hulu's Tug of War with TV," *Los Angeles Times*, May 11, 2009.).

[129] Dawn C. Chmielewski and Meg James, "Hulu's Tug of War with TV," *Los Angeles Times*, May 11, 2009.

[130] Peter Kafka, "Did Big Cable Force Hulu off Boxee?" *All Things Digital Blog*, Feb. 18, 2009.

[131] *See also* Will Richmond, "The Cable Industry Closes Ranks," *VideoNuze.com*, Nov. 12, 2008.

[132] Tim Wu, "Copyright's Communications Policy," 103 *Mich. L. Rev.* 278, 303 (2004).

[133] Tim Wu, "Copyright's Communications Policy," at 305-10.

[134] Tim Wu, "Copyright's Communications Policy," at 320-24.

[135] Tim Wu, "Copyright's Communications Policy," at 324. *See also* Satellite Home Viewer Act of 1988, Pub. L. No. 100-667, 102 Stat. 3949 (codified as amended in scattered sections of 17 U.S.C.).

not compete directly with Cox in San Diego.[136] Similarly, Verizon, which offers cable TV service in New York City, brought a complaint against Cablevision because the company denied Verizon access to a Cablevision-owned high-definition version of a channel airing local professional sports.[137]

The cable operators and other distributors have engaged in this content-lockout strategy with online distributors, too. Time Warner Cable has been particularly public in pressuring programmers not to put content online. According to the *New York Times*, Time Warner Cable's chief executive Glenn Britt told reporters in response to a question about making more content available online, "Guess what? We do mind."[138] Britt announced to content providers at the 2008 Cable Show in New Orleans that putting shows online the same day of cable TV broadcast "will erode your other business model" of cable per-subscriber fees. If the cable networks continue putting shows online, said Britt, "we have to intervene at some point."[139] Britt has repeatedly argued "that free, ad-supported TV sites such as Hulu undermine the subscription-TV revenues that the [content] industry depends on."[140]

Time Warner Cable Chief Operating Officer Landel Hobbes agrees with his boss. "We have to be very careful of stuff like over the top or all video content over the top on the Internet," he said. "There is a dual revenue stream that we have to be careful of. Surviving on just advertising is a very tough thing."[141] These comments are focused not on survival, of course, but on preserving a model where cable companies and programmers are overpaid and consumers underserved. Incumbents recognize that, in a competitive world, their current margins are not sustainable.

Time Warner Cable also engaged in hardball tactics to limit the content its programmers made available online. Time Warner Cable threatened to pull Viacom's 18 networks, which include MTV, Comedy Central and Nickelodeon, from its TV service based partly on online TV. Its execs "put together a document outlining which shows Viacom is distributing online and where" and threatened to "start instructing subscribers how to connect their TVs to a computer and watch Viacom content online."[142] Viacom caved, agreeing to delay releasing shows online and not to provide full online episodes of *The Daily Show* and other popular content, to benefit Time Warner Cable's controlled video-on-demand offerings.[143] Time Warner Cable used the

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[136] Molly Peterson, "FCC Rejects AT&T Program-Access Complaint Against Cox (Update2)," *Bloomberg*, March 9, 2009.

[137] John Eggerton, "Verizon Files Program Access Complaint Against Cablevision," *Broadcasting & Cable*, July 8, 2009.

[138] Saul Hansell, "The Real Fight Over Fake News," *New York Times Bits Blog*, May 29, 2008. *See also* Meg James, "Viacom, Time Warner Cable Face Midnight Deadline," *Los Angeles Times*, Dec. 31, 2008. ("Cable operators such as Time Warner are also miffed that Viacom and other companies have made some of their most popular programming available for free on the Internet.")

[139] Saul Hansell, "The Real Fight Over Fake News."

[140] Jon Healey, "Time Warner Cable Shows Customers How to Get TV for Free," *Los Angeles Times Technology Blog*, Oct. 6, 2008.

[141] Steve Donohue, "Time Warner Cable COO Rips "Over-the-Top" Services," Contentinople, March 18, 2009.

[142] Michael Learmonth, "Viacom vs. Time Warner Cable: Is Hulu to Blame?" *Ad Age*, Dec. 31, 2008.

[143] Merissa Marr and Nat Worden, "Viacom, Time Warner Cable Reach Last-Minute Programming Deal," *Wall Street Journal*, Jan. 5, 2009.

same strategy last fall against LIN TV, an over-the-air broadcaster, regarding its online offerings.[144]

Some online TV distributors have already failed for lack of content. Joost, for example, was a company started by the successful founders of Skype that raised over $50 million in capital. Joost aimed to provide TV programming directly to consumers, as an online virtual cable TV provider. But after years of gaining little traction, Joost announced it would become a technology provider, rather than a competitor, to incumbent cable TV distributors. In a detailed look at "what went wrong for Joost," telecommunications analyst Om Malik concluded, "it all boiled down to a lack of content."[145] Other companies, like Vuze, similarly had cutting-edge technology for delivering high-definition TV online but lacked access to much premium content.[146] After many years and more than $34 million raised in private equity, Vuze finally abandoned its first business model of competing with cable TV distributors.[147]

Netflix's ability to get valuable content is something of an exception that proves the rule. Netflix began as a DVD service through the mail, but it always intended to become an Internet service (hence the name Netflix, not Postalflix).[148] To get valuable content, Netflix found a "loophole" in contracts, realizing that premium channels like Starz could sell rights to Netflix.[149] This window may not stay open long because "unhappy studios or cable companies could easily renegotiate their contract with Starz to discourage it from working with Netflix."[150]

Distributors also pressure companies to ensure online content stays off the living room TV. Perhaps the most high-profile scuffle in the online TV space was between Hulu and Boxee. In February 2009, Hulu announced that it was denying access to Hulu through Boxee at the request of its content providers.[151] Despite an outcry from Hulu users,[152] Hulu has since blocked Boxee even from Hulu's public RSS feed.[153] Hulu's terms of service for its desktop software now forbid using the software with any device other than a personal computer — including, notably, with TV screens.[154]

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144 Jon Healey, "Time Warner Cable Shows Customers."
145 Om Malik, "What Went Wrong With Joost?" *GigaOm.com*, June 30, 2009.
146 Even YouTube, a company with dominant market share owned by Google, has had some trouble making revenue-sharing deals to access content. John Kell, "Google to Host Time Warner Content on YouTube," *Dow Jones*, Aug. 19, 2009.
147 Mark Hendrickson, "Vuze Raises $20M More in Series C, Brings Aboard TiVo Co-Founder Ramsay," *Tech Crunch*, Dec. 18, 2007.
148 Daniel Roth, "Netflix Inside, See Ya, Cable," *Wired*, October 2009, at 120, 122.
149 Daniel Roth, "Netflix Inside," at 142. (" 'We looked at our contract rights and saw that they [Netflix] were an aggregator of content just like any of the other distributors,' says Starz CEO Robert Clasen.")
150 Daniel Roth, "Netflix Inside," at 142.
151 Jason Kilar, "Doing Hard Things," *Hulu Blog*, Feb. 18, 2009.
152 Jose Castillo, "Boxee vs. Hulu vs. Cable (Spoiler: The Customer Loses)," *StreamingMedia.com*, March 10, 2009.
153 Mike Masnick, "The Hulu/Boxee Battle Continues To Go Back And Forth," *TechDirt*, March 9, 2009.
154 "Hulu Desktop License," *Factory Joe Blog*, *available at* https://factoryjoe.pbworks.com/Hulu-Desktop-License.

UNLEASHING TV EVERYWHERE

The latest strategy to "preserve the revenue stream and business model of subscription TV," in the words of an AT&T executive,[155] is an industry-wide agreement to ensure users cannot watch cable TV programming on the Internet without also paying for a cable TV subscription.[156] The TV Everywhere initiative aims to ensure content distribution online is "a natural extension of the existing [cable TV] model."[157] With TV Everywhere, a consumer can watch online programming only if "authenticated" as a subscriber to traditional cable TV; in other words, only cable TV subscribers can watch the most popular content through the Internet.

Forging an Industry-Wide Agreement Among Competitors

The TV Everywhere strategy, which saw rapid adoption in the summer of 2009, took hold months earlier in questionable discussions and agreements among competitors, in which the competitors sought to avoid a paper trail of evidence. In early 2009, according to the *Wall Street Journal*, the largest phone, satellite, and cable companies held off-the-record discussions on how to combat the threat of free online TV.[158] As that report noted, competitive rivals were making agreements to ensure continued control over the market: "The satellite television, telecommunications and cable industries — *longtime rivals — agree* on one issue: The need to put TV shows that are available online, most of which are now free, behind a pay wall."[159]

All incumbent cable TV technologies were involved: "Cable companies have been out-front on this issue, but satellite and telcos are joining the fight."[160] The *New York Times* reported that among the companies in these discussions were AT&T, Comcast, DirecTV, Time Warner Cable and Verizon.[161] The *Wall Street Journal* noted: "The rare *agreement among the normal combatants* reflects their strong concern that allowing free access to such content could lead to problems similar to those faced by the music and news industries, now struggling to establish subscription-based business models. No barriers to Internet content also could push subscribers to cancel their TV service and rely solely on the Web."[162] An analyst at an independent financial

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155 Sarah Reedy, "TV Everywhere and the End of Free TV," *SuperComm Daily News*, Oct. 8, 2009 (quoting Dan York, AT&T's executive vice president of content and programming: "It is important to the established pay TV providers and content community to preserve the revenue stream and business model of subscription TV, and authentication could be an important initiative to maintain that.").

156 Sarah Reedy, "TV Everywhere and the End of Free TV."

157 Staci Kramer, "Time Warner CEO Plans 'TV Everywhere' – But Not For Everyone," *Paid Content*, March 2, 2009.

158 Roger Cheng, "Telcos, Satellite Join Cable's Push to Build Pay Wall On Web," *Wall St. Journal*, April 20, 2009.

159 Roger Cheng, "Telcos, Satellite Join Cable's Push to Build Pay Wall On Web," *Wall St. Journal*, April 20, 2009. (*Emphasis added.*)

160 Roger Cheng, "Telcos, Satellite Join Cable's Push to Build Pay Wall On Web," *Wall St. Journal*, April 20, 2009.

161 Brad Stone and Brian Stelter, "Some Online Shows Could Go Subscription Only," *New York Times*, March 20, 2009.

162 Roger Cheng, "Telcos, Satellite Join Cable's Push to Build Pay Wall On Web," *Wall St. Journal*, April 20, 2009. (*Emphasis added.*)

advisory firm told *AdWeek*: "This is a way to stem concern about cable infrastructure being bypassed by free online viewing."[163]

Because of fears of violating antitrust law through colluding, the cable TV executives did not seek an antitrust exemption; instead, they attempted to hide their actions by eliminating a paper trail. They deliberately engaged in only unwritten, verbal conversations. As the *New York Times* reported:

> The electronic media chiefs, including [Time Warner CEO Jeffrey] Bewkes, Jeff Zucker [CEO] of NBC Universal and Philippe P. Dauman [CEO] of Viacom, among others, have been more careful [than newspaper executives had been in their discussions], so as to avoid being accused of collusion: much of the discussions have been *on the telephone and in private, one-on-one chats* during industry events. Pricing is *rarely*, if ever, discussed, according to executives involved in the discussions.[164]

Jeff Gaspin, president of NBC's Universal Television Group, said the idea of collaborating with cable operators on online video has been floated for a while but talks began in earnest this year.[165] If the incumbents believed they were conforming to the law, they would likely have documented their discussions, rather than avoided a paper trail.

Learning from Newspapers and the Music Industry

According to news reports, cable executives have closely watched the struggling newspaper industry. As Stephen B. Burke, Comcast's chief operating officer, told the *New York Times*, "The biggest risk is so much stuff gets on the Internet for free that we turn into the newspaper business."[166]

On the Internet, consumers can access content from any print newspaper in the world — from New Jersey to Jerusalem — and countless online publication. As Michael Kinsley, the founding editor of *Slate*, recently observed, "Just a few years ago, there was no sweeter perch in American capitalism than ownership of the only newspaper in town. Now, every English-language newspaper is in direct competition with every other."[167]

Newspapers have been forced to compete and to give consumers what they want — access to content, widely available, sometimes under subscription, sometimes free. If a newspaper refuses to make its content available online, or does so only at high rates, another newspaper can gain revenue by making its content available at more reasonable rates or giving it away for free and relying on ad revenue. Most newspapers haven't charged or required subscriptions to their content because they fear being undercut by their competitors. And any industry-wide agreement to set prices for newspaper content would be a classic antitrust violation of collusion.

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[163] George Szalai, "Opinion: Online Video's Impact Remains Unclear," *AdWeek*, July 3, 2009 (quoting Collins Stewart analyst Thomas Eagan).
[164] Tim Arango, "Cable TV's Big Worry: Taming the Web," *New York Times*, June 23, 2009. (*Emphasis added.)*.
[165] Deborah Yao, "Cable Companies Want a Way to Win with Online TV," *Associated Press*, Feb. 24, 2009.
[166] Saul Hansell, "Tweaking the Cable Model, to Avoid Newspapers' Fate," *New York Times Bits Blog*, April 6, 2009.
[167] Michael Kinsley, "You Can't Sell News by the Slice," *New York Times*, Feb. 9, 2009.

In April 2009, Newspaper CEOs held "under-the-radar discussions" about online payment systems at the annual meeting of the Newspaper Association of America, which were "held quite separately from the convention under the guidance of a lawyer to ensure the talks don't stray into inappropriate territory."[168] Such assurances didn't temper all fears of industry collusion about erecting a "pay wall" requiring payment or subscriber authentication for access to newspaper content.[169]

But during these conversations, U.S. newspaper executives were openly seeking an antitrust exemption – and idea endorsed by some newspaper columnists and industry analysts — so they could hold industry-wide talks on how to put all newspaper content behind pay walls.[170] On April 21, Brian Tierney, the CEO of Philadelphia Newspapers LLC, testified before Congress to ask for a "limited antitrust relief for newspapers and journalists to discuss and experiment with new and more sustainable business models and strategies";[171] at the same hearing, however, the Department of Justice opposed such an exemption.[172]

In contrast, the cable industry never sought or received an antitrust exemption for its backroom discussions on TV Everywhere; it just had the talks and made the agreements, avoiding a paper trail. Yet cable TV distributors explicitly invoked the newspaper industry in discussions. "The newspaper industry … is suffering because newspaper publishers opted to make their product free, and are now scrambling to put up walls," said one cable executive discussing TV Everywhere. "Once the horse has left the barn, it's hard to get it back in."[173]

The cable executive did not note that the newspapers' "scrambling" would require an exemption from the antitrust laws to make agreements. Neither did he explain that his industry had to get a horse of its own back into the barn. As one trade publication reported, "Beating a full-scale retreat from last year's enthusiastic experimentation with Web video initiatives, cable operators and programmers are struggling to figure out how to offer traditional cable network fare online without hurting their successful financial model for delivering pay-TV."[174]

Cable TV distributors also drew lessons, correctly or not, from the music industry. A Comcast executive, in discussing TV Everywhere, noted that keeping valuable content off the Internet would eventually push users to piracy.[175] As one network CEO said, while moderating a

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168 Alan Mutter, "Publishers Zero in on Charging for Online News," *Reflections of a Newsosaur*, April 5, 2009.
169 Michael Masnick, "Newspapers Gather In Secret (With An Antitrust Lawyer) To Collude Over Paywalls," *TechDirt*, May 29, 2009.
170 Tim Rutten, "Newspapers Need an Antitrust Exemption," *Los Angeles Times,* Feb. 4, 2009; John Chacas, "4 Steps to Stave Off the Death of Newspapers," *The Dallas Morning News*, Feb. 6, 2009 (discussing antitrust exemption for a unified response to aggregators).
171 Brian P. Tierney, Written Statement Before the Subcommittee on Courts and Competition Policy, Committee on the Judiciary, United States House Of Representatives, April 21, 2009.
172 Carl Shapiro, "A New Age For Newspapers: Diversity of Voices, Competition and the Internet" (Statement Before the Subcommittee on Courts and Competition Policy, Committee on the Judiciary, United States House Of Representatives), April 21, 2009.
173 Steve Donohue, "Execs Rip Hulu for Giving Away Content," *Contentinople.com*, Sept. 23, 2009 (quoting YES Network CEO Tracy Dolgin).
174 "Cable Grapples With Striking Balance Between TV and Web Video," *Communications Daily*, April 7, 2009.
175 "Cable Grapples With Striking Balance Between TV and Web Video," *Communications Daily*, April 7, 2009.

panel on TV Everywhere at a cable show: "In the music business, as theft accelerated ... they didn't get ahead of the trend, and they offered consumers no option but to steal if they wanted to get the product the way they wanted."[176]

"Whether it is music or newspapers or radio," concluded Comcast's Burke. "[They] didn't have a model that protected their core business, and then, boom, here comes the Internet as this destroyer of wealth."[177] By "destroyer of wealth," Comcast really means "creator of competition," which might hurt Comcast's bottom line but is good for consumers.

Ongoing Industry Negotiations and Conversations to Collude

In conjunction with the private conversations reported in the *Wall Street Journal*, industry executives held conversations in at industry events like the Cable Show, the annual event of the National Cable & Telecommunications Association, the largest cable operators' lobbying arm,[178] In "several sessions" at this event, distributors and programmers "advanced different ideas for developing a responsible, lucrative business model for the content convergence concept. It's known as 'TV Everywhere' or 'everything-on-demand.' "[179] A trade publication reporting on the show noted that distributors feared "cord-cutting" but concluded that, despite discussions, programmers and distributors had still "failed to reach *broad consensus* on the best way for *the industry* to move forward"[180] As the publication reported, "To stave off such cord-cutting, [the] president of Comcast Interactive Capital said his group is now building a 'cross-platform experience' … to 'create a cable-friendly model good for consumers' that protects cable's current dual-revenue stream from subscriptions and advertising fees."[181] The *New York Times* stated that "perhaps the hottest topic at the show" was that "cable operators and networks could create a joint way to put subscription-based video onto the Internet."[182]

The first public discussion of the TV Everywhere strategy happened at an even earlier cable conference held by Cable & Telecommunications Association for Marketing (CTAM) in Boston on Nov. 9-11, 2008. According to Will Richmond, a former cable TV executive: "[After] moderating two panels, attending several others and having numerous hallway chats, I've reached a conclusion: The cable industry — including operators and networks — is closing ranks to defend its traditional business model from disruptive, broadband-centric industry outsiders."[183]

CableFax: The Magazine noted that Time Warner Cable Chief Strategy Officer Peter Stern first discussed Time Warner Cable's plans to "create a Web replica of cable programming" that became TV Everywhere at the CTAM conference.[184] (This speech oddly helped Time

[176] Steve Donohue, "Execs Rip Hulu for Giving Away Content," *Contentinople.com*, Sept. 23, 2009 (quoting YES Network CEO Tracy Dolgin).
[177] Jeff Baumgartner, "Comcast Nears 'TV Everywhere' Launch," *Light Reading*, Sept. 9, 2009.
[178] "Cable Grapples With Striking Balance Between TV and Web Video," *Communications Daily*, April 7, 2009.
[179] "Cable Grapples With Striking Balance Between TV and Web Video," *Communications Daily*, April 7, 2009.
[180] "Cable Grapples With Striking Balance Between TV and Web Video," *Communications Daily*, April 7, 2009. (*Emphasis added.)*
[181] "Cable Grapples With Striking Balance Between TV and Web Video," *Communications Daily*, April 7, 2009.
[182] Saul Hansell, "Tweaking the Cable Model, to Avoid Newspapers' Fate," *New York Times Bits Blog*, April 6, 2009.
[183] Will Richmond, "The Cable Industry Closes Ranks," *VideoNuze.com*, Nov. 12, 2008.
[184] "Leadership Award: Time Warner Cable," *CableFax: The Magazine*, July 2009, at 22. *See also* Daisy Whitney, "Open Source: A Web of Cable," *OMMA Magazine*, May 1, 2009 ("Time Warner first floated the idea of

Warner Cable earn *CableFax*'s Leadership Award for moving on this "hot button issue" and making it "clear that cable programmers must remember where their bread is buttered."[185]) Another industry publication reported that Stern told the audience: "Programmers should work with cable operators to distribute TV content to paying customers over the Internet — instead of throwing it up online for free and undermining cable's existing business model."[186] Stern argued that "the challenge for the cable industry" is to get content to consumers "on that high-def, communal [living room] television when they want it — and that means we need to aggressively embrace time-shifting … but we need to do that in a way that grows the pie."[187]

Viacom CEO Philippe Dauman defended these discussions to the press, saying, "we can't get together and talk about business terms, but we can get together to work on setting open technology standards."[188] Yet his colleagues admit the business terms, not the technology, are the issues worth discussing. As Multichannel News reported from an industry conference in June 2009:

> The chief roadblock to "TV Everywhere" -- the concept that pay TV customers should be able to access the content available on the television sets online – *isn't with the technology*, Time Warner Cable chief operating officer Landel Hobbs told an industry conference Thursday, but rather the sticky situation of the *business rules* governing the service. … "The hard part is not the technology," Hobbs said. "The hard part is putting the business rules around it, which is really from the programmers' perspective."[189]

Simply, industry-wide "business rules" require more attention than the technology, which is not "the hard part." A Verizon vice-president agreed: "*As an industry*, it is critical that we get the TV Everywhere user experience and value proposition right."[190]

The executives have also been clear that an *industry-wide* solution can only succeed if they collude, as such a solution is not in a company's interest *unless others agree with one another* on the solution. A centerpiece of our market economy is that consumers are better off if each company follows its own self-interest rather than colluding with its competitors to raise prices, allocate markets, or otherwise harm consumers and competitors. Stephen B. Burke, the chief operating officer of Comcast, has publicly admitted that if each incumbent operator and programmer merely followed its own self-interest (as each should under the law in a competitive market), then each incumbent would be worse off. As the *New York Times* reported:

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building a Web replica of its programming at the CTAM Summit in Boston, revealing that it had begun talks with programmers.").

185 "Leadership Award: Time Warner Cable," *CableFax: The Magazine*, July 2009.

186 Todd Spangler, "CTAM Live: TWC's Stern Urges Exclusive Web-Video Deals," *Multichannel News*, Nov. 10, 2008.

187 Todd Spangler, "CTAM Live: TWC's Stern Urges Exclusive Web-Video Deals," *Multichannel News*, Nov. 10, 2008.

188 Tim Arango, "Cable TV's Big Worry: Taming the Web," *The New York Times*, June 23, 2009.

189 Mike Farrell, "Hobbs: Business Rules Delay 'TV Everywhere," *Multichannel News*, June 11, 2009. *(Emphasis added.)*

190 Verizon press release, "Verizon Launches Trial of FiOS TV Online, Extending Multi-Screen Leadership," Aug. 27, 2009. (*Emphasis added.*)

> The problem is that if each goes in different directions — some offering more shows free, others holding them back only for cable subscribers — then the economics of the industry could crumble.
>
> "It's the classic prisoner's dilemma," said Mr. Burke, referring the famous problem in game theory. "If there's a vacuum, and some start to inch in to the water hoping others will hold back, the whole industry could be affected."[191]

This reflects the understanding that if each actor independently follows consumer demand, all the participants would make content available online (like incumbent newspapers did) and be worse off than they would be *without collusion*.

This public statement sends a signal to other participants. Indeed, Burke made a similar statement in April 2009, shortly after the Cable Show in Washington: "What I worry about is that of the 50 cable channels that matter, five of them will have a bad year and start putting up more and more free [content online]."[192] This competitive pressure from "defectors" would — through competitive forces — compel other channels to follow suit.

An NBC executive noted another potential problem with competition, worrying that competitors could try to differentiate their TV Everywhere platforms, confusing customers: "We have to be careful that the competitive nature of this ecosystem doesn't create an issue."[193]

While the executives have been fairly vocal at industry events, the company lawyers seem to have noticed that these statements might raise legal concerns. Recently, cable company lawyers have objected to letting their executives speak on industry panels to discuss TV Everywhere, forcing these executives to cancel speaking engagements.[194]

<u>Programmers Get On Board</u>

In the current market, cable TV distributors can threaten programmers with a choice — either the benefit of dual revenue of cable TV or the exposure to new competition and uncertain sources of revenue online. Programmers would prefer to receive *both* cable TV revenues and online revenues, but if they must choose only one, the former are more secure and likely larger. According to one network president, cable programmers would switch to online distribution if that provided the same economic value.[195] Cable distributors want to make sure that time never

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[191] Tim Arango, "Cable TV's Big Worry: Taming the Web," *New York Times*, June 23, 2009.

[192] Saul Hansell, "Tweaking the Cable Model, to Avoid Newspapers' Fate," *New York Times Bits Blog*, April 6, 2009.

[193] Ryan Lawler, "User Experience Could Hamper TV Everywhere Adoption," *NewTeeVee.com*, Nov. 18, 2009.

[194] Kent Gibbons, " 'Cheerleader' Urges Speedy Adoption of 'TV Everywhere,' " *Multichannel News*, Aug. 18, 2009.

[195] Todd Spangler, "CTAM Live: TWC's Stern Urges Exclusive Web-Video Deals," *Multichannel News*, Nov. 10, 2008 ("For cable programmers, distributing ad-supported content online simply doesn't provide the same level of return on investment, Scripps Networks Digital president Deanna Brown. 'When the Internet is able to provide us with that same economic value [as affiliate fees], we'll probably shift our activities accordingly,' Brown said.").

comes, and today programmers generally follow the money to the incumbent distributors. The industry and press understand this dynamic.[196] In the words of *CableFax*, "So what's a cable programmer to do? Give in to customer demand or keep its distribution partners happy?"[197]

Cable distributors are apparently offering programmers nothing "extra" for being part of TV Everywhere. A programming executive (who did not want to be named) told the *New York Times* that cable operators were not guaranteeing networks "any additional revenue for the right to distribute their content online."[198] Time Warner claimed that it did not expect the cable operators to pay any more for being able to offer Time Warner's content online; Time Warner sought merely to "hold the value" of its current fees.[199] This may be enough for some powerful programmers like Time Warner that are happy under the current system. Such powerful programmers can negotiate for a healthy cut of the increasing cable bill, garnering operating profit margins well over 50 percent.[200]

Some programmers, however, initially expressed doubts about TV Everywhere, noting the initiative is anti-consumer and that the programmers are hoping for additional online revenues. Several major programmers such as Discovery and Scripps reportedly were skeptical about cable operators controlling what network video programming might be made available to cable subscribers online.[201] But both networks are part of Comcast's TV Everywhere trial.[202] In

[196] Cable programmers "are loath to put programs online unless they can maintain their per-subscriber fee" from cable operators. (Brad Stone and Brian Stelter, "Some Online Shows Could Go Subscription Only," *New York Times*, March 20, 2009.) As Will Richmond, president of consulting firm Broadband Directions, noted, cable programmers "are not going to do anything to encourage cord-cutting by putting their content online. … That undermines not only their own business models but also their best customers' models." (Todd Spangler, "Breaking Free," *Multichannel News*, Nov. 2, 2008.) The chief operating officer of Comcast told the press, "We [cable TV distributors] have the exact same interests that the content providers have in making sure that we get ahead of the steamroller that is the Internet." (Jeff Baumgartner, "Comcast Nears 'TV Everywhere' Launch," *Light Reading*, Sept. 9, 2009.) The CEO of Move Networks, TV Everywhere's technology provider, has stated that content programmers need cable TV distributors, rather than online distribution, for the "big S: subscriptions. In 2008, DirecTV, EchoStar, Comcast and Time Warner Cable alone paid [a combined] $22 billion for content. You can't walk away from that." (Saul Hansell, "Don't Count Out Cable Online," *New York Times Bits Blog*, Feb. 20, 2009.) The *New York Times* suggests the obvious relationship between cable operators' fees to cable programmers and the result of programmers keeping their content offline: "Comcast alone writes $6 billion in checks to Viacom, Time Warner and other media companies. And *in return* those companies have kept most their best programs off the Internet." The domestic distribution president for Turner Broadcasting stated, "We have to be mindful of the fact that we have a good business that works for all the players. … We have to find ways to advance the business rather than cannibalize it." (Dawn C. Chmielewski and Meg James, "Hulu's Tug of War with TV," *Los Angeles Times*, May 11, 2009.) Another programmer notes the pressure: " 'There's pressure on all of us,' [Jeff Gaspin, president of NBC's Universal Television Group] said, referring to TV networks. 'We get paid quite a bit of money from cable operators. ... It's important we find ways to do business that protects that business model.' " (Deborah Yao, "Cable Companies Want a Way to Win with Online TV," *Associated Press*, Feb. 24, 2009.)

[197] "Leadership Award: Time Warner Cable," *CableFax: The Magazine*, July 2009, at 22.

[198] Brad Stone and Brian Stelter, "Some Online Shows Could Go Subscription Only," *New York Times*, March 20, 2009.

[199] Staci Kramer, "Interview: Jeff Bewkes, Chairman and CEO, Time Warner: Part One: TV Everywhere Front And Center," *PaidContent.org* (April 2, 2009).

[200] David Lieberman, "NBC Universal's Bonnie Hammer Plans to Build on Cable," *USA Today*, March 22, 2009.

[201] "Cable Grapples With Striking Balance Between TV and Web Video," *Communications Daily*, April 7, 2009.

[202] Yinka Adegoke, "Verizon, Time Warner Cable to Test TV on the Web," *Reuters*, Aug. 27, 2009.

fact, a few short months later, a Discovery executive stated, "You're going to hard-pressed to find anybody in the industry that says they don't support TV Everywhere."[203]

However, at the 2009 Cable Show, Disney CEO Robert Iger gave a keynote address raising questions about TV Everywhere, noting he was "curious about its practicality, both technically and otherwise."[204] He stated: "Preventing people from watching any show online unless they subscribe to a multichannel service could be viewed as anti-consumer and anti-technology. … That's something we would find very difficult to embrace."[205] Iger "was worried that making it harder for customers to see video they want might alienate users and could encourage piracy."[206] He "challenged what he implied were proposals by cable companies that Disney restrict the video programming that it makes available free."[207]

But it is no longer so hard to imagine Hulu, the free video service co-owned by Disney, becoming part of TV Everywhere, especially if Comcast completes it proposed merger with NBC Universal, another Hulu partner.[208]

<u>Rushed Announcements and Launchings.</u>

With TV Everywhere, these large companies are moving faster than they did on anything else having to do with the Internet. On June 24, Comcast and Time Warner announced a partnership to promote TV Everywhere, presenting "principles" designed "to ensure rapid adoption and deployment of online television content across the industry."[209]

And the adoption has been rapid. Comcast initially called its service "Comcast OnDemand Online" — though it already has been renamed "Fancast Xfinity" — and set up trials for 5,000 of its customers to access cable-network programming through their Internet access service.[210] Other programmers, including Scripps Networks, Cablevision's Rainbow Media, A&E Television Networks,[211] and premium channels Starz[212] and HBO[213] agreed to add their shows and movies to the Time Warner and Comcast network offerings.[214] A long-time industry analyst running a popular tech blog wrote: "The deal makes it painfully obvious that everything cable companies do … is done to save their video franchises."[215]

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[203] Steve Donohue, "Cisco: Set-Top Data Could Boost 'TV Everywhere,'" *Cable Digital News,* Nov. 19, 2009.
[204] Saul Hansell, "Tweaking the Cable Model, to Avoid Newspapers' Fate," *New York Times Bits Blog*, April 6, 2009.
[205] Nat Worden, "Disney CEO: Open to 'TV Everywhere' Concept," *Wall Street Journal*, April 2, 2009.
[206] Saul Hansell, "Tweaking the Cable Model, to Avoid Newspapers' Fate," *New York Times Bits Blog*, April 6, 2009.
[207] Saul Hansell, "Tweaking the Cable Model, to Avoid Newspapers' Fate," *New York Times Bits Blog*, April 6, 2009.
[208] Julia Boorstin, "Fall TV's Biggest Hit: HULU," *CNBC.com*, Sept. 9, 2009.
[209] Press Release, "Time Warner Inc. Announces Widespread Distribution of Cable TV Content Online," June 24, 2009.
[210] Om Malik, "Comcast, Time Warner Team Up to Control TV on the Internet," *Gigaom.com*, June 23, 2009.
[211] Chris Albrecht, "More Networks Line Up for TV Everywhere Test," *New TeeVee*, June 26, 2009.
[212] Steve Donohue, "Starz Beats Rival HBO to 'TV Everywhere,'" *Contentinople*, July 10, 2009.
[213] Glen Dickson, "It's Not TV, It's HBO Everywhere," *Broadcasting & Cable*, July 31, 2009.
[214] Todd Spangler, "Satellite, Telcos In 'TV Everywhere' Camp," *Multichannel News*, May 21, 2009.
[215] Om Malik, "Comcast, Time Warner Team Up to Control TV on the Internet," *GigaOm.com*, June 23, 2009.

On August 27, Time Warner Cable announced it would begin TV Everywhere trials over the next few months.[216] Time Warner Cable partnered with BBC America, IFC, Sundance Channel, Discovery and others, as well as the Time Warner content arm.[217]Verizon announced its Online Fios TV on the same day.[218] News outlets discussed DirecTV and AT&T's involvement in TV Everywhere the next day, though as early as May 21, the trade press was reporting that "DirecTV, Dish Network, Verizon Communications and AT&T are each aligned with TV Everywhere."[219]

In the haste to launch the product, according to a Comcast executive, the advertising model need not be "nailed down at this point," and "some" people in the industry have suggested getting TV Everywhere "up and running without advertisements."[220] Speaking at an industry panel, the head of CBS Interactive urged "speedy adoption" to ensure success.[221]

Why such a hurry? Speedy deployment is likely needed both to get to market before users get accustomed to online TV that is *un*tethered from cable TV subscriptions and to launch before a possible antitrust investigation.

On Dec. 15, when Comcast launched Fancast Xfinity, the *Wall Street Journal* reported matter-of-factly, "Comcast rolled out its version of TV Everywhere … Tuesday in a bid to keep consumer from cutting their cable cord."[222] A blog on the site NewTeeVee answered the question "Why is TV Everywhere being created?" by saying, "The bigger issue is control. Thanks to the Internet and all kinds of magical video technology, premium content can be piped not only to your PC, but also to your TV. If you get all your video through your Internet connection, then you have no need for your cable company."[223]

Anti-competitive Effects of TV Everywhere

TV Everywhere has many anti-competitive effects in the market. As intended, the outlines of the plan suggest reduced competition, higher consumer prices, less privacy, and less universal television service.

First, the plan undermines new entry and competition by explicitly excluding new competitors —notably online TV distributors. Comcast and Time Warner's published "principles" of TV Everywhere maintain that these deals are "open and non-exclusive"[224] and state, "cable, satellite or telco video distributors can enter into similar agreements with other

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216 Julia Boorstin, "Time Warner Cable's TV Everywhere and the Push to Protect Revenue," *CNBC*, Aug. 27, 2009 (calling it a "push to protect cable subscription revenue"); "Time Warner Cable to Launch TV Everywhere Trials," XChange, Aug. 27, 2009.
217 "TV Everywhere Accelerates as Solutions Prove Effective," *ScreenPlays Magazine*, Aug. 31, 2009.
218 "Verizon Launches Trial of FiOS TV Online, Extending Multi-Screen Leadership," (Press Release), Aug. 27, 2009.
219 Todd Spangler, "Satellite, Telcos In 'TV Everywhere' Camp," *Multichannel News*, May 21, 2009; Todd Spangler, "DirecTV, AT&T Waiting in the 'TV Everywhere' Wings," *Multichannel News*, Aug. 28, 2009.
220 "TV Everywhere Accelerates as Solutions Prove Effective," *ScreenPlays Magazine*, August 31, 2009.
221 Kent Gibbons, "'Cheerleader' Urges Speedy Adoption of 'TV Everywhere,'" *Multichannel News*, Aug. 18, 2009.
222 Andrew LaVallee, "Comcast Opens Fancast Xfinity TV," *Wall Street Journal*, Dec. 15, 2009.
223 Chris Albrecht, Everything You Need To Know About TV Everywhere," *NewTeeVee*, Dec. 3, 2009.
224 Todd Spangler, "Nets Jump Into Comcast's Online VOD Trial," *Multichannel News*, June 25, 2009.

programmers."[225] That is, in each local area, four companies at most *can* join — the local cable operator, the local phone carrier, and two satellite operators, all incumbents. Excluded from these deals are all online TV distributors, the disruptive innovators and potential competitors.

For whatever content they do offer, online distributors will face an apparent price disadvantage. Under TV Everywhere's initial plans, a consumer who pays for a cable TV subscription can view many online TV programs at no additional charge. But an independent online programmer must recoup its costs through charging users or advertisers for content. It must compete with "free." As Time Warner's CEO has said, "We're fortunately in a position where this doesn't cost us much money."[226]

The Independent Film and Television Alliance,[227] the trade association of independent producers and distributors of motion picture and television programming worldwide, filed comments with the FCC attacking the TV Everywhere strategy.[228] IFTA found TV Everywhere "troubling" and fears that the "stage is being set" for "exclusive carriage deals" that "ultimately create new distribution platforms to which independents will be denied equal access."[229] TV Everywhere does nothing, quite deliberately, to support new programming competitors, IFTA points out. TV Everywhere "Web sites will only repeat the program that was lucky enough to secure a network or cable television slot in the first place."[230]

Second, TV Everywhere envisions higher prices for consumers, both through increased subscription fees and more advertisements. Consumers cannot save money by watching only online TV programming or even purchase a TV Everywhere subscription without the cable TV service.[231] Consumers already "pay" for advertiser-supported programming, including "free" broadcast television, by watching advertising. But the shows in Comcast's TV Everywhere trials "will likely carry four times the ad load compared to most web video sites, such as Hulu."[232] Comcast plans to establish a C3 commercial rating accreditation for TV Everywhere, which would require TV programs to run in the same format online as on standard television — meaning about 15 minutes of ads per hour.[233] In addition, consumers in rural areas may face even

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225 Press Release, "Time Warner Inc. Announces Widespread Distribution of Cable TV Content Online," June 24, 2009.

226 "Cable TV Follows Its Subscribers to the Internet," *Knowledge @ Wharton*, July 22, 2009.

227 IFTA represents 150 member companies from 22 countries, including independent production and distribution companies, sales agents, television companies, studio-affiliated companies, and financial institutions engaged in film financing. Comments of the Independent Film & Television Alliance, In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, MB Docket No. 07-269, July 29, 2009 ("IFTA Comments").

228 IFTA Comments, at 3.

229 IFTA Comments, at 11.

230 IFTA Comments, at 13.

231 Responding to reporters' questions whether an online-only subscription for the service would be available, Time Warner CEO Bewkes answered, "I think what we should do is watch this unfold and see what consumer habits tend to be." Considering the plan of TV Everywhere is to replicate the cable TV model, such an option appears unlikely, or to be a replica of the cable TV fee structure. Chloe Albanesius, "Comcast gets TNT, TBS Content for 'TV Everywhere,'" *PC Magazine*, June 24, 2009.

232 David Kaplan, "Advertising Everywhere: Comcast Broadband Trials Bring Fears Of Clutter To Web Video," *Reuters*, July 19, 2009.

233 Claire Atkinson, "Analysis: TV Everywhere Could Remake Online Ad Model," *Broadcasting & Cable*, June 25, 2009.

higher subscriber fees, because small cable operators warn they may receive TV Everywhere content only subject to "unreasonable rates, terms, and conditions, as is the case today in the subscription video market."[234]

Third, TV Everywhere would exact an additional privacy cost on consumers. According to the technology company chosen for TV Everywhere, "We can also do enhanced ad insertion, so we can increase ad revenue. We also have a lot of data on who's watching what."[235] A Comcast executive stated that Comcast will "dynamically insert the ads," with the ability to target based on "audience types."[236] Cable TV distributors have "granular" information about users and can use that information to better target advertisements, with little competition from other distributors that might expand market share based on offering increased privacy.[237]

Finally, the impact of this collusion will affect the wide availability of both Internet services and TV services. Regarding TV services, the 15 percent of Americans who lack a cable TV subscription — at least 30 million — were recently the subject of years of political action to ensure the digital TV transition would be smooth. These Americans should be able to supplement their over-the-air TV watching with programming from online TV. So, while "the cable and telcos argue that more than four out of every five households subscribe to a service, so only few of them would be affected" by denial of content because they do not have a cable TV subscription, one in five households is a lot of people.[238] Further, over time, millions more Americans would likely cancel their cable TV subscriptions more quickly and subscribe to online services instead were it not for TV Everywhere. As it is, all these users (4 of 5 Americans) will have to pay twice, for cable TV and for online TV, indefinitely.

Moreover, online TV could be a driver for Internet adoption. As the United States develops a long overdue national plan to increase adoption,[239] the FCC has already suggested that liberating online TV is one part of the solution.[240]

CONCLUSION

Online TV is this nation's best shot at breaking up the cable TV industry oligopolies and cartels. Permitting online distributors to compete vigorously on the merits for computer screens and TV screens will result in increased user choice, more rapid innovation, lower prices and a more robust digital democracy.

TV Everywhere is the latest attempt of cable TV distributors to destroy the innovative disruption of online TV distribution. And according to both press reports and the circumstantial evidence, TV Everywhere rests on an illegal collusion and other potential violations of the antitrust laws. The government should begin an immediate, aggressive investigation of TV

[234] Comments of the Organization for the Promotion and Advancement of Small Telecommunications Companies, MB Docket No. 07-269, July 29, 2009, at ii-iii, 7-9.
[235] Ed Gubbins, "Move Networks' New CEO on monetizing Internet video," *Telephony Online*, July 20, 2009.
[236] "TV Everywhere Accelerates as Solutions Prove Effective," *ScreenPlays Magazine*, August 31, 2009.
[237] Sarah Reedy, "Will pay TV providers shut down Hulu?," *Telephony Online*, Sep. 9, 2009.
[238] Roger Cheng, "Telcos, Satellite Join Cable's Push to Build Pay Wall On Web," *Wall Street Journal*, April 20, 2009.
[239] Berkman Center, "Next Generation Connectivity, A Review of Broadband Internet Transitions and Policy from Around the World," October 2009 (draft).
[240] Cecilia Kang, "FCC Takes on Cable, Satellite on Television Set-Top Boxes," *Washington Post*, Nov. 18, 2009.

Everywhere to determine the extent and nature of the agreement. If the investigation confirms the apparent collusion, the government should impose structural rules like compulsory licenses to protect consumers.

The government must deliver to consumers what they have long sought and would likely already have without collusion and abuse of market power — the benefits of competition and innovation in online TV.

II. DIGITAL DISINTERMEDIATION IN THE MUSIC SECTOR*

*** Update from Mark Cooper, "Round #1 Of The Digital Intellectual Property Wars: Economic Fundamentals, No Piracy, Explain How Consumers And Artists Won In The Music Sector," Telecommunications *Policy Research Conference,* 2008**

A. A CONSUMER-FRIENDLY BOTTOM LINE

Because the music analogy is so strong in the Wall Street analyses, we begin with examination of historical cases with the digital disintermediation in the music sector. The analysis stresses three elements that are mentioned in the video discussion, but do not take center stage – the market power of the incumbent oligopoly, efficiency gains and consumer welfare increases. By focusing on these, the analysis also rejects the claim that piracy was the central issue in the spread of digital distribution of music. Piracy may have been the solvent that helped to dissolve the glue of an anticompetitive, anti-consumer market structure, but its magnitude has been vastly overestimated by the industry and the transformation of the industry is perfectly consistent with economic theory. The Wall Street analyses of the video sector have recognized what the music labels would never admit, that piracy has reached urban legend status, out of all proportion to its size in reality. This section demonstrates that piracy played a much smaller role in the transformation of music distribution than popular mythology and content owner complaints claim, while economic efficiency played a much larger role.

In April 2006, the Journal of Law and Economics published a symposium on "Piracy and File Sharing"[241] that included versions of several of the major analyses that had played a role in the intense policy debate on file sharing in response to the Supreme Court deliberations in the Grokster case.[242] Given the academic production cycle, the empirical evidence in the papers was very early in the development of digital distribution of music. Most of it was based on the pre-iTunes period, essentially examining developments from 1998 to 2003. Moreover, because the papers were framed in terms of the "piracy" and copyright issue, they did not delve deeply into the fundamental economics of the music industry. They were fixated on the question of whether file sharing helped or hurt the incumbent firms – 'were people stealing and if so, how much was it costing the record companies?' – and paid little attention to the structure of the music industry just prior to the arrival of file sharing, or the likely impact of the new digital technologies on the economics of the industry.

The early studies were all over the map. Some studies found increases in sales resulting from stimulation in certain population segments (older consumers) that offset losses in others (younger users).[243] Other studies found little or no effect.[244] Still others found losses that are not large.[245] Moreover, because of recording industry pricing practices, even where recording industry revenue declined as a result of file sharing, consumer welfare may have increased.[246]

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[241] Journal of Law and Economics, April 2006

[242] "Amicus Brief of the Consumer Federation of America, in Metro Goldwyn Mayer Studios v. Grokster, Ltd., 259 R.Supp. 2d 1029 (C.D. Cal. 2003).

[243] Eric S. Boorstin, *Music Sales in the Age of File Sharing,* Senior Thesis, Princeton University, April 2004.

[244] Martin Peitz and Patrick Waelbroeck, *The Effect of Internet Piracy on CD Sales: Cross-Section Evidence* (CESifo Working Paper No. 1122, January 2004), *An Economist's Guide to Digital Music* (CESifo Working Paper No. 133, November 2004); Alejandro Zentner, "Measuring the Effect of Online Piracy of Music Sales," Unpublished Manuscript, University of Chicago Price, December 2003; Stan Liebowitz, "Will Downloads Annihilate the Recording Industry? *Pitfalls in Measuring the Impact of File-Sharing,* paper presented at the CESifo Conference, July 2004, Munich Germany.

[245] Zentner, Measuring the Effect of Online Piracy; Liebowitz, "Will MP3 Downloads Annihilate the Recording industry?"

[246] Rafael Rob and Joel Waldfogel, *Piracy on the High C's: Music Downloading, Displacement, and Social Welfare in a Sample of College Students* (NBER Working Paper Series, October 2004).

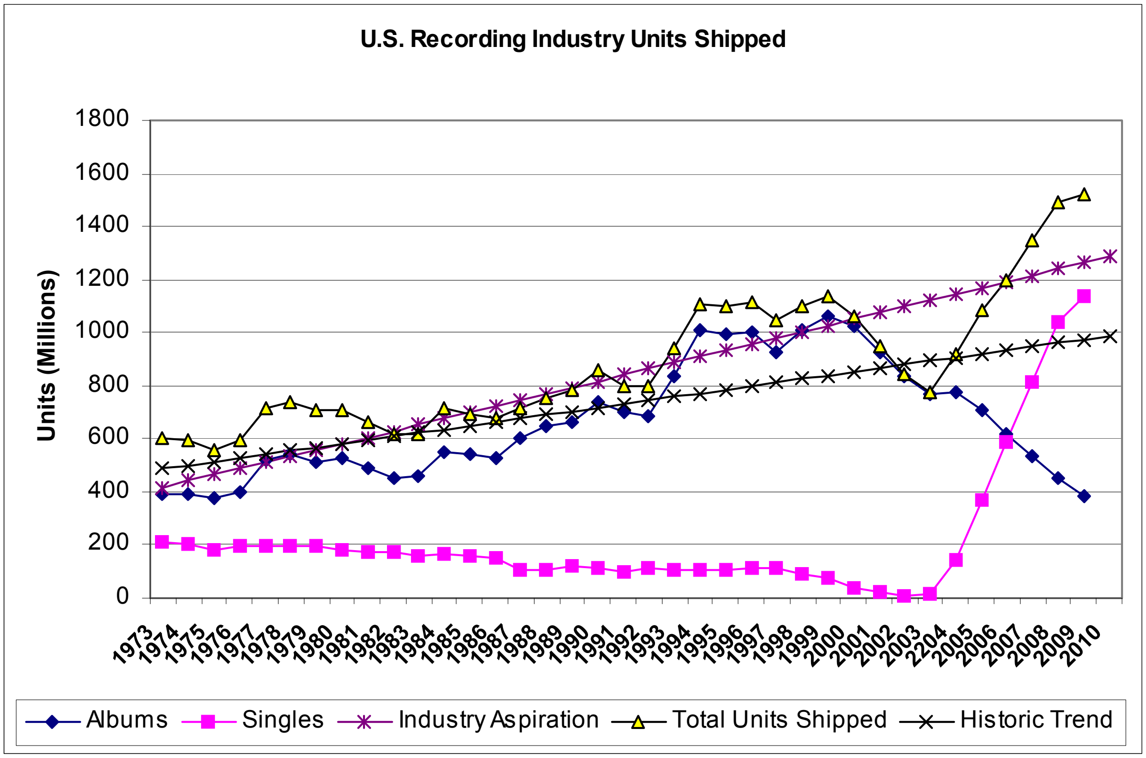
One econometric study of downloading found that the increase in consumer surplus was almost 200 percent larger than the loss of industry revenue.

With another half decade of development in the industry, it has become clear that there was a lot more going on than "piracy." This section assesses the outcome of the battle over digital music distribution, from a broader perspective with a full decade of data. It concludes that, while there was some privacy, it has been vastly over estimated. The new industry structure is much more consumer and artist friendly and "piracy" plays little, if any, role. A decade later, the mid-term (10 year) developments in the industry point in a different direction. It appears that sales had already flattened out before file sharing came along, as existing libraries had already been updated, and high prices suppressed sales (along the low growth trend line in Exhibit I-1). It also appears that once the industry accepted the new distribution technology, the sales of singles exploded. Sales of singles would naturally suppress sales of albums.

This section argues not only that the industry vastly overestimated the role piracy played in upending the oligopoly of record company market power, but also, more importantly, that that the digital revolution radically transformed the fundamental economics of the industry in a direction that is consumer-friendly and also benefited the vast majority of artists. Now that the dust has settled, the outcome of the first round of the digital intellectual property wars suggests fundamental changes in economic structure that the content oligopolies of the industrial age abhor, but will have great difficulty resisting. Beyond the narrow question of the overestimation of "piracy," the recent evidence points overwhelmingly in favor of those who saw it as improving the performance of the market. Music is the template for a consumer-friendly, efficient transformation of media industry structure.

With the advent of digital technologies, three quarters of the cost of producing a CD come under severe pressure. The fixed costs of distribution all but disappear and intermediary functions of promotion are transformed. The effort by record companies to keep singles out of the market and to keep CD prices high was a bald effort to use market power to prevent consumers from enjoying the benefits of more efficient distribution that would flow to them in a competitive market. The central theme of the digital transformation of the music business is one of technology induced efficiency gains that break the stranglehold of a distribution bottleneck. The public interest was well served by digital disintermediation in the music space and this would be an outcome in the video space the serves the public interest equally well. The benefits for music consumers were huge. The number of units purchased by the public has more than tripled – but the vast majority of units sold are singles. The average price per unit shipped has declined by 70 percent. Gains in consumer surplus are close to $10 billion in 2009 alone. The vast majority of artists were beneficiaries as well.

Exhibit II-1:



Source: Recording Industry of America, Annual Statistics, various years. Sources: Recording Industry Association of America, Yearend Statistics: Erik S. Boorstin, Music Sales in the Age of File Sharing, Princeton University, Department of Economics, April 2004. Growth trends are linear projections described in text.

B. The Oligopoly, Physical Music Business

1. Anticompetitive Behavior and Anti-Consumer Practices

Any analysis of the economic impact of digital distribution on the recording industry must start from an understanding of the structure and conduct of the industry in the years just prior to the digital revolution.[247] The picture is not pretty.

[247] The Big Four include Universal Music Group, which includes A&M, Decca/London, Deutsche Grammophon, Island, MCA, Motown, PolyGram and others; Sony BMG Music Entertainment, which as of August 2004 consists of the merger between Sony Music Entertainment and BMG Entertainment, and includes Columbia, Epic, Arista, RCA, and others; EMI Group, which includes Angel, Blue Note, Capitol, Odeon, Parlophone, Virgin and others; and Warner Music Group (a.k.a. WEA), which includes Atlantic, Elektra, London, Reprise, Rhino and others ("A Look at Four Music 'Majors' Left Following Sony-BMG Merger," *AP vi SFGate.com*, July 20, 2004).

"The music recording industry is a highly-concentrated five firm oligopoly. Much of the dominance achieved by large firms in the industry results from control over the distribution and promotion of the products of the industry.

Hollywood major movie studios and recording companies have long understood that their profits are directly tied to their ability to monopolize distribution. After all, [they] are not the creators of the copyrighted works at issue; they are simply the assignees and licensees of copyrighted works. As such, they have but a single means for deriving revenue: control of distribution. [248]

Well before digital distribution mechanisms were in place, the industry was engaged in a series of anti-consumer, anti-competitive practices. Two lawsuits, one by state Attorneys General and an earlier one by the Federal Trade Commission were settled in 2002 and 2000 respectively. As the complaint filed by 41 state Attorneys General put it:

The purpose of the illegal agreements was to raise prices and reduce retail price competition that threatened the high and stable profit margins for CDs enjoyed by both the defendant labels and distributors and many music retailers.

This competitive threat arose with the entry into music retailing of several discount retailers (for example, Best Buy, Circuit City and Target), which could profitably undercut the prevailing retail prices charged for CDs by traditional retailers. Consumers flocked to the discount retailers that rapidly gained market share at the expense of traditional retailers.

The traditional retailers reacted by pressuring defendant distributors to impose minimum advertised pricing ("MAP") policies which established the retail price levels at which CDs were sold, thereby effectively reducing and/or eliminating retail price competition for CDs.

The effect of these anticompetitive agreements has been twofold. First, retail CD prices, which had been dropping, were stabilized and then raised industry-wide. Second, the oligopoly of defendant distributors was able to maintain high wholesale prices and margins for CDs. As a result of both effects, consumers have paid higher prices for CDs than they would have absent the illegal agreements.[249]

"In a series of announcements to their retail customers in 1995 and 1996 the defendant distributors transformed their MAP programs into blunt and effective instruments for putting an end to price competition."[250] With discipline applied to the industry, "retail and wholesale price increases occurred despite the fact that, as the records of one of the music companies revealed, per-CD unit costs had decreased sharply during the 1990s."[251] Once pricing discipline and prices

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[248] Peter J. Alexander, "Peer-to-Peer File Sharing: The Case of the Music Recording Industry," *Review of Industrial Organization,* 20 (2002) at 151. Note that a subsequent merger rendered the industry a four firm oligopoly.
[249] State of Florida by Attorney General Robert A. Butterworth, et al., v. BMG Music, et al. at paras 3-7.
[250] State of Florida at para 49.
[251] State of Florida at para 72.

began to rise, sales increases stopped. The benefits of economies of scale and falling costs that would have been passed through to consumers in a competitive market were redirected to suppliers through price fixing.

While these anticompetitive practices were enjoined in 2000 by the Federal Trade Commission and in 2002 by the state Attorneys General, the industry remains a tight oligopoly with suspect business practices.[252] There continue to be battles over high prices of CDs. The anecdotal example frequently cited is the fact that "The soundtrack to the film High Fidelity has a list price of $18.98. You could get the whole movie [on DVD] for $19.99."[253]

The manipulation of CD prices was combined with a second strategy to further exploit consumers. Over the course of the 1990s, even though production costs were falling, the recording industry all but eliminated the sale of singles (see Exhibit II-1, above). In other words, consumers were being forced to pay too much for CDs that contained a lot of content they did not want to purchase.

In the 1980s sales of singles had been in the hundreds of millions and, with declining production costs, could have remained high but the industry sought to increase profits by restricting the availability of singles. Implementing this strategy, sales volumes of singles fell by 90 percent.

Prior to the 1990s, singles had the effect of allowing consumers to cost effectively meet their needs cost, while stimulating sales with the purchase of individual songs which consumers could use to 'try out' an artist. During the 1990s, however, the industry virtually eliminated sales of singles and provided no alternative online. Only after peer-to-peer file sharing became prevalent did the industry reluctantly offer sales of singles online.

> At one time, singles made up a hefty part of the record industry's income… But things have changed. Record companies want consumers to buy full length CDs when they fall in love with a song. So they have shut off the spigot when it comes to releasing less expensive commercial singles to retail…
>
> The debate rages. Labels insist they simply cannot make a big enough return if fans are buying $3 singles instead of $16 albums. Retailers, though, fume that they are suffering without singles, which have historically increased foot traffic in stores, especially among younger shoppers.
>
> Labels like the single when it suits their purposes; during parts of the overheated 1990s, labels released them in floods at deeply discounted prices to help promote blockbuster albums and claim fanciful new sales records…

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252 Bill Werde, "Payola Probe Heating Up: New York Attorney General Investigating Record Labels' Links with Radio Stations," *Rolling Stone,* November 1, 2004. The importance of promotion and radio play (and hence payola) is emphasized by Alexander, The Music Industry at 137, and the core of the argument presented by Nadel, How Current Copyright Law Discourages Creative Output.

253 Lessig, Free Culture at 70, citing Jane Black, "Big Music's Broken Record," *BusinessWeek Online,* February 13, 2003.

> But that was then, this is now, and the music fans are the losers.[254]

Keeping prices high with anticompetitive collusion and eliminating singles in order for the new CD format to thrive created a windfall for the record labels. "The record companies minted money," one major-label exec told me. "We made huge margins off CDs. We'll never have those margins again."[255] When the anti-competitive behavior of the industry sought to control discounting, it had an immediate and substantial effect on prices.

> By June 1996 Billboard reported, "Thanks to the majors' new-found resolve on MAP prices of hit CDs at discount chains rose by $2 to $11.99 over the last month. In the meantime, NARM reported that the average price paid by their SoundData Consumer panel during the period of December 1995 through February 1996 was $13.64, up from $12.71 in the previous survey.[256]

A survey of consumers at the time of the first consent decree in 2000 revealed significant consumer dissatisfaction with recording industry pricing.[257] Three-quarters of respondents felt that pricing levels were unreasonable and almost as many felt they were excessive compared to other forms of entertainment. They said they would increase their purchases of music if prices fell substantially, and almost all the respondents said they would not be willing to buy digital downloads at the same prices as CDs. The public was clearly not satisfied.

The history of the anticompetitive behavior outlined by the Attorneys General makes fascinating reading in light of subsequent developments (see Exhibit II-2). CDs entered the market in the mid-1980s, constituted a quarter of total sales by 1990, and three-quarters by 1995. Competition arrived in the early 1990s along with the expansion of CDs, a new technology of distribution that was lower cost and easier to store and handle. As shown in Exhibit II-2, competition drove prices down, "from $15 to $10 in a short period of time."[258] As a result, "discount retailers' sales grew dramatically."[259]

The list prices in the Exhibit do not reflect significant discounting that was going on prior to the mid 1990s before the industry engaged in its price fixing scheme to stop the practice. Total sales grew dramatically as well (as shown in Exhibit II-1, above). In fact, this period of price competition saw a faster rate of sales growth than at any time over the prior 30 years – "CD sales during this period have the largest increase of any 5 year period in our data."[260] Prices fell by 40 percent and sales more than doubled. The big gains came in the early 1990s when list prices were at their low, discounting was widespread, and the big discount outlets were slashing retail prices. This expansion of sales was the result of the price competition that had broken out and a shift in technology, which stimulated library replacement. It affirms the importance of the price elasticity of demand in the market. " All major labels report that moving albums to mid- or

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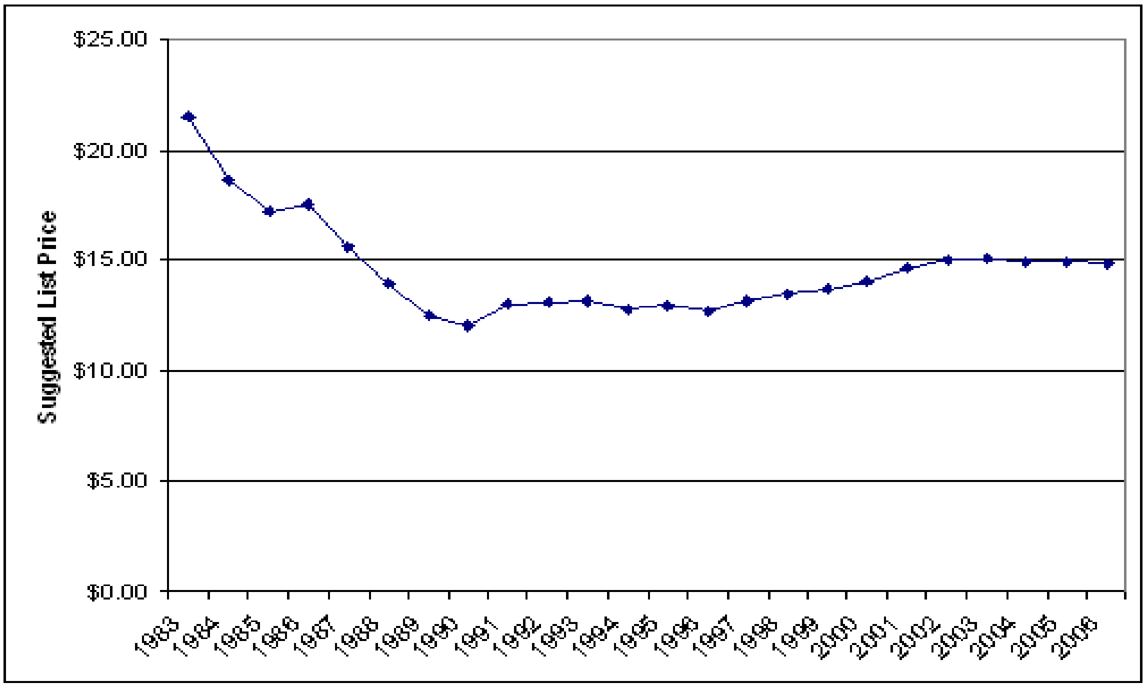
[254] Boelhert, Eric, "Why the Recording industry is Killing the Single," *Salon.com,* December 19, 2004.
[255] Seth Mnookin, "The Angry Mogul," *Wired,* December 2007.
[256] Geoffrey P. Hull, *The Recording Industry* (New York: Routledge, 2004), 2nd ed., p. 183.
[257] Michele Wilson-Morris, "28 States Sue Major Labels and Retailers Over Alleged Price Fixing Conspiracy," *Music Dish,* August 8, 2000.
[258] State of Florida at para 37.
[259] State of Florida at para 38
[260] Liebowitz, Pitfalls at 22.

budget-pricing increases sales significantly."[261] The failure to recognize the price elasticity of demand has also distorted the analysis of the digital transition in the music sector.

Unfortunately, the industry used its market power to undermine price competition. It was this price fixing scheme that the antitrust authorities challenged. Thus, the growth in industry revenue through the 1990s was, in part, a result of anti-competitive and anti-consumer practices.

Exhibit II-2: CD List Prices

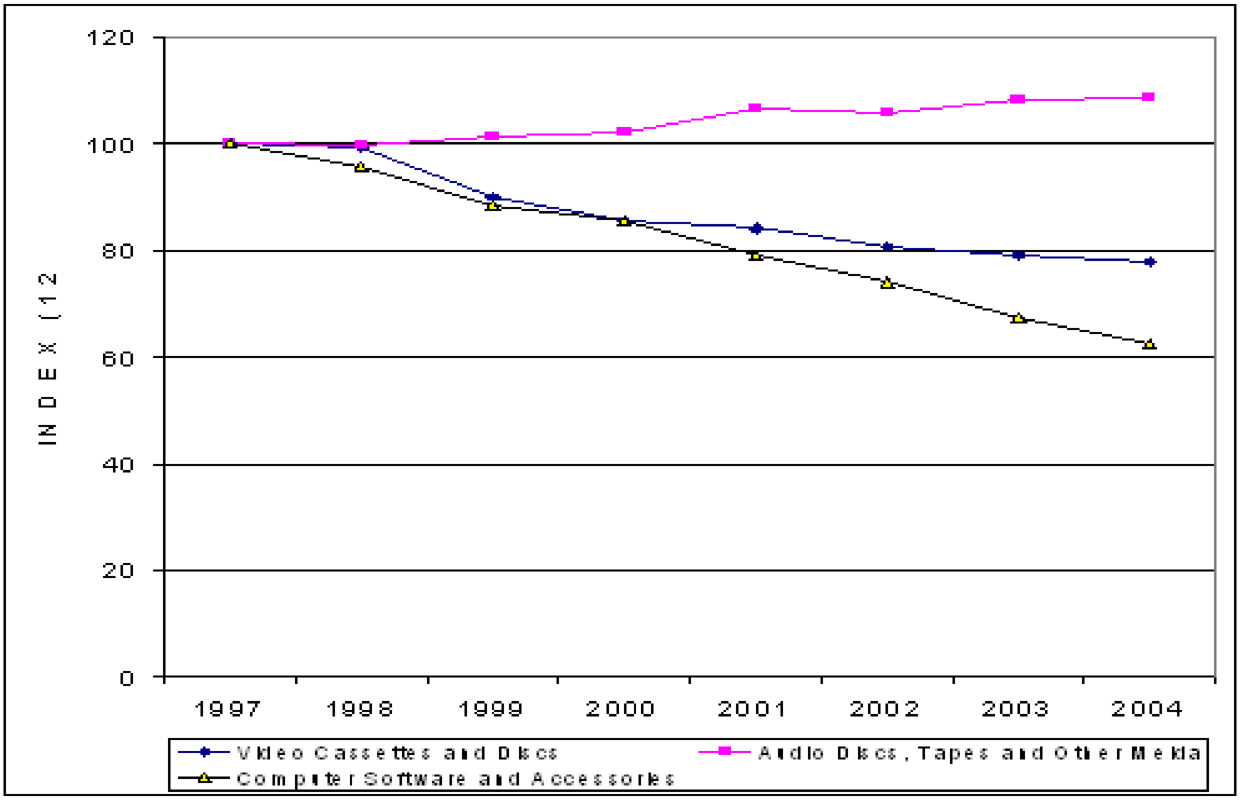


Source: RIAA, *The CD: A Better Value Than Ever,* **August 2007**

To gain further insight into the impact of competition and anticompetitive practices, contrasting sales of consumer products that were good candidates to b affected by digital distribution. Prices for other products that could be digitally delivered were declining. Exhibit II-3 compares CD prices with several other products that, as Internet usage spread rapidly, were subject to pressures of digital distribution. At this level of disaggregation, the available data dates only to 1997, but that is a reasonable starting date. Each of the products was affected somewhat differently, but the pattern is quite clear. CD prices increased somewhat, while the other product prices declined. CD prices were generally flat over this period, while sales fell. In contrast, DVD prices declined sharply and sales increased.

[261] Hull, p. 179.

Exhibit II-3: Prices for Mass Market Items Affected by Digital Distribution



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

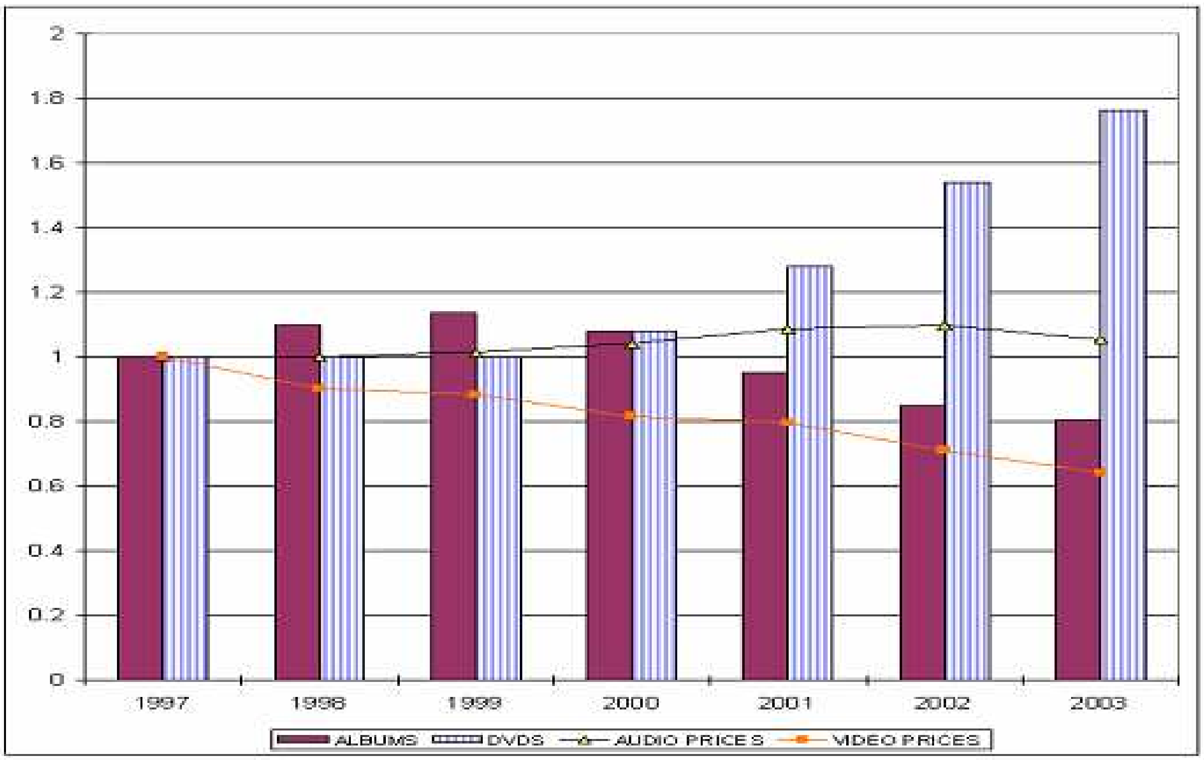
Sharply declining prices for DVDs in the late 1990s were associated with sharply increasing sales (see Exhibit II-4). By contrast, rising prices for CDs were associated with declining sales. We observe a similar effect for digital singles in the audio market in 2004. As shown in Exhibit II-1, above, when prices of singles tumbled from $4 for CDs to $1 for digital singles, sales skyrocketed.[262]

File sharing enters this market structure as an "arbitrage" opportunity. The experience of rising sales and declining prices in the early 1990s due to competition is what we would expect with a cost-reducing technology penetrating the market. The experience of declining costs of digitally distributed products should extend to the music industry. When the opportunity for

262 Because sales of singles had been artificially suppressed, calculating a price elasticity is difficult. The aggregate data reviewed by Alexander, Music Recording at 127, indicates a price elasticity of 6.8. The experience of the digital distribution industry is consistent with this level, as Slater, Content and Control A-9 point out "When Real's Rhapsody cut in half its per-song CD burning rates, CD burning tripled; when the Real Music Store cut its per-song and per-album download prices in half, purchases increased six-fold." The headlines of the press accounts reporting these experiences tell the story, for example, Stephen Levy, "Forecast: Song Costs May Fall Like Rain, *Newsweek,* September 27, 2004; Amy Harmon, "What Price Music?", *The New York Times,* October 12, 2003.

arbitrage presented itself, in the face of anti-consumer and anti-competitive practices, we should not be surprised that consumers avail themselves of some self-help measures.[263]

Exhibit II-4: Prices and Sales of Mass Market Items Affected by Digital Distribution



Source: Bureau of Labor Statistics, *Consumer Price Index*, **database; Stan Liebowitz,** *Pitfalls in Measuring the Impact of File Sharing*, **School of Management, University of Texas at Dallas, 2005.**

> Perhaps most peculiarly, the costs of production, reproduction and distribution in the industry are close to zero (from a physical standpoint), yet the industry structure in which five firms dominate the field worldwide has been essentially unchanged since the mid-1980s. One implication of this structure is that firms are able to more easily coordinate and carry out anticompetitive activities, such as price fixing. Prices that are held artificially high generate social welfare losses (in absence of perfect price discrimination), and might have accelerated and amplified the use of file-sharing networks by consumers.[264]

This underlying economic picture also casts doubt on the claims that every downloaded file is a lost sale. One can certainly argue that the combination of anticompetitive pricing and the elimination of singles hurt consumers in two ways. It priced a significant number of people out

263 Fisher, pp. 140-142, describes self-help from the copyright holders side.
264 Peter Alexander, "Music Recording," in James Brock (Ed.), *the Structure of American Industry* (2005) at 138.

of the market and transferred a great deal of surplus from consumers to producers.[265] The failure to take into account the anti-competitive, anti-consumer practices of the industry in the 1990s completely distorts the picture one paints of the events of the period after peer-to-peer communications networks came into existence. The fact that prices failed to fall with the shift to much less expensive CDs reinforces that suggestion. This anti-competitive behavior led to the run-up in margins and the battle to keep low margin single sales out of the market. Singles disappears in the mid-1990s, not because they were an uneconomic product, but because the record labels had the market power to eliminate them. Digital singles grew exponentially because they were a vastly superior product, from the consumer point of view and the record labels had lost the market power to exclude them from the market.

The fact that singles now play a larger role than at any time in nearly three decades casts doubt on the decision to exclude them from the analysis. It is clear that there is an immense, latent demand for singles that had been suppressed by the anti-consumer bundling practices of the industry. This demand was initially expressed in the form of illicit file sharing, but quickly shifted to legal sales when new business models made that possible. More than two-thirds of file sharing activity was dedicated to downloading of singles. Indeed, the most detailed study of downloading found that only one or two songs were downloaded from the most popular albums and that digital sales are concentrated in singles by more than twenty-to-one, breaking the long-worn chains of anti-consumer bundling and anti-competitive pricing.[266]

2. The Artists' View

While the anti-consumer practices of the recording industry are proven as a matter of law (memorialized in consent decrees), some have argued that the worst aspect of the industry, though harder to prove, is its anti-artist and therefore anti-social impact. Pricing abuse only costs the consumer money; the centralized, star-oriented system that the industry enforced tyrannized artists and impoverished the culture.

It is a frequent lament in the music industry that few albums and almost no artists ever make any money on the sale of records. The gap in income between the handful of stars and the vast body of artists is huge. The range of works that are widely played and circulated is narrow. A handful of companies selected a small number of releases and promoted them heavily, marketing them through expensive distribution channels.

Peter Alexander examined product diversity over the history of the recording industry and reached a clear conclusion.

> These studies unambiguously suggest a strong negative, linear link between market structure and diversity. The more atomistic the structure is, the greater the

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[265] For example, Stan Liebowitz, one of the strongest defenders of the claim that file-sharing is harming the industry, uses the competitive period of the early 1990s as the basis for estimating the damage, but never mentions the anti-competitive behavior of the late 1990s, which suppressed sales and set the stage for peer-to-peer growth. Referring to the 1991-1996 period, he notes that

[266] Oberholzer-Gee, Felix and Koleman Stumpf, "The Effects of File Sharing on Record Sales: An Empirical Analysis, Harvard business School, January 2004, at 6; "US Sees Growth in CD Sales Market, *BBC News,* January 6, 2005.

> diversity is, and the more concentrated the structure is, the less diversity there is…
>
> On the other hand, a study using actual musical characteristics of hit songs, rather than simply the number of songs, suggests that a moderately concentrated industry structure may better promote diversity than either an atomistic or monopoly structure… When measured against market structure, these results suggest that product diversity is maximized in a structure characterized by a four firm concentration ratio of about 50 percent.[267]

By either measure, then, when the top four firms in the industry have more than 50 percent of the market, the output is likely to be less diverse than would be socially desirable. By this measure, throughout this period, the industry was too concentrated.

The costs of the distribution system that the recording companies controlled placed a huge drag on the market. Manufacturing, distribution and retail account for over half of the final price of the CD. These costs could be all but eliminated with digital distribution. Another quarter of the costs – record company overhead, marketing and profits– are vulnerable to sharp reduction in an environment that emphasizes horizontal structure and peer-to-peer communications. Thus, three-quarters of the costs and the central point of control could be eliminated, spelling the end of the highly skewed star system.

To put these numbers in stark relief, one author notes that the average price per CD in 2001 was about $17.99, while the cost of producing a CD in quantity was $0.50. The average amount an artist receives is $0.12.[268] Others put the artist share somewhat higher, but not much more than a dollar, net of costs.[269] Combining the composer, performer and producer share of the CD price, we find that the creators' get between 12 cents and 16 cents of every dollar the consumer paid (see Exhibit II-5). Thus, the intermediaries that stand between the musician and the audience account for about 85 percent of the final price.

These large intermediary costs can be seen as inefficient from two points of view. The recording companies that control distribution have an incentive to maximize profits at the expense of the artists and the public.

Music is owned by the artists, but in control of the sellers. There are traditional agency problems in this context. Those who have control of music distribution have incentives to sell the music that can bring them the most revenues, and distort the market by extensive and disproportional promotions in favor of a small number of works. Music listeners may not value the music produced by the big labels as much if they have a chance to know about smaller labels and new musicians; this is a severe distortion and

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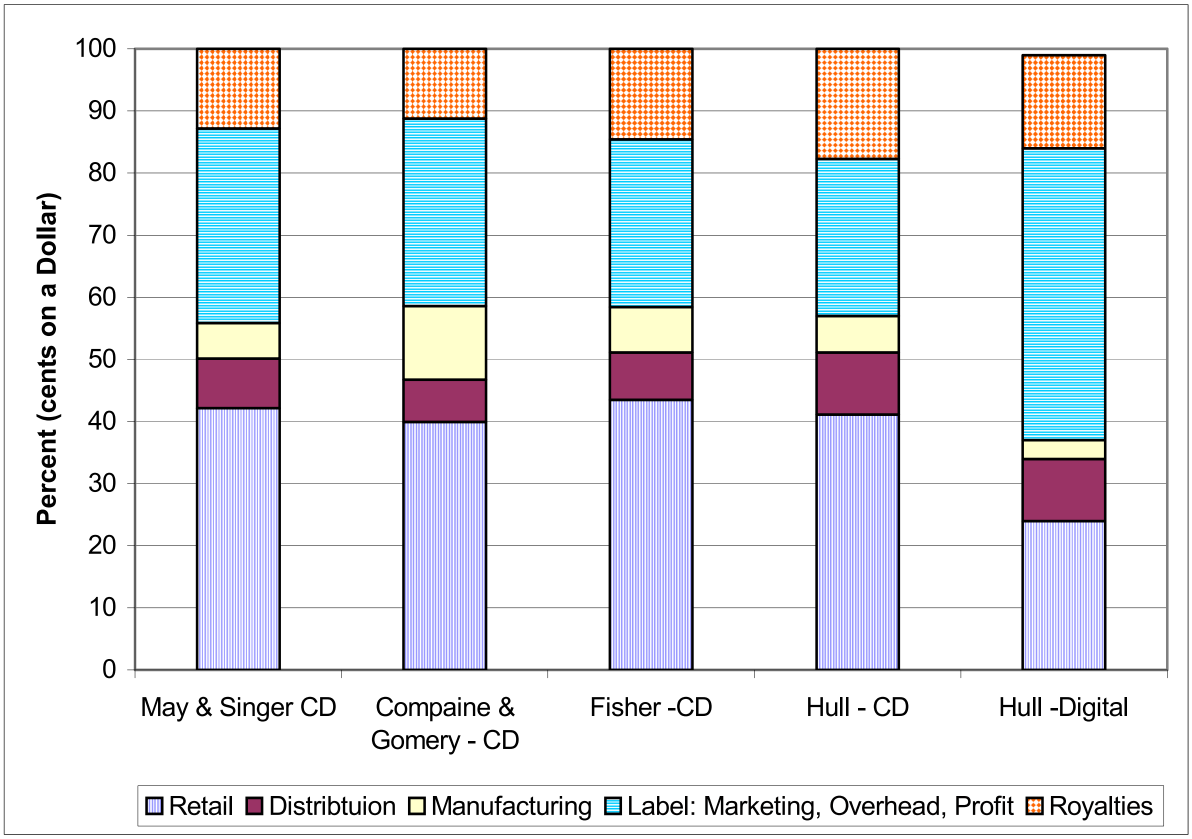
[267] Alexander, "Music Recording."

[268] Bill Wittur, "Selling Minor Chords in Exchange for a Happy Tune," *Music Dish,* December 12, 2004.

[269] William Fisher, *Promises to Keep* (Stanford, Stanford University Press, 2004), Appendix; Dereck Slater, et al., *Content and Control: Assessing the Impact of Policy Choice on Potential Online Business Models in the Music and Film Industries* (Cambridge: Berkman Center for Internet and Society, Harvard University, January 7, 2007), Appendix A.

source of social inefficiency. The overwhelming advertising campaign may further skew the consumers' preferences and lead to distorted demand.[270]

Exhibit II-5: Who Get What from the Music Consumer Dollar



Sources: William Fisher, Promises to Keep (Stanford, Stanford University Press, 2004), Appendix for May and Singer, Compaine and Gomery and Fisher; Geoffrey P. Hull, The Recording Industry (New York: Routledge, 2004), 2nd ed., pp. 182 and 259 for CDs and Digital, respectively.

It is possible to arrive at this inefficiency and distortion as a pure information problem.

> In essence, music consumers do not have accurate information on the quality of the music, because it is an experience good. Music publishers, because of the delay in obtaining market information for all of their music, may over-invest in certain music genres and under-invest in others. A typical strategy to overcome the inefficiencies and uncertainties in the market is to focus on superstars.[271]

[270] Michael X. Zhang, *A Review of Economic Properties of Music Distribution,* Working Paper, November 2002 at 14.

[271] Ram D. Gopal, Sudip Bhattacharjee and G. Laurence Sanders, "Do Artists Benefit From Online Music Sharing," *Journal of Business,* forthcoming.

The brunt of these inefficiencies falls on the artists. High costs and the incentive to focus on a narrow range of output reduces demand for the product overall and narrows the prospects for most artists.

> New scale-reducing technologies can erode existing market structures by facilitating new entry… [N]ew technology has fostered two periods of significant structural turbulence in the music recording industry in which new firms, producing innovative products, displaced the existing firms. Reconcentration resulted from horizontal mergers among other factors. New digital distribution networks may promote greater competition in the industry, if they are non-exclusionary. This should promote greater levels of product diversity and variety in the offerings of the music recording industry.[272]

Exhibit II-5 also includes an estimate of the recording company take on digital distribution in its early days. The companies did not give up their rents easily and while the hard costs of distribution declined, they pushed up their share of the total delivered price, seeking to turn the eliminated costs of manufacturing, distribution and retail into record company rents. Even the large increase in record company take shown in Exhibit II-5 may be too low because the companies could take charges against artist royalties. While these charges were always a bone of contention, with the advent of digital technology some of these had become utterly fictitious in a digital environment.

> However, labels typically deduct a packaging charge, 25 percent for CDs, even from digital files where there is no packaging. Labels also typically pay a rate for singles that is lower than the album base rate, often 75 to 80 percent of the album rate. Labels also pay a lower rate on "new technologies"; also often 75 to 80 percent of the base album rate. If all of these deductions were taken, the artist's and producer's combined royalty would shrink to about 4.2 cents per download. Some major artists objected to this small portion of this small pie.[273]

This observation on the battle over the rents between artists and labels reminds us that the outcome of struggle is not determined by technology alone.[274] Technology creates possibilities but the market structure that emerges reflects the business models that can be built on the technology and those models reflect the political and economic power of the players in the market; in this case, consumers, artists and record companies.

B. The Emergence of a Digital Music Business

1. Complexities in Evaluating Market Performance

With digital technology arriving to shake up a market structure that was not very consumer or artist friendly, we should not be surprised to find that early economic analyses of its impact were all over the map. The analytic problem is rendered complex by a variety of

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272 Peter Alexander, "New Technology and Market Structure: Evidence from the Music Recording Industry," *Journal of Cultural Economics*, 18 (1994) at 122.

273 Hull, pp. 259-260.

274 Yochai Benkler, *The Wealth of Networks* (),

competing factors that might also explain the changing level of demand for certain types of products. A debate raged about the positive and negative factors affecting sales. On the one hand, a series of partial explanations for the decline in recorded music sales, independent of the advent of file-sharing, was offered, including substitution of other forms of entertainment, saturation of new music technologies, and a reduction of output from the recording companies.[275]

> According to industry figures, from the early 1970s through the late 1980s the total number of albums (in all formats) shipped each year in the US hovered around 650 million. In 1992, CD sales reached 400 million; six years later they hit 800 million. By 2000, more than 900 million CDs were being shipped each year. Many of those were back-catalog purchases, as music fans converted to the format that seemed destined to make all others extinct.[276]

This ambiguous empirical outcome, from an analytic point of view, is perfectly predictable from a theoretical point of view.[277] It has been well-recognized for over two decades that some technologies that appear to facilitate "piracy" can actually stimulate sales or have effects that offset the presumed loss of sales resultant from increased "piracy." Thus, a series of potentially positive impacts of peer-to-peer has been suggested that includes sampling and networking.[278] This is especially true, where, as here, the industry has not been vigorously competitive, while the technology has reduced costs dramatically and enhanced the consumer experience of the product.

Digital distribution can dramatically lower the costs of producing and distributing music. The elimination of the cost of manufacture, transport, storage and sale of CDs represents an overwhelming efficiency gain, although some part of the cost of burning a CD is transferred from the record company to the consumer. Instead of CDs being produced by an assembly line in a factory, they are burned by consumers on an as-needed basis. The fact that supply and demand can be better matched in the process in which consumers become producers multiplies the efficiency gains by avoiding the waste that occurs when recording companies misjudge consumer tastes.

Every downloaded song need not represent a lost sale. There are many songs that would not be purchased because their cost is bundled into CDs. Sampling of individual songs through downloads may increase sales of CDs, as consumers experience the music and discover its value.

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[275] Martin Peitz and Patrick Waelbroeck, *File-Sharing, Sampling and Music Distribution* (International University, School of Business Administration, Working Paper 26, December 2004), *Piracy of Digital Products: A Critical Review of the Economics Literature* (CESifo Working Paper No. 1071, November 2003), An Economist's Guide.

[276] Moonkin, p. 209.

[277] Robert Picard, "A Note on Economic Losses Due to Theft, Infringement, and Piracy of Protected Works," *Journal of Media Economics* 17: 3 (2004).

[278] Gopal, Bhattachariee and Sanders; Michael X. Zhang, *A Review of Economic Properties of Music Distribution,* Working Paper, November 2002 at 14; Martin Peitz and Patrick Waelbroeck, *An Economists Guide to Digital Music* (CESIFO Working Paper, No. 1333, November 2004); Alexander, The Music Industry.

There was evidence that lower value songs are more likely to be downloaded than higher value songs.[279] This is consistent with the notion that some of the downloads would not have been purchased, so many of the sales are not lost. There is evidence that downloaders in high purchase groups purchase some CDs after downloading some songs and that downloading increases purchases in those demographic groups least likely to purchase.[280] This supports the sampling function of downloading.

In a broader sense, singles and albums are complements to the purchase of audio equipment and other merchandise and services. By stimulating purchases of complementary and related goods and services, downloading may ultimately expand the market for legitimate purchase of content to play on the newly acquired equipment or goods and services related to albums. Artists are the primary, direct beneficiaries of the revenues, rather than recording companies.[281]

The public policy problem is rendered complex by the fact that the ultimate issue is not whether some revenues have been lost as a result of peer-to-peer communications networks, but whether the losses have been sufficient to threaten the viability of the industry[282] and whether the new business models and industry structure might better serve the public and the promotion of progress.[283]

In a remarkably prescient article in 1994, Alexander considered the prospects for diversity in an industry that relies on digital technology for production and distribution. After studying repeated historical examples of technological change leading to outbreaks of competition in the recording industry, Alexander provided the first reference to the potential impact of digital file distribution in the academic literature. He offered an analysis of the potential cost savings and the "exponential" increase in product creativity afforded by new digital technology that was just a decade away.

> The network for distribution in the music recording industry is highly concentrated, and many fringe firms and new entrants are unable to obtain national distribution. This trend limits the extent of competition in the industry, and possibly reduces the diversity and variety of product offerings (in part, because small new firms tend to be product innovators). If non-exclusive distribution networks existed, fringe firms and new entrants might provide robust competition for market share….

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[279] Rob and Waldfogel, Piracy on the High Cs at 15-16, 22-25; <u>*Brief of Felix Oberholzer-Gee and Koleman Strumpf; Brief of Intel Corporation;*</u> at 20.

[280] Boorstin, Music Sales, at 60-62. Stan Liebowitz, "Will Downloads Annihilate the Recording Industry? *Pitfalls in Measuring the Impact of File-Sharing,* paper presented at the CESifo Conference, July 2004, Munich Germany at 31, reanalysis of Boorstin reduced the size of the effect and in some cases eliminated the statistical significance, but did not demonstrate the effect was absent.

[281] Amit Gayer and Oz Shy, *Publishers, Artists and Copyright Enforcement,* Working paper, January 27, 2005.

[282] Even Stan Liebowitz, "Will MP3 Downloads Annihilate the Record Industry? The Evidence so Far," in Gary Libecap (Ed.), *Advances in the Study of Entrepreneurship, Innovation and Economic Growth* (2003) at 27) recognizes this "harm is not the same as fatal harm."

[283] Nadel, How Current Copyright Law Discourages Creative Output; Raymond Shih Ray Ku, "The Creative Destruction of Copyright: Napster and the New Economics of Digital Technology," *University of Chicago Law Review,* 69 (2002).

> A digital delivery highway for the products of the music recording industry might take the following form. A distributor, or group of distributors, would transmit digital product samples to consumers via cable or telephone lines. The consumers could review the product samples… and then inform the distributor… which products they wish to purchase. These products would then be uploaded to the consumers, and a charge made to the consumers' account.
>
> A distribution network of this type may potentially attenuate the effects of the significant barriers to entry in the music business. First, it could give firms (particularly fringe firms and new entrants) the opportunity to have their products distributed in a less costly and non-exclusionary fashion. By providing product samples to consumers, the new distribution network would also transmit information relating to product specifications. This would lessen the need for more traditional and less efficient techniques, such as radio airplay and other costly promotional activities, to inform consumers of the existence of new products. Given the modest marginal costs of adding a new product line to a digital delivery system, it is conceivable that the number of product offerings could increase exponentially. The costs of distribution should decline dramatically, as physical distribution at national or international levels has significant scale features. A competitive digital delivery system would reduce substantially the minimum efficient scale of distribution, and likely stimulate a highly competitive producer market.[284]

2. Consumer Welfare Gains

With the ability to choose singles, consumers can spend a lot less to get the music they want. In 2009, according to the RIAA, they spent about $1.2 billion on singles, $1 billion for subscription services and about $5 billion on albums. The recording industry would have liked to force them to spend as much as $17 billion more for three times as many albums, along the high growth line (in Exhibit II-1, above), which is the future the industry claimed, absent downloading. Of course, we do not know how many albums consumers would actually have purchased if the recording industry had won its war against digital distribution. The industry's hope for very high rates of growth in album sales with inflated prices was likely entirely too optimistic. In other words, consumers are meeting their music needs in a much more convenient way at less than half the cost.

At the other extreme, if we look at total music sales, recognizing that rising prices and declining quality had already dampened the growth of sales and that the process of transitioning to the new CD format had already played out, we can argue that the industry was not going to enjoy much growth in album sales at all (the low growth line in Exhibit I-1). In that case, the effect of the shift to digital distribution was to increase total units shipped by pulling in consumers who had been priced out of the market. Total revenue, versus the industry's high-growth hopes, would still be down due to the large number of album that consumers do not want

[284] Peter J. Alexander, "New Technology and Market Structure: Evidence from the Music Recording Industry," *Journal of Cultural Economic*, 18 (1994) at 121.

to purchase. Reality may lie in between the extremes, but there is no doubt that consumers are better off.

We also do not know precisely how many singles consumers buy per album, although we do know the number is small (one to three). Consumers might want more than one song per album, but the ability to pick and choose nonetheless represents a massive victory for consumer sovereignty. If we assume consumers buy albums for two favorite songs, consumer savings from the availability of singles would be as high as $10 billion. If we assume three songs per album, consumer savings would be about $6.3 billion. While there are uncertainties due to different assumptions about growth patterns and the number of songs consumers would purchase per album in a non-digital world, there is no doubt that the consumer savings are quite large. These figures represent a substantial savings in an industry with total sales of just over $7 billion.

The total number of units purchased by the public has more than tripled, but the vast majority of units sold are singles, most not owned by record companies. The average price per unit sold declined by 70 percent. The implicit elasticity of demand in this period is similar to that observed during the period of competitive declining prices in the late-1980s-early 1990s. Of course, the dominant firms in the tight, music oligopoly and the handful of artists who benefited from the blockbuster/star system have suffered a reduction in the rents they collect.

In a world of physical distribution, with high fixed costs and near-zero marginal cost, it is still good business to put as many songs as one can on each CD (even though the cost of distribution had declined as a result of the new technology). The need for brick and mortar distribution infrastructure for physical products reinforced this logic. However, recall that singles had thrived in that environment and retailers liked them because they attracted traffic to stores and with declining costs sales of singles should have been expanding. With the advent of digital distribution, fixed costs of distribution all but disappear, physical infrastructure is no longer necessary, and transaction costs are slashed. The compelling economic logic of bundling disappears. The result is that the revenue per unit shipped plummeted (See Exhibit II-6)

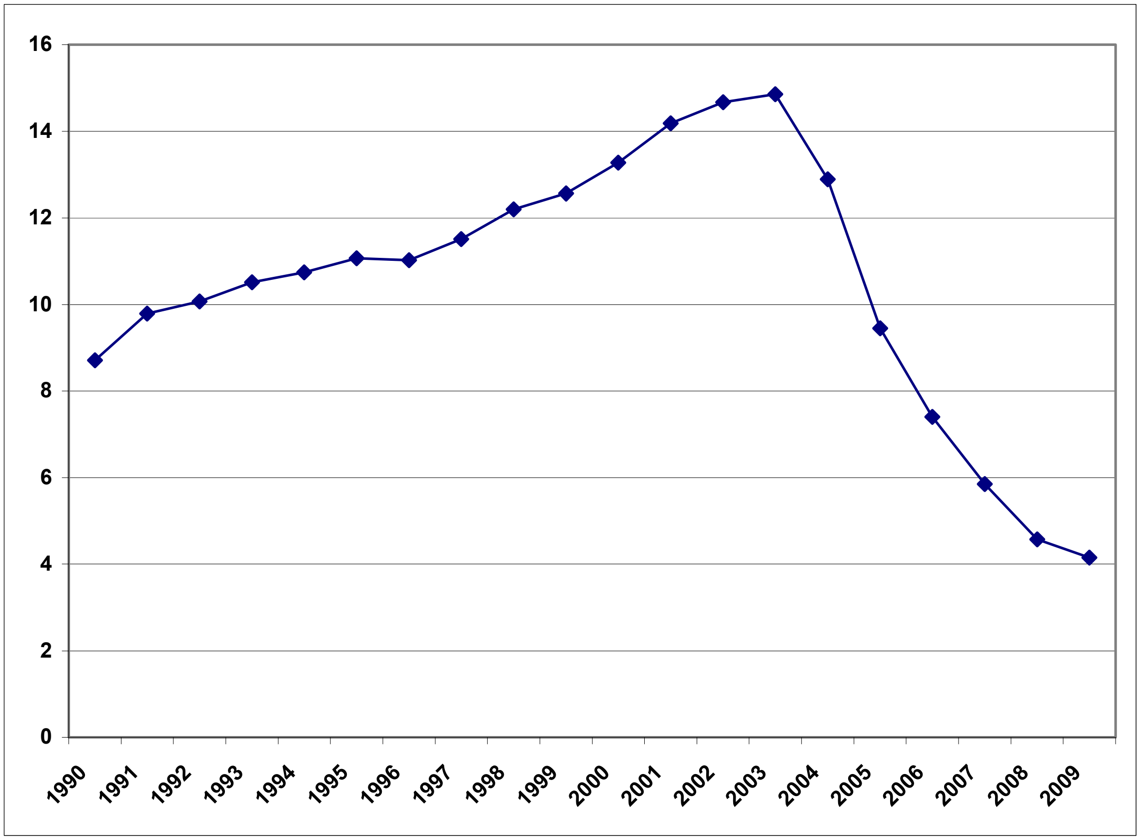
The digital transformation goes beyond the impact of cost reduction and the elimination of the exercise of market power. Demand shifts as well, as a result of both production and transaction changes. New flexible, consumer friendly formats expand demand.

> The rise of the compact disc (like the rise of cassette tapes before them) demonstrated the market appeal of flexibility and convenience. CDs weren't a hit because they had the best audio fidelity; that honor still belongs to vinyl records. Rather, they gave consumers more control over the listening experience. If you wanted to replay your favorite song (or skip a crappy one), you didn't have to bother with delicately moving a phonograph arm or engaging in a frustrating rewind-stop-play-stop-rewind tango with your tape player. Everyone came out a winner.[285]

Digital technologies take the consumer-friendly transformation of music to another level.

[285] Mnoonkin, p. 209

Exhibit II-6: RIAA Revenue Per Unit Shipped



Sources: Recording Industry Association of America, Yearend Statistics.

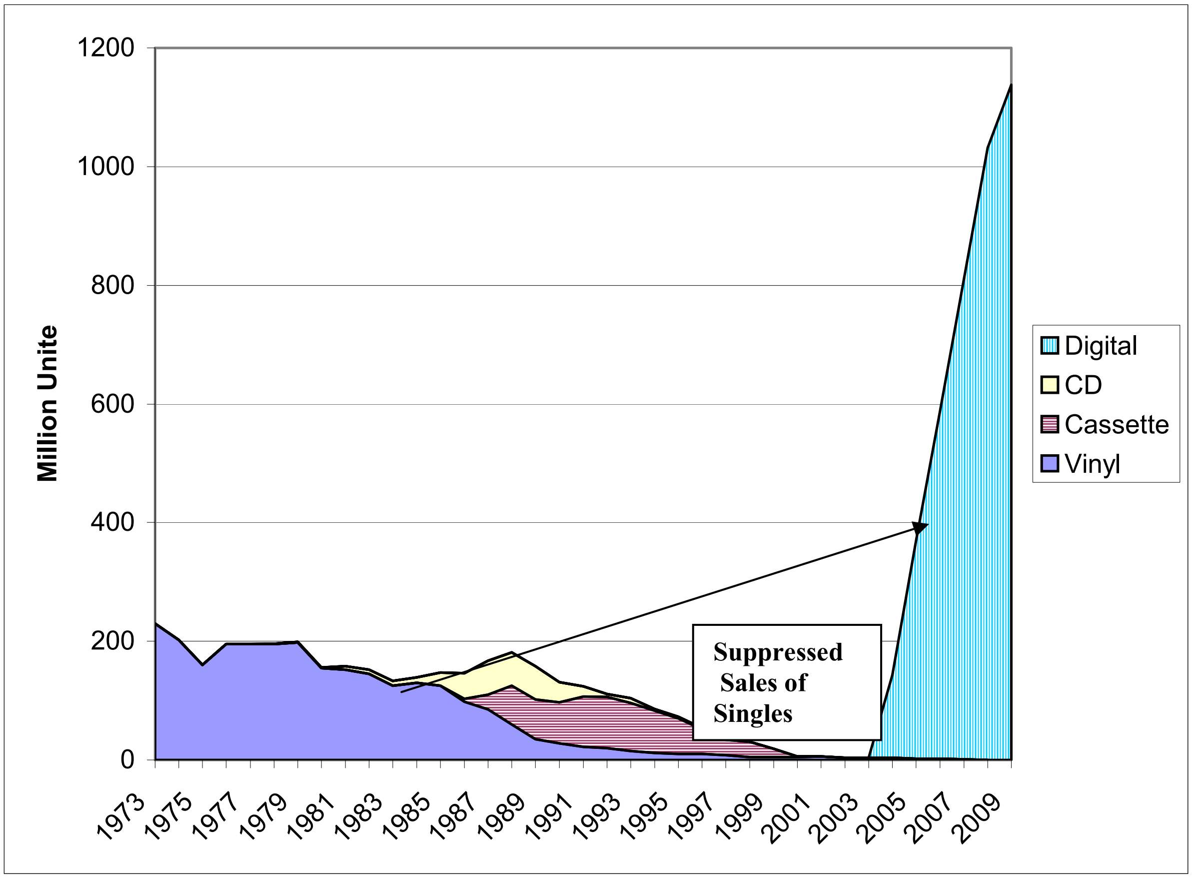
If we look at the long-term trend in single sales we could easily conclude that a large part of this piracy claim is demand that was suppressed by the exercise of market power to eliminate singles (see Exhibit II-7). Singles had gone through two transitions.

(Vinyl to Cassette to CD), but the industry had all but eliminated them by the late 1990s, creating the pent-up demand that exploded once the digital distribution model took hold. Single sales had been well above 150 million in the late 1980s and above 200 million in the 1970s. With CD price falling sales of singles on the order of 400 million could well have been achieved.[286] Digital distribution amplifies the attractiveness of singles, with convenience and portability, and consumer control. These levels are not out of the question, had the industry chosen to promote their sales. This estimate of suppressed single sales is well within the range of the estimate of lost album sales. Obviously, the conclusion that consumers shared singles that they could not buy in the market with a value of a couple of hundred million dollars stands in sharp contrast to the industry claims of mega billions of losses due to "piracy." It also pales in

[286] This represents one-third of units shipped, which is the level of sale of singles in the mid-1980s.

comparison to the huge consumer and artist gains that we have shown from digital distribution. Technology replacement and anti-consumer practices need to be taken into account.

Exhibit II-7: RIAA Claimed Shipments of Singles



Source: Recording Industry Association of America, Yearend Statistics, various years.

3. Artist Gains

From the artists' point of view, the benefits of the transformation are also readily explained in classic welfare economic analysis. In the oligopoly environment, producer surplus is inflated by high cost products and results in the large surplus earned by a small number of recording companies that produce "high value" blockbuster albums (area BTS in Exhibit IV-2). In the digital environment, producer surplus is much smaller per unit, but made up of the much larger low cost output earned by unsigned artists (area QREF in Exhibit IV-2). Using the midpoint estimate of 14 percent of the retail price of a CD going to the artists (composers and performers) we estimate that about $1.1 billion of the revenue from CD's goes to artists in 2007. Apple takes about 30 percent of the digital sales revenue, returning 70 percent to artists. This is just under $2 billion for 2007. Some of that goes for administrative and other costs, so the artists end up with about $0.50 or about $1.4 billion on digital singles. The big difference on the supply side is the much broader range of artists to whom the surplus goes. If the oligopoly model had prevailed by expanding sales of CDs, the artists' share of the producer surplus would have been larger, but it would have been much more narrowly distributed.

Album sales are not the primary way artists earn their living. The mechanism through which the vast majority of artists became beneficiaries of the new market structure is easily explained by the reduction of transaction costs.

> More interestingly, artists and publishers may benefit differently from the network effects generated by the number of those who buy legal copies and those who obtain illegal recordings… If the demand for, say, live performances is enhanced by the "popularity" of the artists generated from the number of distributed recordings (legal and illegal copies combined), then we obtain the conditions under which publishers of recorded media may lose for piracy, whereas artists may gain from piracy.[287]

Artists earn their living by getting play time, which makes it possible to sell more songs, perform more shows and sell more merchandise (see Exhibit II-4). Digital distribution expands the opportunity to engage in each of these activities. Collaboration between artists and contact with fans is greatly facilitated. The ability to be heard expands through easier promotion, viral communications and sharing. Playtime, which had been largely restricted to radio (and hemmed in by repeated payola scandals), explodes on the Internet. A new distribution channel is opened up for direct sales from artists to consumers.

Exhibit II-8 shows the percentage of respondents to a recent Pew Internet and American Life Project poll on the use of the Internet in regard to acquisition of music and conduct of music related activities. The behavior has become pervasive.

The dramatic improvement in the discovery and information function of the market expands sales as well. This is a process that needs to be given more credit in the transformation. We tend to think about the digital revolution as inherently technical, a change in the means of production, i.e. the tools that are used to produce content, and the form of the end product. However, the transformation of transactions and transactions costs is at least as important. The digitization of content, which has captured so much attention in the intellectual property wars because of the ability to copy perfectly and infinitely, is not all that matters. Changes in the mode of production, the relationship between artists and audiences, matter, too.

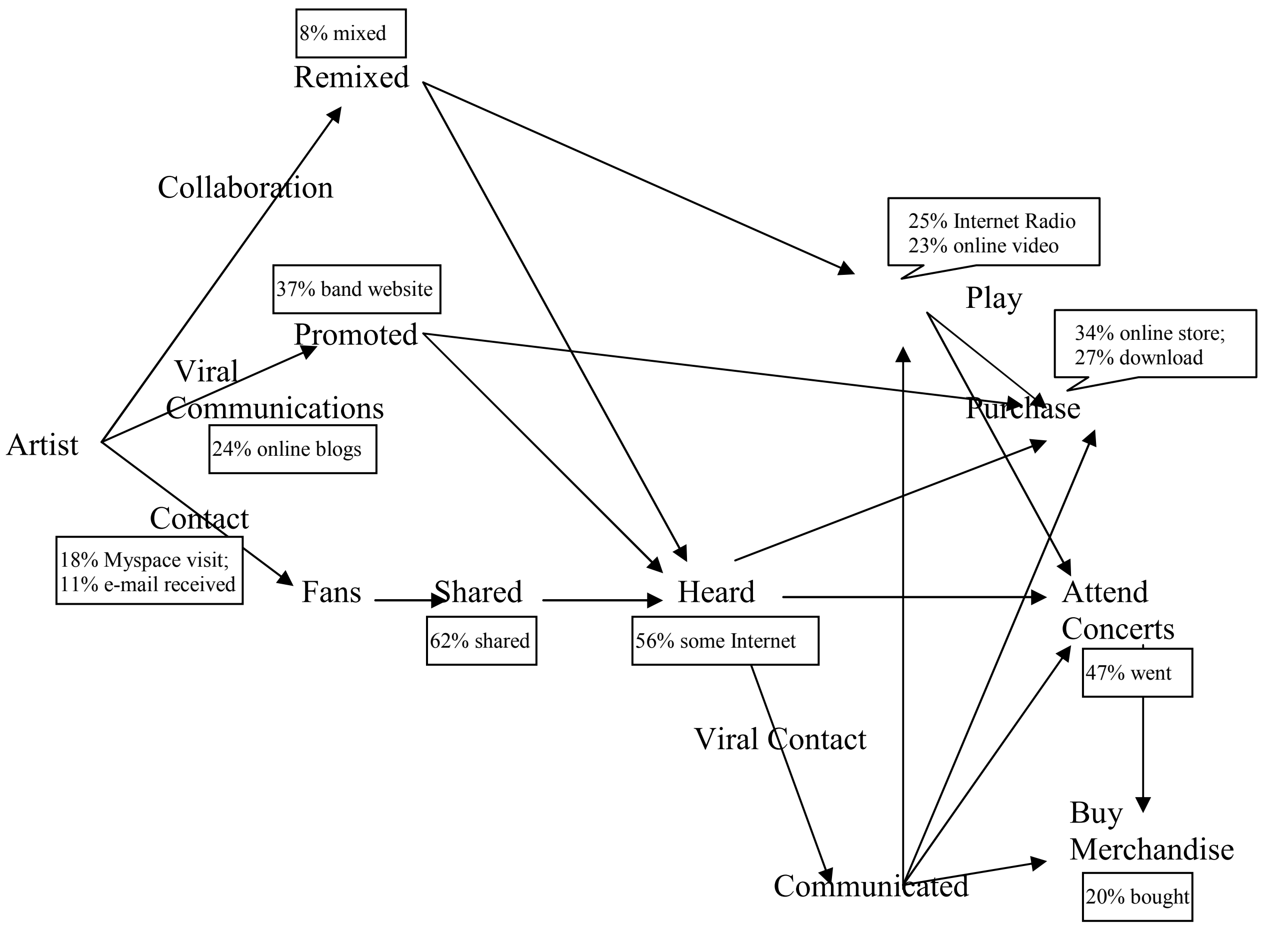
At the same time that the new technology changes the relationship between artists and recording companies, it weakens the star system because "there is a greater probability of discovering other high quality music items by lesser known artists with the new technology."[288]

The ultimate cost savings in marketing and distribution come from both the supply side and the demand side. On the demand side, the ability to sample "is an information-pull technology, is a substitute to marketing and promotion, an information-push technology."[289] As

[287] Gayer and Shy at 2.
[288] Gopal, Bhattachariee and Sanders at 38.
[289] Peitz and Waelbrock, *File-Sharing,* at 5.

the cost structure of the industry changes through the adoption of digital technologies, performance improves since "variable costs relative to fixed costs are more important for music downloads than for CDs. This suggests that acts with a smaller audience can succeed in the digital music market. As a consequence, we could observe more music diversity and a less skewed distribution of sales among artists."[290]

Exhibit II-8: Digital Production and Distribution Enhances the Artist's value Proposition



Source: John B. Horrigan, The Internet and Consumer Choice, May 18 2008, p. 18, 21 for usage.

In fact, we do observe this pattern. The payoff for artists and society is increasing diversity. Although the examples above are geared more toward the starving artists, those who may never get onto the charts, the impact has been documented even at the top of the charts. One set of authors states that:

[290] Peitz and Waelbroeck, An Economist's Guide at 35.

> we find strong evidence that over the last decade, the number of unique artists and albums that have appeared on the Billboard Top 200 album charts is statistically related to the number of Internet users. The implication is that with lowering of information sampling costs, consumers become aware of more new albums they like, leading to more artists and albums being ranked on the charts….
>
> The implication is that as sampling becomes less expensive, the superstar effect is eroded overall, and more users purchase music items based on their actual, not perceived, valuations.[291]

C. The Economic Structure of the New Industry

Of equal if not greater importance with the consumer savings is the fact that the transformation reflected fundamental economics, not illegal behavior; an explosion of digital singles was inevitable. From the consumer's point of view this transformation is perfectly consistent with economic theory and can be explained in the classic terms of welfare economics. Exhibit II-9 shows the welfare economics. It includes both the supply and demand side shifts (falling costs, rising demand) and a shift from oligopoly pricing to competitive pricing.

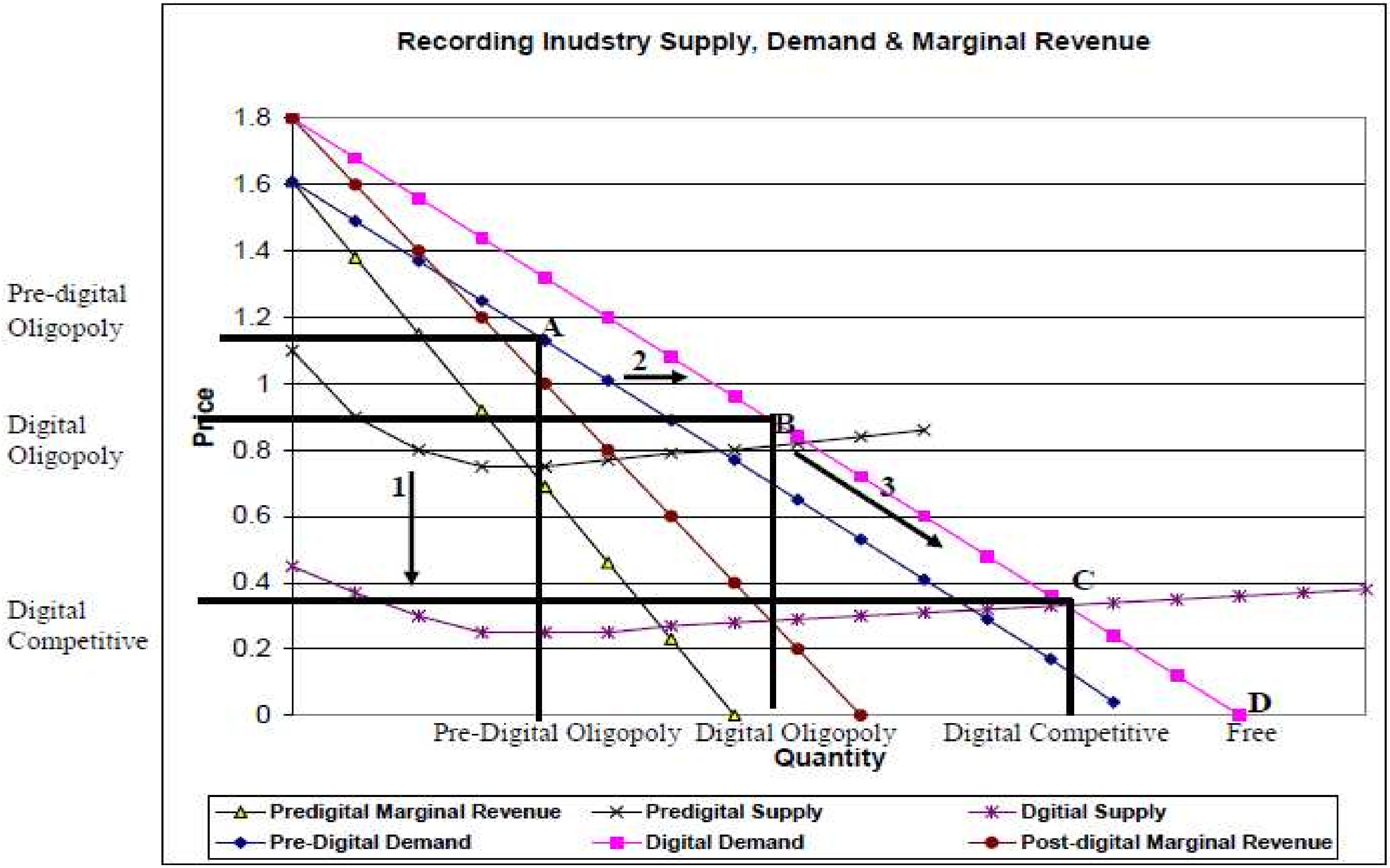
The pattern of pricing and surplus we have seen can be readily described in neoclassical economic terms. The recording industry and the newspapers had very high margins due to the exercise of market power over product and price because of the distribution oligopoly. The digital revolution changes the picture. (1) There was a dramatic shift in the cost curve (2) There was a shift in the demand curve. (3) The market power of the industry was undermined by consumer sovereignty, so pricing power shifted from producers to consumers.

Record labels were fat and happy living at point A. Fixing prices and bundling songs onto albums they had supranormal profits. They would like to live at point B in the digital economy because rents could increase, if he can capture a disproportionate share of the cost savings. The technology allows consumers to engage in some self-help and the labels must build new business models, which are located at point C. Rents are thin here, but the industry can achieve a stable equilibrium with normal profits. Content producers can survive. Some analysts make the mistake of suggesting that the industry can survive at point D, but it cannot. The costs at point C are real and they must be recovered. Neither the fat and happy copyright holder world of oligopoly rents, nor Internet fairy tale world of free everything should survive long in a dynamic capitalist economy. In the former, entry will compete the ill-gotten gains away and return them to consumers; in the latter exit will cause the rents, and the products, to disappear.

The effort by record companies to keep singles out of the market and to keep CD prices high was a bald effort to continue exercising market power to increase producer surplus by capturing the bulk of the cost savings and preventing consumers from enjoying the benefits of more efficient distribution that would flow to them in a competitive market.

[291] Gopal, Bhattacharjee and Sanders, at 33-37.

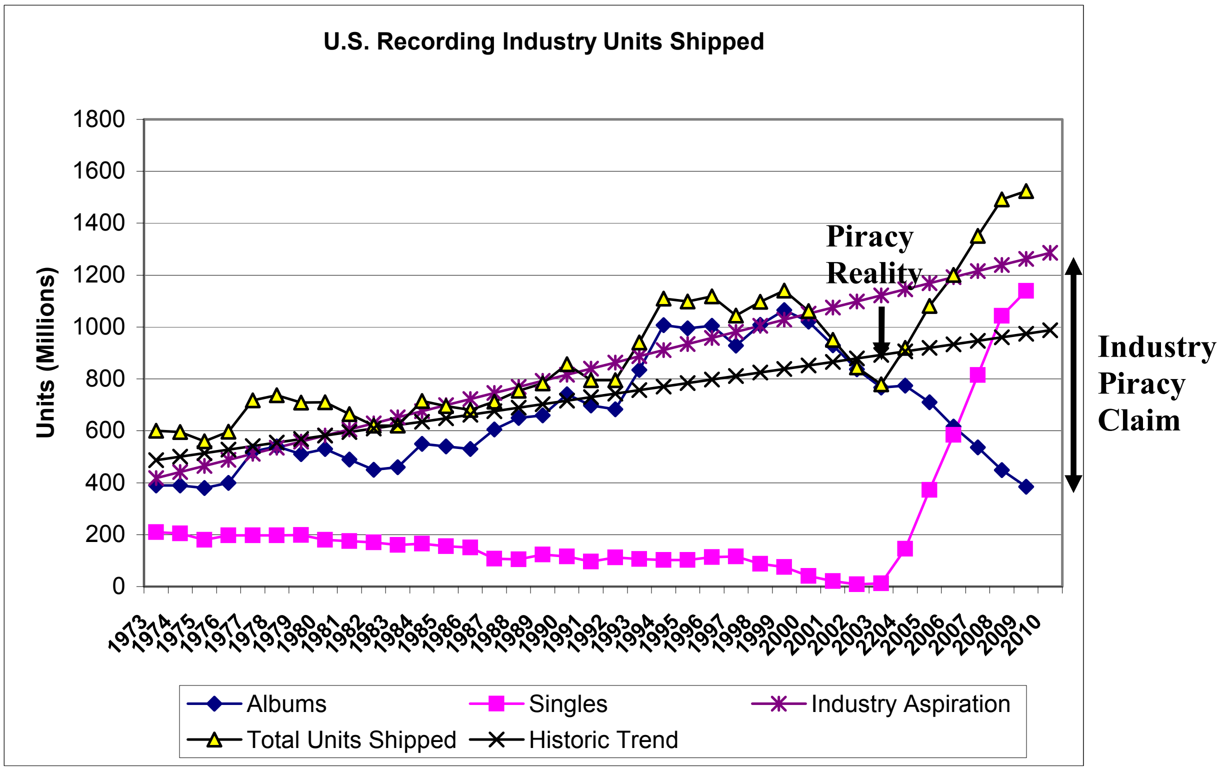
Exhibit II-9:



Pre-digital Oligopoly
Digital Oligopoly
Digital Competitive
Recording Inudstry Supply, Demand & Marginal Revenue
Price
1.8
1.6
1.4
1.2
1
0.8
0.6
0.4
0.2
0
A
B
C
D
1
2
3
Pre-Digital Oligopoly
Digital Oligopoly
Digital Competitive
Free
Quantity
Predigital Marginal Revenue
Predigital Supply
Dgitial Supply
Pre-Digital Demand
Digital Demand
Post-digital Marginal Revenue

Based on a series of assumptions that this paper argues were erroneous, the industry put forward vastly overblown claims of piracy and revenue loss. At the end of the 1990s, the industry assumed that the bubble of sales created by the previous change in formats (from 8-track tapes to CDs) would continue (along the high growth trend line in Exhibit II-10). At the same time, the industry intended to preserve its anticompetitive pricing structure of the mid-1990s that jacked up the price of CDs, in spite of the dramatic reduction in costs made possible by digital production and distribution. It also hoped its policy of forcing consumers to buy bundles of songs rather than singles could be maintained in spite of the advent of digital technology, which dramatically altered the economics of music distribution in favor of singles.

Exhibit II-10:



Source: Recording Industry of America, Annual Statistics, various years. Sources: Recording Industry Association of America, Yearend Statistics: Erik S. Boorstin, Music Sales in the Age of File Sharing, Princeton University, Department of Economics, April 2004. Growth trends are linear projections described in text.

The implications of the analysis of market power and its dissolution under the weight of digital distribution are not well reflected in the Wall Street analyses or the public policy debates in Washington. The high prices that consumers pay and the small share that artists get have been well-known inside the industries for decades. As the dominant firms in these industries seek to defend their market power and gain some policy advantage or economic concessions to “preserve” their business models, the secret is exposed to broader scrutiny. In a world where physical production costs do not exist, advertising costs are lowered because digital advertising is more efficient, and management costs can be lowered because the enterprise is much smaller (i.e. no costly physical production to organize) and management can be decentralized, the prospects for finding a digital business model to produce high quality content are a lot brighter than the picture painted by the industrial incumbents. If the creator is the central concern in public policy analysis (e.g. how do we ensure we have enough quality journalists, authors and musicians producing high quality products) and the cost of providing for them is only 15 percent of the costs of the industrial production model, the challenge looks a lot more manageable. Public policies that bail out the industrial model or allow it to defend itself by leveraging the continuing elements of market power to pursue anticompetitive tactics retard progress and impose unnecessary costs on the public.

III. VERTICAL INTEGRATION AFTER THE REPEAL OF THE FIN-SYN RULES*

*** Updated from, Mark Cooper, and Derek Turner, "The Negative Effect of Concentration and Vertical Integration on Diversity and Quality in Video Entertainment," *Telecommunications Policy Research Conference,* 2007.**

A. Why Repeal of Fin-Syn Deserves attention

1. The Lessons of the Repeal of Fin-Syn Rules For the Comcast-NBC Universal Merger

The importance of the vertical integration issue in the video market became apparent almost immediately after the merger was announced. At one of the first Comcast-NBC merger review hearings, Senator Al Franken reopened an old debate over the need for policy to prevent abuse of market power in the video market by discussing the Fin-Syn rules that had been applied to broadcasting in the period from 1970 to 1993.[292] These rules restricted the ability of national broadcast networks to demand an ownership interest in the programming that appeared on the network and limited the amount of prime time programming that the national broadcast networks were allowed to own. The goal was to ensure that independent programming, not owned by the networks, had a chance to be aired on prime time.

The repeal of the rules in the 1990s led to an immediate and extensive integration of ownership of video content and broadcast distribution and the near elimination of independently produced content from prime time and syndication. In short, the rules had accomplished the goal of deconcentrating ownership of prime time content and their repeal swiftly reversed that outcome.

The discussion of the impact of the repeal of the Financial Interest and Prime Time Syndication Access rules also spilled over into the question of whether the rules had improved the quality of the output and the diversity of the video content, with the repeal of the rules contributing to a decline in quality. This debate is difficult to resolve, because measuring the quality of the output in the video space is challenging. Since the product is a work of art, "beauty is in the eye of the beholder." Moreover, public policy is expressed in terms of goals, like diversity and localism that address process rather than products.

While these rule might seem like ancient history, the issue immediately gained attention because the fundamental questions that the rules addressed are raised by the Comcast-NBC merger. The Comcast-NBC merger represents the first time that a national broadcast network would be owned by a cable operator. Cable is the dominant means of distributing video content in America today and cable has emerged as the dominant means of providing broadband Internet access. Comcast is the largest cable operator and the largest broadband Internet access provider in the nation. While its national market share is just under 25 percent, its share of the local markets where it provides access is well over 50 percent, and even the CEO of Comcast, Brian Roberts, states the cable is a local business.[293] Thus, not only does Comcast have a national market share of distribution that is close to the level any of the major broadcast networks had in 1970, when the Fin-Syn rules were adopted, but also its local market share is much higher.

Combining fundamental questions of the impact of vertical integration on concentration of ownership, quality of output and diversity of content with a unique and dramatic increase in vertical integration of content and distribution are not the only factors that seem to have given the history of Fin-Syn some traction. During the debate over the repeal of the Fin-Syn rules, the

[292] Franken's career at NBC is virtually co-terminus with the period in which the Fin-Syn rules were in force.
[293] Senate Commerce testimony.

network executives gave Congress assurances that independent producers would continue to be a prominent part of prime time programming. Those promises were not fulfilled and the failure to live up to their assurances raises questions about the many promises that Comcast has made in an effort to gain approval of its merger. While the broken promises can be analyzed as political deception, their real import should be seen as the result of perverse economic incentives created by vertical integration. Industry executives could well have intended to preserve the role of the independent content producers and expected them to remain prominent, given the remarkable success that they had experienced under the Fin-Syn rules, but the logic of vertical economics takes over once vertical integration is implemented. Self-dealing is simply more profitable for the acquisition of new product and the repurposing of product through various integrated distribution channels, even if the self-supplied product is inferior. Whether or not the executives intended to mislead legislators is irrelevant, once they owned vertically integrated enterprises, they could not help themselves. They had to eliminate independent production to increase profits.

There is a final historical twist to the Fin-Syn history that makes it relevant to the Comcast-NBC merger. Simultaneously with the Federal Communications Commission adopting the Fin-Syn rules, the Department of Justice had brought an antitrust case against the broadcast networks for monopolizing the prime time TV product space. The FCC's rules were deemed a sufficient response to the problem so the antitrust action was vacated. When the FCC was ordered by a court to reconsider its rules in the early 1990s, it chose not to do so and the DOJ never revisited the decision to vacate the antitrust action. Neither of the agencies is precluded from revisiting this issue by those past actions. Today, both the FCC and the DOJ are reviewing the merger. A coordinated action between them is certainly possible.

Because the Fin-Syn rules have been raised in the current context and because vertical integration in video distribution is such a persistent issue, a review of the impact of the Fin-Syn rules is appropriate both in the context of the merger review and in the broader context of specific remedies to address the paucity of independently produced video content being aired.

The fact that some of the vertically integrated firms created after the repeal of the Fin-Syn rules have decided to loosen the vertical links a little in recent years is no reason for policy makers to drop their concerns about vertical integration or abandon policies that reduce its harm. On the contrary, the speed with which repeal of the Fin-Syn rules led to the total destruction of an extremely productive independent sector and the rapid deterioration of the quality of vertically integrated content are testimony to the need for vigilance in regard to the harmful effects of vertical integration. While public policy generally allows businesses to make mistakes, when the outcomes are certain to harm consumers and competition in the economy and undermine values like diversity that are important to democratic discourse, policymakers have a legitimate interest in preventing the harm, even if it means telling the corporations they cannot do something. These are the principles on which both the antitrust laws and the Communications Act are based, especially in the context of merger review. The antitrust basis of merger review is predictive, focused on preventing harm to competition. The Communications Act is also forward looking in its effort to promote the public interest by fostering localism, diversity and competition.

Over the course of a decade, the content aired on prime time network television, TV syndication, basic and pay cable channels, and theatrical movies came to be dominated by a handful of vertically integrated entities. Dozens of independent entities that produced video content were replaced by a handful of firms that own major movie studios and television production units, hold multiple broadcast licenses and own the dominant cable networks. The role of independent producers has been squeezed across all distribution platforms.

By two widely accepted economic measures of market concentration, the Herfindahl-Hirschman Index (HHI) and the market share of the top four firms (the 4 Firm Concentration Ration or CR-4), the video market has become a concentrated, vertically integrated, tight oligopoly.

The vertically integrated major studios and broadcasters now account for over 85% of broadcast prime time television programming while independents account for less than 15%. The few independents that get on prime time television produce reality shows, not scripted programming. As a result, independents were virtually shut out of the lucrative syndication market, accounting for just one-fifth of all first run syndication programming hours and none of the programming hours for shows that have gone into syndication over the last two years.

The economic terrain of cable television also changed for independents. The vertically integrated media companies own 24 of the top 30 cable channels. The independents' share of pay cable programming also continues to decline as a percentage of programming, dropping by some 15% since the late nineties. Independent product was also squeezed out of syndication. Independent product is increasingly consigned to the far less visible and less financially rewarding basic cable channels where license fees are much lower and in many cases inadequate to cover production costs. Additionally, product placed on basic cable does not have the same potential to realize foreign sales that pay cable product enjoys.

The business practices used to accomplish this dramatic shift in the flow of content in the video product space exhibit characteristics that clearly fit the pattern of abuse of market power. By controlling distribution and vertically integrating into production, five dominant broadcasters firms have become gatekeepers who favored their affiliated content, restricted access of independents to the market, and imposed onerous terms and conditions on independent producers, which has further shrunk the sector.

This oligopoly engages in a number of predatory business practices that foreclose the market to independents by leveraging their vertical market power and self-supplying product. They exercise their market power as buyers of content (monopsony power) with two practices that are especially damaging to competition from independent producers. The first is that networks often demand that they be given an equity participation in an independently developed television series in order for it to be placed on the primetime schedule. The second is that basic cable channels owned by members of the oligopoly will not pay license fees that are commensurate with the production values they demand in independently produced TV movies.

The key elements of the video entertainment product space fit a pattern that the literature on industrial organization describes as the exercise and abuse of market power. These elements include:

Market structure and market power

- Market shares that have risen to the level traditionally defined as a source of concern about concentration setting the stage for the abuse of market power.
- Substantial barriers to entry in the industry.
- A history of anticompetitive practices.

Vertical Integration

- Barriers to entry increased by vertical integration.
- The foreclosure of markets to unaffiliated producers through favoritism of affiliated upstream production and the subsequent exit of upstream product suppliers from the market.
- Parallelism and reciprocity among the dominant firms in the oligopoly.
- A rush to integrate and concentrate across the sector.

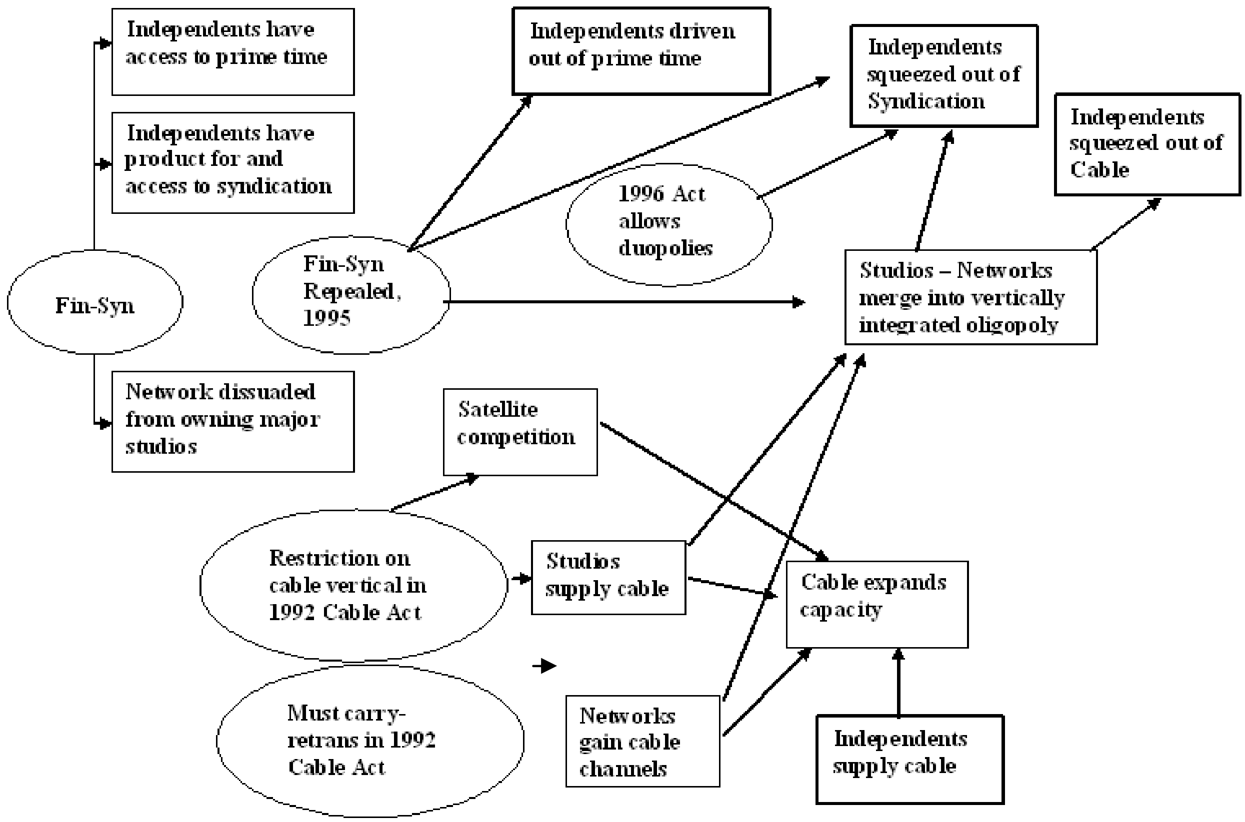
Monopsony (buyer) Power over independent producers.

- The imposition of prices that squeeze unaffiliated producer and terms that shift risk onto those producers.
- Indications of a decline of quality in product attendant on the abuse of monopsony power.
- Flooding of downstream outlets with integrated product.

B. THE EMERGENCE OF A VERTICALLY INTEGRATED VIDEO OLIGOPOLY

Exhibit III-1 identifies the key policy changes (ovals) and the structural and conduct changes that followed (rectangles) in the 1990s. The primary policy that triggered the vertical integration in the industry was the repeal of the Financial and Syndication Rules by the Federal Communications Commission. In retrospect, it is quite clear that the Financial and Syndication rules, which restricted the amount of broadcaster-owned programming in prime time, had a major effect on the diversity of not only the broadcast television market, but also television in general. When the rules were eliminated in the mid-1990s, broadcasters moved to replace the lion's share of independent programming with content they produced. Self-dealing became the predominant mode of operation, which led to the merger of networks and studios.

Exhibit III-1:
The Impact of 1990s Policy Changes on Independents in the Television Market



The impact was more profound than the direct effect on prime time for an ironic reason. At the time that the Fin-Syn rules were relaxed, restrictions on vertical integration in the cable industry were implemented. Cable operators were restricted in the percentage of capacity on their systems they could fill with programming they owned. In the Cable Consumer Protection Act of 1992 they were also required to make their own programming available to competing delivery systems (the program access rules). As a result of the improved access to programming, satellite competition, which had been anticipated in the 1984 Cable Act, finally increased its market share. Satellite was a digital technology with greater capacity than cable. The cable industry responded by deploying its own digital capacity. Thus, just as the broadcast space was closing, the cable space opened for the major studios (majors) and independents. Given their structure, cable operators could not provide nearly all the programming that a 24/7 channel required. The studios, which had been prevented from integrating with broadcasters, funded and supplied programming for cable channels. A substantial market for independent movie production opened up.

Majors and independents were not the only beneficiaries of the 1992 Cable Act. The Act also gave the broadcasters a wedge into the cable platform, with the must carry/retransmission rules. Cable operators needed to carry the major broadcast networks to make their basic subscription packages attractive to the public. Without the networks, they would b slow to gain subscribers. The Cable Act of 1992 gave the broadcasters bargaining power over the cable operators. They could insist on a high fee for their national networks or they could negotiate for carriage of other programming. Must-carry and retransmission were government granted rights of carriage, means of ensuring access to audiences. The broadcasters chose to bargain for more channels on cable systems, rather than charge for their broadcast networks.

The 1996 Telecommunications Act reinforced this process. The Act allowed the FCC to lift the ban on horizontal concentration in the television industry. Broadcast licenses had been limited to one per entity in each market. The 1996 Act allowed the FCC to award more than one license per market after it had considered its impact on the industry. The FCC chose to allow duopolies in markets in which there would be at least eight "voices" in the market after the merger of two stations. Generally, the largest markets were opened to duopolies under the reasoning that diversity would be preserved in those markets.

For independents that sold product into TV syndication, this change had the opposite effect. By allowing the broadcast networks to own two stations in the most important markets – especially New York, Chicago and Los Angeles – a second major outlet was pulled into the tightening, vertically integrated core. The new owners of the second station now had a great deal of content of their own, since over the course of a decade, every major network acquired one of the major studios. Vertical integration became complete. Syndication was more difficult because access to the most important markets became much more difficult.

Within less than a decade after repeal of Fin-Syn and the passage of the 1996 Telecommunications Act, the process of vertical integration and horizontal consolidation was complete (se Exhibit III-2). There were two flurries of consolidation activity, one in the second half of the 1980s after changes in policy at the FCC and one triggered in the 1990s by the major policy changes discussed above. Fowler had declared that television is "just a toaster with pictures" and set out to eliminate many of the horizontal restrictions on ownership, which would change the incentives for vertical integration. Congress restrained the extent of change, but there were significant relaxations and economic activity flowed through the gate that had been opened.

EXHIBIT III-2: CREATION OF A VERTICALLY INTEGRATED VIDEO OLIGOPOLY

	News Corp./Paramount	Time Warner	Viacom/CBS	GE/NBC/universal	ABC/Disney	Other
1985	Buys Metromedi basis for Fox	Turner buys MGM		GE Buys RCA	Cap Cities Buys ABC	
1986			Natrional Amusement Acquires Viacom			
1987						Sony buys Columbia
1989		Time & Warner merge (TW)				
1990				Matsushita buys Universal		
1993	Buys NY Post	US West buys part of TW	Buys Paramount, Blockbuster		Disney buys Miramax	TCI buys Liberty
		Turner buys Castle Rock & New Line	Buys Blockbuster			
1994		TW buys CPP/Belwin				Cox buy Times Mirror
1995		TW buys Houston Industries	Westinghouse buys CBS	Seagrams buys MCA (U)	Disney buys Cap Cities (ABC/D)	TCI buys Vicacom cable MSO
		TW buys Turner	Westinhouse buys CBS			
			UPN launched			
1996	Buys New World		Buys Infinity			US West buys cable MSOs
						Tribune buys Renaissance
						Belo buys Providence Journal
1997	Buys Burnham		Buys American Radio			Microsoft buys part of Comcast
			Westinghouse buys Gaylord			TCI buys part of Cablevisoin
1998		AOL buys Netscap		Seagram buys Polygram		ATT buys TCI
1999		atHome buys Excite	CBS buys Kingworld	NBC buys part of Paxson		DirectTV buys Primestar
		Columbia House merges with CDNow	Viacom & CBS merge			Charter buys Bresnan
						ATT buys MeidaOne
						Cox buy sGannet cable, TCA, Media General
2000	Buys 10 stations from Chris Craft	TW & AOL merge	Buys BET	Vivendi buys Seagrams		Trinbune buys Times Mirror
2001				Vivendi buys USA Net	Buys Fox Family	
				NBC buys Telemundo		Comcast buys ATT Broadband
2002		TW buys out ATT creates TW cable		NBC buys Bravo		Univision buys Hispanic
2003	Buys Hughes			GE buys Vivendi		
2005			Buys Dreamworks			
2006		CW created with Viacom/CBS	CW create with TW		Buys Citadel, Pixar	Comcast/TW swap cable MSOs
		Buys part of Adelphia				

Five firms have come to own major studios, broadcast networks and cable TV channels while holding television station licenses as well (see Exhibit III-3).[294] The names are familiar to all in both the television and the theatrical movie space. All of the entities have a presence in each of the major video entertainment areas – network television, cable television and movie production. These firms account for five of the seven studios that produce motion pictures – known as the majors[295].

The 1990s policy changes triggered a series of acquisitions and product developments over the course of the decade that created a vertically integrated oligopoly in the television industry. Most directly, the networks could monopolize access to audiences in prime time broadcast television, foreclosing the streams of revenue that sustain production of all forms of content.

Each of the big three networks merged with a major studio and acquired cable programming over the course of the 1990s. Fox had taken a different path to vertical integration. After being rebuffed in an effort to acquire Warner studio, News Corp. acquired Twentieth Century Fox and a number of television stations in major markets, both in 1985. Since the late 1970s, Twentieth Century Fox had been one of the least active of the major studios in providing television programming. Fox's focus through the 1990s would not be on original programming as traditionally defined for prime time. It would focus on sports in programming and broadcast duopolies. Interestingly, Fox was vertically integrated but remained below the threshold for being subject to the Fin-Syn rules. For the big three networks who were subject to the rules, the repeal of Fin-Syn made mergers between networks and studies profitable, as self-supply was now allowed

[294] The depiction and data are for the early 2000s. While there have been some changes in the direction of deintegration that movement is not complete and its implications are not yet clear. CBS/Viacom have become partially separated. CBS/Viacom still share the same President and CEO and each of the two potential entities is vertically integrated, with production and distribution facilities. Similarly, Fox and Liberty are still intertwined by substantial ownership of shares. These situations may change the landscape somewhat, but the distribution the separate entities would have would reflect the legacy of vertical integration. Thus, we may see these entities unwind toward true, deintegration and independence, although the history of Liberty teaches that spin-offs and pull-backs are entirely possible. Moreover, whether these developments will constitute a true opening of the field to independents, or simply use contracts to replace the integrated flow of content also remains to be seen. Nor is it clear that the parts that have been broken up will not use their remaining partially integrated assets (production and distribution) to reintegrate across the entire space (Grove, Martin A., "CBS' Moonves Smart to Eye Movies," *Hollywood Reporter.com,* July 7, 2006). The effects of any real de-integration, if it comes about, will play out over time.

[295] These changes did not take place instantaneously, but unfolded over a number of years for several reasons. When a policy change takes place, it frequently takes a period of time for regulators to implement legislated requirements. Parties will frequently litigate such changes and move slowly until the legal terrain is clear. Further, existing business relations must unwind. Contracts run their course and new models are developed. Finally, because many of these policies are highly visible political decisions, market participants try to avoid triggering a political reaction with extreme moves.

Exhibit III-3: The Vertically Integrated, Video Entertainment Oligopoly Circa 2006

Parent	Television Property	Cable/Satellite	Film Production
News Corp.	35 TV Stations reach 39% of U.S. Households 9 duopolies – NY, LA, Chic. Minn. D.C. Dallas, Phoenix Orlando, Houston Fox Network	Fox News, Fox Movie FX, FUEL, Nat. Geog. Speed, Fox Sports, Regional Sports, College, Soccer DirecTV	20th Century Fox, Fox Searchlight, Fox Television S, Blue Sky Studios
General Electric	27 TV stations reaching ~30% of U.S. households 6 duopolies through Telemudo – NY, LA, Chic., SF, Dallas, Miami NBC Network 30% of Paxson	CNBC, MSNBC, Bravo, Sci-Fi, Trio, USA	Universal
Disney	10 TV stations reaching X% of U.S. households ABC Network	ESPN, ABC Family, Disney Channel, Toon Disney SAOPnet, Lifetime A&E	Walt Disney Touchstone Hollywood Buena vista Pixar Miramax
CBS/Viacom	17 TV stations reaching 39% of U.S. households CBS Network CW King World	Showtime MTV, Nickelodeon BET, Mick at Night TV land, Noggin Spike TV, CMT Comedy Central, Flix The Movie Channel Sundance	Paramount Paramount Home
Time Warner	CW Network	HBO, CNN, Court TV, Road Runner New York News 1 Time Warner Cable 14.5 million subscribers	Warner Bros. Studios, TV Home Video Domestic Pay-TV Telepictures, Hanna- Barbera Witt-Thomas,

Source: Columbia Journalism Review, *Who Owns What,* August 22, 2006.

C. MARKET STRUCTURE

Note that each of the entities has a presence in all of the key areas of video product production and distribution (see Exhibit III-4). Each owns studios that produce video product for both television and theatrical release. Each has a substantial ownership of television distribution. The four national broadcast networks are represented here. The broadcasters have substantial ownership of TV stations. The fifth entity, Time Warner, is a major cable operator.

As a result of the recent Adelphia acquisition and exchange of cable systems with Comcast, Time Warner dominates the two entertainment centers in the U.S., New York and Los Angeles. It also has a share in the new broadcast network, CW, to which its production operations are providing content. Each of the five also has substantial cable offerings. Indeed 24 of the top 25 cable channels, as measured by homes passed, are owned by these five entities. In terms of actual viewers, as opposed to homes where programming is available, these five entities account for the vast majority – as much as 85 percent of prime time viewing.

Reflecting this concentration of subscribers, viewers and facilities, these five, vertically integrated entities have come to dominate the domestic U.S. video entertainment product space (see Exhibit III-4). They accounted for about three quarters to four-fifths of the output of the video product in terms of writing budgets, programming expenditures, hours of prime time content, and domestic theatrical box office or video sales/rentals. In each case, the HHI is in the concentrated range and the four firm concentration ratio is in the tight oligopoly range.[296] The networks have also concentrated their control over TV stations in the largest markets.

First, as shown in Exhibit III-5, the four major broadcast networks concentrated their station ownership in the top twenty-five markets. The big four networks (CBS/Viacom, Fox/News Corp., ABC/Disney; NBC/Universal), still constrained by the national cap on station ownership, own about 10 percent of the commercial, full power television stations in the nation. However, they own about 30 percent of the stations in the top twenty-five markets. They achieve their high level of national coverage by concentrating on the larger markets. The coverage numbers in Exhibit III-5 count UHF stations at full value, since most such stations have carriage on cable systems and their signal strength is no longer an impediment to coverage. However, the coverage numbers in Exhibit III-5 do not count duopolies, so they underestimate the prominence of big four in the major markets. The big four networks have almost two dozen duopolies in the top twenty-five markets. They also tend to be the highest rated stations.

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[296] The two potential changes in the sector mentioned above in note 37 (the CBS/Viacom Split, and the Liberty Media changes) would not change this basic finding. Each of the measures of concentration would likely remain in the concentrated tight oligopoly range, but the identity of the leading firms might change a bit.

Exhibit III-4: Vertically Integrated Video Oligopoly Domination of Television and

Production and Distribution (Circa 2006)

	TELEVISION							MOVIES/DVD (U.S. Revenue)	
	Subscribers*		Writing Budgets		Programming Expenditures		Share of Prime Time	Box Office	Video
	# Million	%	$ Million	%	$ Million	%	%	%	%
FOX/LIBERTY	1250	21	236	19	3803	9	3	11	10
TIME WARNER	925	15	206	17	7627	18	10	22	20
CBS/VIACOM	910	15	45	12	9555	22	28	8	7
ABC/DISNEY	705	12	132	11	6704	16	21	20	22
NBC/Universal**	720	12	159	13	3879	9	21	12	15
Subtotal	4315	75	772	72	31568	74	83	73	74
TOTAL	6000	100	1225	100	43212	100	100	100	100
HHI	**1179**		**1084**		**1226**		**1775**	**1213**	**1258**
FOUR FIRM CR	**63**		**61**		**65**		**70**	**65**	**67**

Notes: and sources: * Subscribers includes broadcast and cable homes passed. ** Universal added to NBC to project post-merger market. Federal Communications Commission, In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming, CC Docket No. 00-132, Seventh Report, Tables D-1, D-2, D-3, D-6, D-7; Television Market Report: 2001 (Washington, D.C.: BIA Financial Network, 2001); Comments In the Matter of 2002 Biennial Regulatory Review –MB Docket No. 02-277, MM Dockets 02-235, 01-317, 00-244, January 2, 2003, Bruce M. Owen and Michael G. Baumann, "Economic Study E; Concentration Among National Purchasers of Video Entertainment Programming," Comments of Fox Entertainment Group and Fox Television Stations, Inc., National Broadcasting Company, Inc. and Telemundo Group, Inc., and Viacom; Comments of the Writers Guild of America Regarding Harmful Vertical and Horizontal Integration in the Television Industry, Appendix A. Federal Communications Commission, In the Matter of Implementation of Section 11 of the Cable Television Consumer Protection and Competition Act of 1992 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; Federal Communications Commission, Program Diversity and the Program Selection Process on Broadcast Network Television, Mara Epstein, Media Ownership Working Group Study 5, September 2002, pp. 26. David Waterman, Hollywood's Road to Riches (Cambridge: Harvard University Press, 2005), pp. 21, 25.

Exhibit III-5: Concentration of National Networks on Major Markets

	Number of Stations		% of Stations in Top 25	National Reach (% of Pop.)
	Total	Top 25 Markets		
Big 4 Networks	**110**	**78**	**71**	**37.8**
Next 4	**138**	**77**	**44**	**45.2**
3rd 4	**125**	**34**	**27**	**20.2**
Next 4	**116**	**23**	**20**	**13.11**
Next 4	**84**	**14**	**8**	**9.4**

Source: William M. Kunz, *Culture Conglomerates* (New York, Rowman and Littlefield, 2007), p. 88

I have noted that the decision to allow broadcasters to hold multiple licenses in a single market contributed to the difficulties of independents gaining access to the syndication market. The network owners would use their internally produced content on the television stations in the largest markets, squeezing the space available to unaffiliated producers. About 75 duopolies were created soon after the ban on holding multiple licenses was lifted (see Exhibit III-6). The national networks concentrated their duopoly acquisitions in the top ten markets, even though owning multiple stations within a market did not count against the national cap on how many homes they were allowed to reach. These markets account for about 30 percent of all the TV households in the country and almost 40% of all the TV revenues in the country. The big fours market share in the top three markets was particularly high. These three markets alone account for about 15 percent of the population and almost 20 percent of TV revenues in the nation.

This gives the big four network owners a disproportionate clout in the video market because these entities control multiple outlets in the most important markets. It is not only prime time programming that they control, but also syndication. Lacking content, because they are banished from prime time, independent producers, to the extent the have content, such as movies, confront the same handful of vertically integrated firms in the syndication market, who have a strong incentive to favor their own content. By gaining large market shares in the largest markets they get disproportionate leverage over the syndication market.

Exhibit III-6: Big 4 Network Duopolies and Market Share in Top 10 Markets

Designated Market Area	Number of Big 4 Duopolies	Market Share Big 4 Duopolies	Total Market Share of Big 4
New York	2	44	77
Los Angeles	3	62	79
Chicago	2	40	73
Philadelphia	1	25	57
San Francisco	2	37	56
Boston	1	28	42
Dallas	3	59	59
Washington D.C.	1	27	52
Atlanta	0	0	24
Detroit	1	24	42

Source: BIA Financial, *Television Market Report,* 2003

D. DOMINATION OF THE TELEVISION PRODUCT SPACE

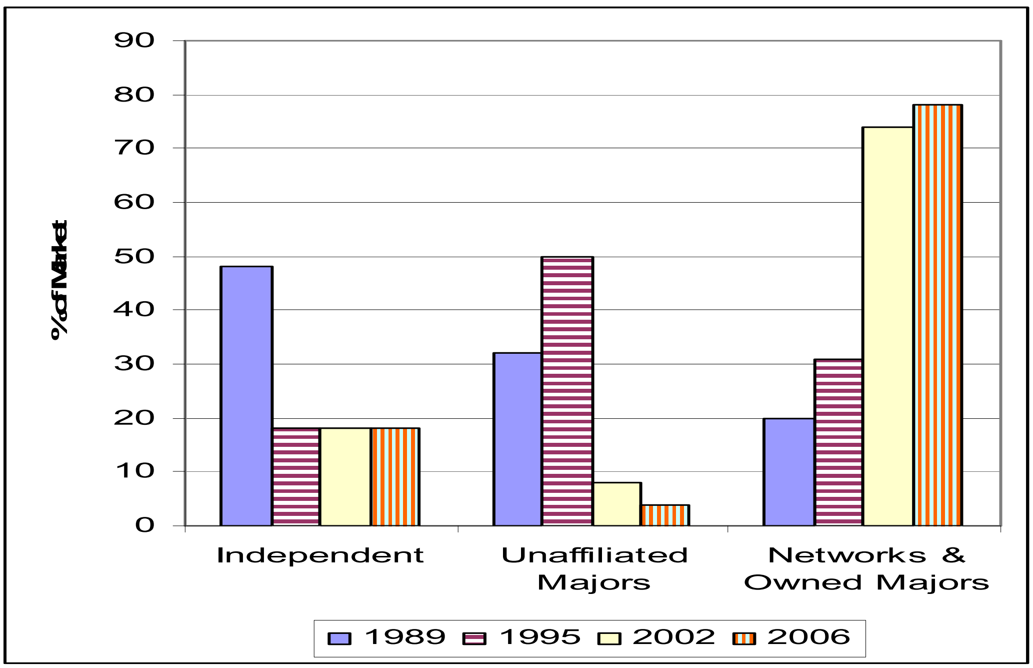
1. BROADCAST/NETWORK TELEVISION

Prime Time

The central empirical fact at the core of the narrative of the 1990s is the dramatic and swift change in the ownership of prime time programming after the repeal of the Fin-Syn rules (see Exhibit III-7). Studies of prime time programming just prior to the repeal of the Fin-Syn rules find that the networks owned around 15 percent of shows aired in prime time.

Exhibit III-7:

Prime Time Market Shares



Source: 1989-2002 calculated from Mara Einstein, *Media Diversity: Economics, Ownership and the FCC* (Mahwah: Lawrence Erlbaum, 2004), p. 169; 2006 based on Baseline Research, *Fall Television Schedule: 2006-2007 Season.*

Major studios owned about one-third and independents accounted for about a half. Within five years, the role of the independents had been dramatically reduced – to less than one-fifth of the programming. Networks had grown to almost 40 percent. The major studios still accounted for around 40 percent. The mergers of the networks and studios followed and the vertically integrated entities came to dominate prime time, accounting for over three quarters of the programs. In 1989, fifteen entities produced 2 percent or more of the programming on prime time. By 2002, that number had shrunk to five. The programming produced by independents in 2006 was largely reality shows, not scripted programming, as had been the case in the past.

Traditional measures of market concentration used in economic analysis reinforce this observation. As Exhibit III-8 shows, the prime time market moved very quickly from an unconcentrated competitive market (CR4=34%; HHI=541) to a tight oligopoly (CR4=74%) well up into the moderately concentrated range (HHI=1596). If the calculations are based only on series, i.e. excluding movies, the concentration is even greater. Within a decade after the repeal of Fin-Syn, the market was a highly concentrated (HHI=2070) tight oligopoly (CR4=84).

Exhibit III-8: Concentration of Prime Time Programming

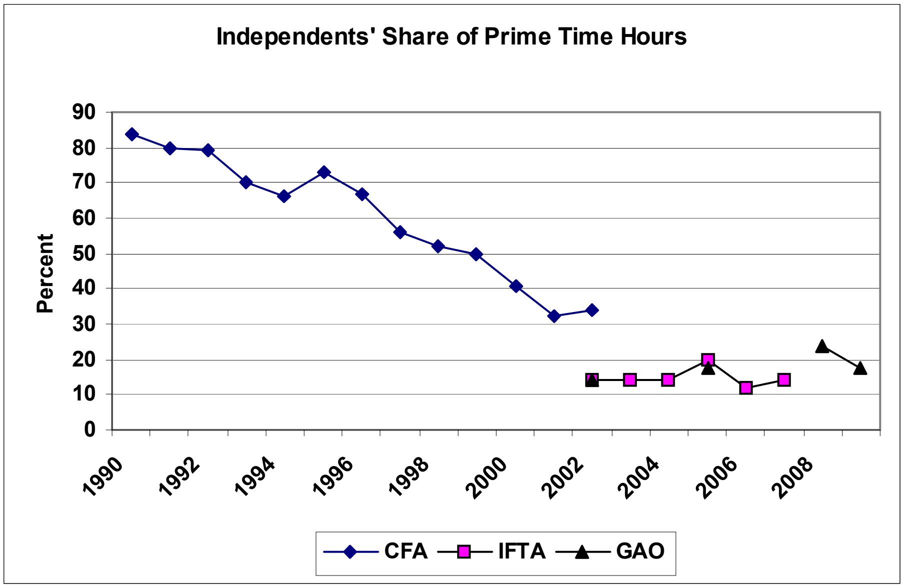
Year	Four Firm Concentration	HHI	Four Firm Concentration	HHI
All Prime Time Hours			Series only	
1989	35	541	40	703
1995	47	776	57	1165
2002	74	1596	84	2070

Source: Calculated from Mara Einstein, *Media Diversity: Economics, Ownership and the FCC* (Mahwah: Lawrence Erlbaum, 2004), p. 169.

As the vertically integrated networks came to dominate prime time, independents were pushed out of prime time, as Exhibit III-9 shows. As ownership has become more complex, estimates of the role of independents vary according to the definition of who is an independent, but there is agreement that the percentage plummeted.

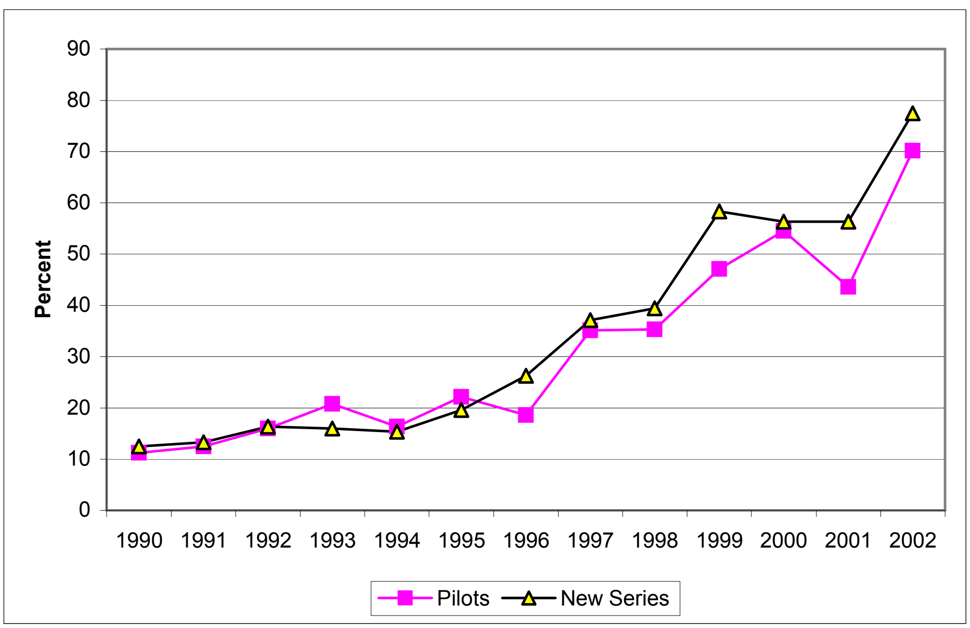
Exhibit III-10 shows the pattern of ownership by the networks of prime time programming, new shows and pilots. We observe a modest increase in network ownership in the early 1990s, as the Fin-Syn rules were partially repealed, debated and litigated. With final repeal of the rules in 1995, we see a rapid and steady increase in network ownership.

Exhibit III-9:



Sources: CFA: Mark Cooper and Derek Turner, 2007; IFTA: Comments of the Independent Film & Television Alliance, *In the Matter of Preserving the Open Internet Broadband Industry Practice,* Federal Communications Commission, GN Docket No. o0-91, WC Docket No. 07-52, January 14, 2010; GAO: GAO, *Media Programming: Factors Influencing the Availability of Independent Programming in Television and Programming Decisions in Radio,* March 2010.

Exhibit III-10: Network Ownership of New Shows and Pilots



Source: Calculated from Mara Einstein, *Media Diversity: Economics, Ownership and the FCC* (Mahwah: Lawrence Erbium, 2004), p. 171; William T. Bielby and Denise D. Bielby, "Controlling Prime Time: Organizational Concentration and Network Television Programming Strategies," *Journal of Broadcasting & Electronic Media,* 47: 4 (2003), p. 588.

Syndication has been studied less than prime time, but the available data suggests a similar pattern (see Exhibit III-11). Although there is less self-dealing, the five networks dominate the syndication market because of a large amount of internal dealing. Particularly interesting to note is the lack of recent independent shows in syndication. Having been forced out of prime time, independents simply do not have series to place as product in syndication.

Exhibit III-11:
Self-Dealing and Internal Dealing in First-Run Syndicated Programming (2004)

TYPE OF TRANSACTION	**HOURS** All Shows	**Shows Less Than 2 Years Old**
Self-Dealing (Subsidiaries of Big 5 syndicating to themselves)	32%	61%
Internal Dealing (Subsidiaries of Big 5 syndicating to unaffiliated Big 3 station groups)	41	16
Independents syndicating to Big 3 Station Groups	18	0

Sources and Notes: Calculated from Goro Oba and Sylvia M. Chan-Olmstead, "Self-Dealing or Market Transaction?: An Exploratory Study of Vertical Integration in the U.S. Television Syndication Market," ***Journal of Media Economics,*** **19 (2), 2006, p. 113. Big 3 station groups are CBS/Viacom, Fox and ABC Big 5 syndicators are King World, Paramount, 20th Century Fox, Buena Vista, WB and Universal. Other Major is Sony (Columbia). Independents are "other." There are 22.5 hours per week of first-run syndicated programming in the 9am to 8pm day part analyzed (77 hours).**

The foreclosure of the broadcast/network television market, particularly for 1st run series, is reinforced by a complete lack of pilots coming from independents. Interviews with independent producers done for this paper reveal that since there is little chance that they will get on the air, they have abandoned this market.

2. Cable

The leveraging of retransmission rights to gain carriage has been an often told and well-documented story that does not need to be repeated here. Data clearly show that broadcasters are disproportionately likely to get carriage,[297] as does the anecdotal evidence of carriage battles in which broadcasters prevailed.[298]

A different element of the vertically integrated video conglomerates that is embedded in Exhibits III-2, III-3 and III-4, above, but which needs highlighting, is the critical role that repurposing content from broadcasting to cable plays. Broadcasting, with its much larger audience, is where brands and franchises are made. Vertically integrated owners can than use their marquee broadcast programming to launch national cable channels. The examples involve the launch of the most prominent national cable networks – Fox-FX- *X-Files*; Warner-TNT-*ER*; CBS-Spike- *CSI,* NBC-Bravo, *West Wing*; NBC-USA-*Law & Order*, ABC-Family-*Alias;* ABC-ESPN- ABC Sports.[299]

Independent programmers do not have this possibility. In other words, the cable space may look crowded and like an opportunity for entry, but the playing field is not level. The vertically integrated firms with broadcast product and retransmission rights dominate the field of general, national cable programming.

The evidence compiled in the Cable A la Carte Proceeding[300] and the Adelphia merger is testimony to the remarkable cross-platform dominance that has resulted from the mix of policies adopted in the early 1990s. The dominance of the cable dial by the big five can be seen in a variety of ways. First, they assemble "program suites" that cover the major demographic groups and product categories (see Exhibit III-12).

This has enabled them to capture audiences on both platforms (see Exhibits III-13). Dominating the top 25 cable networks (see Exhibit III-14), they can then dominate the cable advertising revenue. As discussed above, these five entities have a 70 to 80 percent market share of everything video – prime time hours, cable subscribers, cable viewers, programming budgets, writing budgets, theatrical sales, and DVD sales and rentals.

3. TV Movies, the Role Of Cable

The history of prime time programming is primarily a story about television series. While a small number of made for TV movies appear in prime time, the overwhelming majority of programming is series. Interestingly, for independents, the growth of cable in the late 1990s was a story about TV movies.

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[297] GAO *Issues Related to Subscriber Rates in the Cable Television Industry, October 2003, Appendix V.* See "Reply Comments of Consumers Union and the Consumer Federation of America," *In the Matter of Comment Request on a La Carte and Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems,* MB Docket No. 04-207, August 13, 2004, pp. 8-9 for additional references.

[298] Kunz, William M. Kunz, *Culture Conglomerates* (New York, Rowman and Littlefield, 2007), pp. 205-208.

[299] Kunz, pp. 134-135; 194-195.

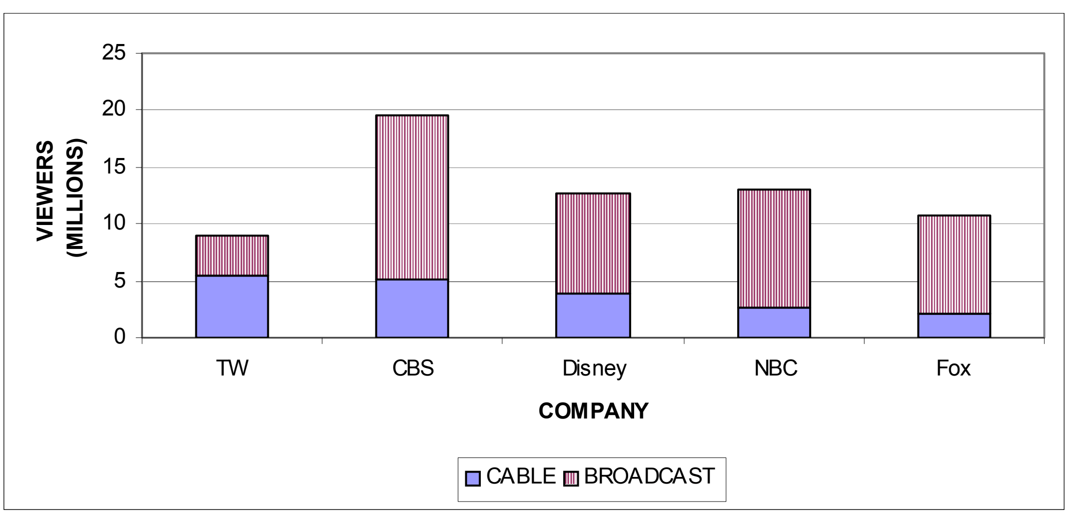
[300] See Reply Comments of Consumers Union, 2004; See Reply Comments of Consumer Federation of America and Consumers Union, in the Matter of Applications of Adelphia Communications Corporation Comcast Corporation and Time Warner Cable Inc., For Authority to Assign and/or Transfer of Control of Various Licenses, MM Docket No. 05-192, August 8, 2005.

Exhibit III-12: Suites of Big Five Programmers Cover Major Types of Programming Circa 2004

	ABC	NBC	CBS	TW	FOX
GENERAL	ESPN Lifetime	USA	NICK	TBS TNT	(Fox Sports)
NEWS	(ABC news)	CNBC MSNBC	(CBS news)	CNN	FOX News
EMERGING MASS	Family	SciFi	TV Land	Court	
OLDER TRENDING	A&E Bravo History			(TCM)	(FMC)
YOUNGER TRENDING	Disney (Toon Dis)		Comedy (TOON) MTV NickToons	FX	
EMERGING NICHE	(LMN) (Soapnet) ESPN2 ESPN Class		BET Jazz CMT Spike VH1 VH1 Class VH1 Count MTV2, MTV Espan MTV Hits Nick Gas Noggins	Oxygen	Speed Nat. Geog

"Comments of American Cable Association," ***Inquiry Concerning A La Carte, Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems,*** **MB Docket No. 04-207, July 12, 2004.**

Exhibit III-13:
Top Network Suites by Prime Time Household Viewership



Source: Duetsche Bank Securities Inc., ***Walt Disney Company: After Further Review… ESPN Still Has The Leverage Over Distributors,*** **October 27, 2003.**

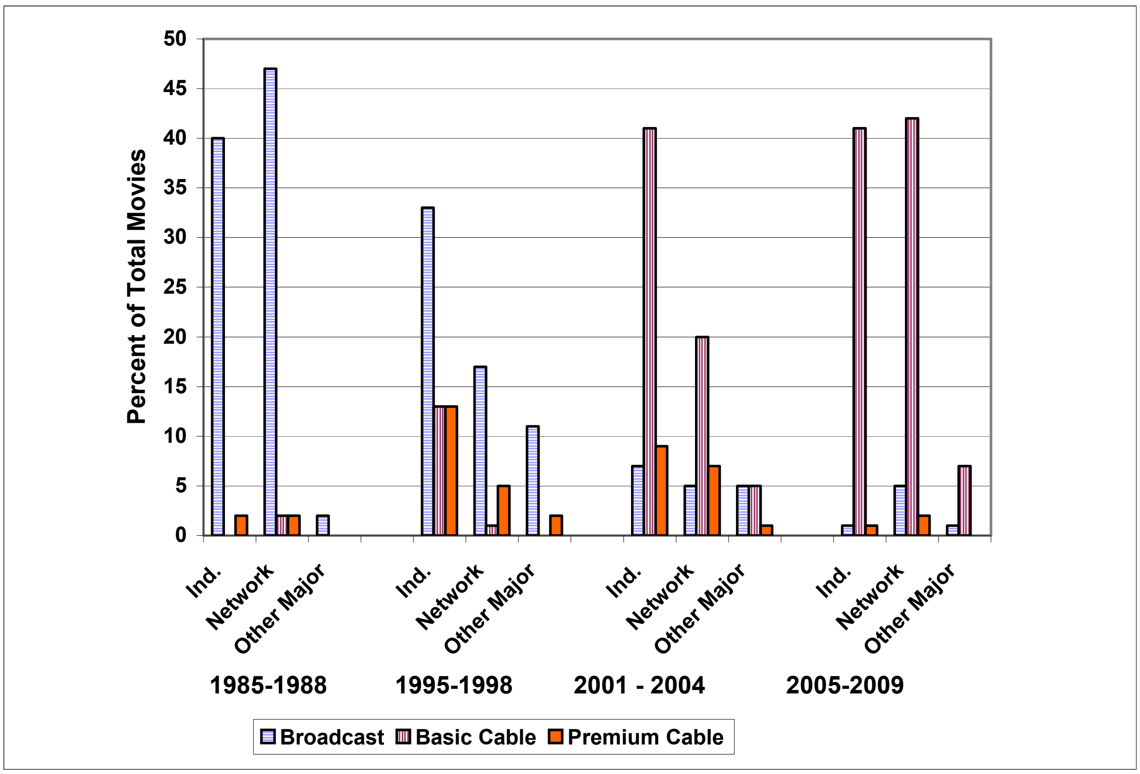
Exhibit III-14: Top Channels and Shows, 1993-2005

Channel	1993 Rank Subs.	1993 Rank Prime Time	2005 Rank Subs.	2005 Rank Prime Time	Owner
ESPN	1	4	2	12	ABC/Disney
ESPN2			13		ABC/Disney
CNN	2	12	4	7	AOL-TimeWarner
USA	3	1	6	4	Liberty
Nickelodeon	4	6	9	1	CBS/Viacom
Nick at Nite				3	CBS/Viacom
Discovery	5	10	1	14	Liberty
TBS	6	2	9	8	AOL-TimeWarner
TNT	7	3	4	2	AOL-TimeWarner
CSPAN	8		6		Cable Group
MTV	9	13	18	13	CBS/Viacom
Lifetime	10	7	11	6	ABC/Disney
TNN	11	11			CBS/Viacom
Family	12	8	20		ABC/Disney
A&E	13	9	11	8	ABC/Disney
Weather	14		13		
HDLN New	15		18		AOL-TimeWarner
CNBC	16	18			NBC
VH-1	17	20			CBS/Viacom
QVC	18	16	15		COMCAST
AMC	19	19			CABLEVISION
BET	20	14			CBS/Viacom
Cartoon		5			AOL-TimeWarner
SCI-FI	5	5		15	Liberty
TLC			15		Liberty
History				11	ABC/Disney
Disney				5	ABC/Disney
Toon Disney				7	ABC/Disney
Fox News				10	Fox
Spike			9	9	CBS/Viacom
HGTV			18		

Source: Federal Communications Commission, Video Competition, First and Tenth Annual Reports.

To analyze the changing patterns of TV movies, I examined all films aired in three four-year periods (see Exhibit III-15). The first period was before the Fin-Syn rules were in play (1985-1988). The second period was the four years after Fin-Syn was repealed (1995-1998). The third period was after the networks became integrated with studios (2001-2004. The pattern of broadcast movies follows the pattern we observed for series. The independents played a large role under Fin-Syn, were diminished immediately after repeal of Fin-Syn and then reduced dramatically within a decade. Their share in premium movies grew in the mid-1990s, but was reduced after the integration of the studies. In this category, there was also a shift for independents from HBO to Showtime.

Exhibit III-15: Movies Aired on Video Outlets



Source: Baseline Beta Studio Database 1985-2004; IFTA comments 2005-2009

In the most recent period, cable movies have become quite prominent. The numbers of movies produced have increased dramatically. In the mid-1990s, independents aired about 120 movies, 95 of them on broadcast and premium cable. In the 2005-2009 period, they produced just 14 movies on broadcast and premium cable, and 328 on basic cable. The apparent increase in production, however, is less significant than it appears. There are two different sets of reasons that the expansion has not helped independents greatly. One set has to do with the nature of the business and the distribution channels.

First, broadcast and premium movies have much higher budgets and larger audiences. Thus, the 27 movies produced by independents that aired on broadcast and premium cable probably had a total budget that was equal to almost half of the total budget the 328 movies that aired on basic cable and an audience that was (xx) percent of the total audience of the basic cable movies.

Second, where studios compete for resources to maintain a production base, the relative output is important. Whereas the independents declined by about 85 percent between the mid 1990s and the 2004-2009 period in the high value spaces, the networks and major studios grew by almost 60 percent. As the networks grew larger and larger, they control more resources in the sector.

Third, placement on basic cable makes it more difficult to tap into other revenue streams – DVD sales/rentals and foreign television – which have become vital to maintaining the program's prominence.

The second set of factors that suggests the growth of basic cable, as an outlet is less important than it appears has to do with the market structure.

First, approximately 70 percent of the basic cable movies are aired on networks that are owned by two of the vertically integrated media corporations – ABC/Disney (ABC family, Disney Channel and Lifetime) and NBC (Sci-Fi) – in the s004 to 2009 time period.

Second, the genres are highly specialized. These cable networks buy three genres and there is essentially only one buyer for each. ABC Family/the Disney Channel buys family/children-oriented movies. Lifetime buys romances. Sci-fi buys horror films. This is a classic situation for the exercise of monopsony power.

Third, the vertically integrated oligopoly that dominates the other video outlet spaces also thoroughly dominates the TV movie space. The five entities I have identified account for about three-quarters of the distribution of movies one –third through broadcast and premium cable, a little over one-third through basic cable, and another handful of movies on more general networks (A&E, MTV, ESPN, FX, Spike).

E. THE CRITICAL ROLE OF GATE KEEPING IN THE VIDEO PRODUCT SPACE

1. The History of Movies and TV

At the center of the picture I have painted of vertical integration following the policy decisions of the 1990s stands the broadcasters as gatekeepers of access to audiences. A key role in the process was played by the absorption of the major studios. Interestingly, David Waterman's economic history of the major studios is based on the premise that

> the most important feature of the studios is their role as *distributors,* and we often refer to them by that term. By controlling distribution, the studios act as gatekeepers: they decide which movies get produced and how they are made,

> and they also largely determine when and at what price viewers get to see them on which media.[301]

The historic role of vertical integration in the movie industry and the effects of policy underscore the enduring importance of these aspects of video industry structure. The key gate-keeping role of distribution in the movie industry depended upon integrated and consolidated entities in the first half century of the existence of the movie industry. While there is a debate about the factors that shaped the role of the major studios, Waterman pinpoints two critical issues that parallel the core of my analysis of the video product space in the 1990s. One was a policy decision that forced deintegration.

> Fox, MGM, Warner, Paramount, and RKO, known at the time as the five majors, were vertically integrated into production and theater exhibition and had consistently dominated the industry since the mid-1930s. The three others – Universal, Columbia and United Artists, known as "the minors" at the time – owned no theaters… All eight of these studios were brought to trial by the U.S. Justice Department in the 1940s, and an eventual Supreme Court decision in 1948, *United States v. Paramount Pictures, Inc. et al.,* ruled that the eight distributors had violated the Sherman Act and other antitrust laws… The Court ordered the five major distributors to divest their extensive theater holdings… established a number of regulations on contractual relationships between distributors and theaters that were incented to level the playing field for independent companies.[302]

The second factor that shaped the market for theatrical movies was the growth of television.

> After the *Paramount* decision, the prewar stability of industry structure among the eight Paramount defendants began to crumble. Industry positions of the majors and the minors converged, and the extent of independent entry increased. We argue in the following chapter that the almost coincident diffusion of television has more profound long-range effects on the movie industry than did *Paramount*, but it is likely that ascendance of all three of the minor studios into the majors ranks, and perhaps the rise of independents in the 1960s, were related to the Court's intervention.[303]

Thus, the policy of forcing deintegration of production and distribution of theatrically released movies opened the door to entry, while the advent of television created a whole new channel for the distribution of video product. Waterman reckons that the technological factor played a large part in shaping the video entertainment space, although not so much in determining concentration as in altering the types of products the sector produced and the marketing patterns of those products. However, from the point of view of the analysis in this paper the critical point is that the convergence of the same two factors – integration policy

[301] Waterman, David, Hollywood's Road to Riches (Cambridge: Harvard University Press, 2005), p. 16.
[302] Waterman, p. 30.
[303] Waterman, p. 23.

and multiple distribution platforms – that worked to weaken the gatekeeper role of the studios in the 1950s, worked in the opposite direction for the broadcasters in the 1990s. Removing the policy restriction on vertical integration opened the door to reintegration of the production and distribution of video product and the merger of production (studios) and distribution (broadcasting and cable). The lesson is clear: if given the chance, entities will merge and integrate vertically in order to dominate the sector by controlling distribution.

Mara Einstein notes that before and after the policy limiting vertical integration the broadcasters used their control over access to audiences to monopolize ownership of network programming. Before the Fin-Syn rules were in place, networks asserted ownership over prime-time programming.

> In the 1970s, what led the FCC to institute the financial interest and syndication rules was a concern that the networks were becoming both too powerful and too demanding when it came to the [program] selection process. Too powerful in that they were the gatekeepers of news, information, and entertainment for the American public. This was so because of the limits of radio spectrum… Too demanding, because networks were requiring an equity stake in a program before it would be accepted as part of the prime-time schedule…. [T]he networks had ownership of more than 70% of their prime-time schedule by the mid-1960s, up from only 45% the previous decade. The strong-arming of producers was a fundamental reason for the creation of fin-syn.[304]

The timing is informative. TV arrived on the scene in the 1950s and becomes the dominant medium by the early 1960s. In the early days, it lacked both production capacity and market power to self-supply content. Once it achieved ascendance, it used it resources and leverage to assert ownership over price time programming.

The broadcast networks also had a history of antitrust problems in their role as gatekeepers of access to the television audience. In 1978 they lost an antitrust case that paralleled the *Paramount* case.

> In the *Unites States v. National Broadcasting Co.,* The government specifically accused the National Broadcasting Company (NBC) of restraint of trade as it related to purchasing programs from independent producers and of using its network power to monopolize prime-time programming production of shows broadcast on the network. The Department also claimed that NBC, with CBS and ABC, was trying to develop a monopoly over the television programming market.[305]

[304] Einstein, Mara, *Media Diversity: Economics, Ownership and the FCC* (Mahwah: Lawrence Earlbaum, 2004), p. 179

[305] Einstein, p. 60.

After a twenty-year period in which the networks were restrained by the Fin-Syn rules, the broadcasters moved to reassert ownership in prime time programming once the rules were repealed.

> Since the rules were repealed in 1995, the economic structure of the industry changed drastically. The television networks have become vertically integrated institutions with the ability to produce programming through internal business units. Corporate parents put pressure on the networks to purchase programming internally to achieve synergies and, of course, increase profits. Being part of large media conglomerates, there is added pressure on the networks to be profitable so that Wall Street may find the parent company appealing.[306]
>
> The networks each have at least a 50% stake in the programming on their air and some have as high as 70 and even 90%.[307] The networks could never achieve those kinds of ownership numbers without requesting a stake in the programming that appears on their air. It is no secret to anyone that the networks do this.[308]

In the previous section I have noted the evolving pattern of behavior by the broadcasters in asserting ownership of prime time programming. Bielby and Bielby have argued that the network behavior was political, as well as economic, and noted the evolving nature of their rhetoric. At first the broadcasters argued that the independents would not be squeezed out. Later they argued that independents were irrelevant.

> The network executives' initial position was that independent producers would thrive in a deregulated industry and that network ownership was not a threat to creativity and program quality. Increasingly, in recent years, network executives and deregulation advocates have taken the position that their opponents' positions are irrelevant, because they are out of touch with the realities of the marketplace. In effect, they are saying, vertical and horizontal integration were necessary for the industry to survive in the face of rising costs and increased competition from new technologies.[309]

As this process unfolded, the impact was felt in more than just access to audiences. The leverage that the vertically integrated core of the industry acquired also dramatically changed the terms of trade between the independents and vertically integrated conglomerates. With a small number of vertically integrated buyers and a large number of much smaller product sellers, the core oligopoly gains monopsony power. They can impose onerous terms on the supplier, appropriating maximum surplus. With all of the major distribution channels

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[306] Einstein, pp. 179-180.
[307] Einstein, p. 217, citing Mermigas, 2002,
[308] Einstein, p. 217.
[309] Bielby William T. and Denise D. Bielby, "Controlling Prime Time: Organizational Concentration and Network Television Programming Strategies," *Journal of Broadcasting & Electronic Media,* 47: 4 (2003), p. 585.

under their control, the vertically integrated oligopoly can slash the amount they are willing to pay for independent product.

The experience in the video product space over the two decades in which the vertical integrated oligopoly emerged suggests that vertical integration increased barriers to entry into the television sector.

> [B]ecause the vertically integrated structure creates such a barrier to entry… it is not necessary for these executives to collude…. The complexity has made it almost impossible for new players to enter the market, because they have to do so on so many levels – production, distribution, cable outlet, and so forth.[310]

> Compared to recorded music, production costs in television are astronomical, creating substantial barriers to entry to new program suppliers and creating incentives to the networks to demand greater control over costs…. In the increasingly deregulated business environment, the enhanced market power of the corporations that control access to channels of distribution has made it more difficult for independent suppliers of new television series to survive in the industry. Moreover, the high cost of producing episodic television makes it extremely difficult to operate through channels of distribution outside of network television, such as first run syndication or cable (especially when those off-network venues are increasingly controlled by the same corporations).[311]

2. Favoring Affiliates

The gatekeeper role translates into leverage because "with increased vertical integration, independent producers have less access to audiences, or they must align themselves with studios or networks to get their shows on the air."[312] Einstein concludes that integration favors internally produced product.

> Given vertical integration and the combined network/programming departments, all things being equal, an internally produced show is going to get an airing over one in which the network does not have an interest. It is also more likely to get a better time slot and be kept on the air longer. While it is possible that some shows of lesser quality are given preference over those produced by outsiders, this is a situation that is not likely to be sustained.[313]

> Producers claim that with the demise of the Fin-Syn Rules, networks have used their enhanced market position in several ways to gain unfair advantage over outside program suppliers. First, they claim that when selecting series for the prime-time schedule and deciding between a series from an outside producer

[310] Einstein, p. 217.
[311] Bielby and Bielby, p. 341.
[312] Einstein, pp. 180-181.
[313] Einstein, p. 194-195.

> versus one of comparable or even less quality produced in-house by the network or by a network joint venture, the network will favor the series in which it has a financial interest. Moreover, many producers perceive that this kind of favoritism has intensified in recent years.[314]

Einstein and others identify a number of ways in which vertical integration affects the flow of programming. Clearly inferior shows are aired primarily because the vertically integrated media conglomerate owns them, although there is a difference of opinion on how prevalent this outcome is.

> There are already many examples of network-produced programs that have failed miserably. Shows that were put on the schedule for no other reason than the network studio produced them.[315]

> There is definitely favoritism for internally produced shows over those produced out of house… There are limits to this…. To the extent that they won't put on a bad show that's produced internally over a good show that's not, but certainly if two shows are of equal value the internally produced show will get the nod.[316]

> Indeed, according to one producer, a network financial stake in a proposed series "practically guarantees" a slot in the prime-time schedule… "Without question, if I know that I am gonna lose, I just want to know that at the end of the day the shows that beat me out did so because they are better shows and not just because they're co-owned by the network.[317]

More generally, owned-programming gets an inside track and is chosen when there are close calls.

> [I]t appears the incentives introduced into the program selection process by the repeal of the Fin-Syn rules have clearly affected the program selection process within broadcast networks. Specifically, the networks have an incentive to select programs produced in-house because of both financial and political reasons. [318]

> [I] is important to note here that internally produced programming has the so-called home court advantage when it comes to being selected for the prime-time schedule…. 'If you put the network person in charge of both sides of the

[314] Bielby and Bielby, p. 581.
[315] Einstein, p. 194-195.
[316] Einstein, p. 217.
[317] Bielby and Bielby, p. 581.
[318] Einstein, pp. 180-181.

fence… It's impossible to ask the network person to have that much objectivity.[319]

Owned programming is given better time slots.

What is less known is that the networks are selling time periods, giving the best time slots on the schedule to those who make the best deal with the network.[320]

Owned programming is kept on the air longer.

Shows are also being maintained on the schedule for longer than they might be if the network did not have an ownership interest in the show.[321]

Owned programming clogs syndication.

A new issue has arisen in the syndication market that is adversely affecting producers to the benefit of the networks and their parent companies. Due to increased vertical integration, more and more companies are selling programs within their own company rather than going out into the marketplace to sell a show. For instance, a network that has its own production company will sell a hit show to its cable network at a below-market rate without opening the show to bidding by other outlets, cable or broadcast. Though this is very lucrative for the company, it is detrimental to the profit participants in the show—the producers, the actors and so forth. If the vertically integrated company sells the show internally, it is at a heavily discounted price, which means that the profit participants are cheated out of their rightfully earned money. By selling internally, the companies have almost created a new form of warehousing. Rather than keeping a show off the market, they are keeping the show off the market to competitors.[322]

The pattern of acquisition of shows and movies discussed in the previous chapter also suggests that when the oligopolists are not self-supplying, they engage in reciprocal dealing, buying shows from one another. The interviews with the independent producers indicate that with the vertical integration of studios into the core of the oligopoly, the problem afflicted the movie segment as well. The playing field is simply not level.

Interviews with independent movie producers suggest that the problems that afflict independents in syndication are somewhat different for producers of series and movies. The literature on independent producers of series shows that when independents were squeezed out of the prime time series market, they simply did not have product to sell into syndication, since they were literally put out of business. To some extent, producers of movies were

[319] Einstein, p. 187.
[320] Einstein, p. 217.
[321] Einstein, p. 192.
[322] Einstein, pp. 198-199.

similarly affected, since they did not have larger budget movies to sell into syndication, but they are still in the movie business. Their theatrical releases were also squeezed in the syndication space as the vertically integrated entities came to dominate syndication. The squeeze was two-pronged. They found it more difficult to get placement and the license fees and other terms deteriorated.

3. Monopsony Power

The final area of concern identified in the analytic framework is the exercise of monopsony power. The gatekeeper problem is at the core of monopsony power problems in the video content industry.[323] The harm in the exercise of monopsony power is the reduction of prices paid to suppliers and therefore a reduction of the quantity or quality of the product supplied.

This problem is evident in the TV video space as well. Broadcasters have the leverage to extract equity shares for shows not developed internally.

> [I]n recent years, the networks seem to have refined their strategy even further – recognizing that when series with high potential do appear from outside producers, they can use their market power to extract an ownership stake after the pilot has been produced.
>
> Secondarily, if the show is not internally produced, then the ability to have equity ownership in an externally produced show is expected for inclusion on the prime-time schedule.[324]
>
> Even shows in which the networks did not originally have an interest have had their financing restructured to allow the network to become a financial partner for a show to stay on air, particularly in the ever-important fifth year…. "'Shakedown is probably too strong a word, but they should not have the right to insist on ownership just to provide real estate on the airwaves.'"
>
> Giving a piece of the show to the network has become a normal way of doing business since the repeal of the Fin-Syn rules, because access to the airwaves depends on giving the networks a financial interest in the program. Sometimes these requirements are subtle, like requesting that a producer create their show with their studio's production facilities, and sometimes they are quite blatant – your money or your show.[325]
>
> Of even greater concern to these producers than the perceived favoritism towards in-house production and joint ventures is an increasingly common

[323] Curtin, John J., 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).
[324] Einstein, pp. 180-181.
[325] Einstein, p. 192.

> practice by the networks of commissioning pilots from independent producers then demanding a financial stake as a condition of picking up a series for the prime time schedule.[326]
>
> Networks gain market power to meddle with the content offered by independents.
>
> The argument being advanced here is that the increase in in-house production following the demise of the Fin-Syn Rules created a conflict of interest as business executives from the networks are placed in a position to meddle in the creative process. Under the Fin-Syn Rules, it is argued independent producers and those affiliated with the major studios were insulated from this kind of interference.[327]

Interviews with the independent film producers underscore the problem of monopsony power. The pervasive control over distribution channels on TV allows the integrated firms to dictate terms and conditions that squeeze the independents. The include license fees that do not cover the costs, given the quality that is demanded, extremely long license periods, and claims to back end-rights – home video, foreign sales and digital distribution -- that limit the ability of independents to make up for the inadequate license fees. The exercise of this monopsony power has gone so far as to allow the buyers to repurpose of content to "higher" value" distribution channels without compensation for the independent producer. By taking a product that was purchased at terms and conditions for a lower value outlet and the re-using it on one its much higher value outlet, the vertically integrated company extracts much greater value, without compensating the producer.

This is exercise of monopsony power is akin to a practice that the vertically integrated companies had applied in the series space. In that space, the vertically integrated firms take a high value product and sell it at very low prices to a lower value outlet, in essence under stating the value of the product, to which independent participants might have a claim.

> A new issue has arisen in the syndication market that is adversely affecting producers to the benefit of the networks and their parent companies. Due to increased vertical integration, more and more companies selling programs within their own company rather than going out into the marketplace to sell a show. For instance, a network that has its own production company will sell a hit show to its cable network at a below market rate without opening the shoe to bidding by other outlets, cable or broadcast. Though this is very lucrative for the company, it is detrimental to the profit participants in a show – the producers, the actors and so forth.[328]

It should be evident from these examples, that cable outlets do not alter the landscape because the networks have captured a substantial hold over the most important cable networks.

[326] Bielby and Bielby, p. 581.
[327] Beilby and Bielby, p. 580.
[328] Epstein, pp. 198-199.

> One way that networks are ensuring a faster return on investment is by having a secondary distribution channel usually in the form of a general entertainment cable channel. These channels are used as a secondary outlet through which they can distribute their programs…. Each of these networks presents programming on the broadcast network that is then re-presented (or repurposed) on the secondary outlet. This will lead to more redundant programming and less new content through more outlets. Networks are also making their prime time programming available through video-on-demand and DVD collections.[329]

> Another increasingly popular business strategy implemented by the big four and emerging networks also offsets the impact of expanding channels of distribution. "Repurposing" involves exhibiting each episode of a series on an affiliated broadcast or cable network immediately after the initial network broadcast.[330]

F. The Debate over Quality

1. Observations on the Creative Process

Should policy makers care that video production is in the hands of a small number of firms. We have already suggested that they should because it plays an important role in democratic discourse and cultural production. But does market structure matter?

The theoretical reason why source diversity is so crucial to the overall goal of diversity is that the larger the number of sources, competing to develop programming, particularly if they are independent, the more vibrant the ideas that are tried will be. There are repeated examples of independents being rejected by one network, but succeeding wildly on another; of one network wanting to alter the essential nature of a show, while another did not. Here I stress that it is the infrastructure of creativity that is important and the willingness to take risk and shop options around to distributors that is undermined by vertical integration. The trend toward consolidation and vertical integration between the production and distribution of content has resulted in a decline in the quality of product and the elimination of independent sources of output.

The exercise of monopsony power is clearly affecting the structure of the industry. Two effects have been noted.

First, the number of entities engaged in the process has been reduced sharply because the distribution of risk and rewards has been shifted in favor of the networks.

> [T]he statistical patterns summarized above include instances in which the networks have used their enhanced market power to negotiate ownership shares in series pilots brought to them by outside suppliers. In these situations,

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[329] Einstein, pp. 218-219, on the latter point Einstein cited Adalian, 2002.
[330] Beilby and Bielby, p. 592.

> the program supplier, not the network, absorbs development costs, while the network acquires a share of the back end profits if the series eventually becomes a hit and goes into syndication. From the program suppliers' perspective, the costs of development for new series remain the same, but to reach the prime-time schedule, the supplier has to agree to forgo a share of the future revenues. According to some in the industry, this revenue squeeze on independent program suppliers is the primary reason that a number of them have exited the business of prime-time series development.[331]
>
> So far, the most visible impact of deregulation has been a reduction in the number of organizational settings in which those who create television series are employed, and an increase in corporate control over the circumstances under which they practice their craft.[332]

The second effect is to eliminate the creative tension that once existed between the producer and the distributor of product.

> Vertical integration is seen as eliminating a valuable step in the development process. First, developing programming is a creative process. When one entity created the programming and another would select it, the two companies could argue and disagree and out of those discussions, the show would often be improved... [T]he process did favor internal shows and eliminated much of the development process altogether. Producers also stated that this process was detrimental to the overall quality of network programming.[333]

One aspect of the debate over quality that is intriguing but little studied is the potential relationship between integration, declining quality and declining ratings. As Bielby and Bielby note:

> In 1999, *Advertising Age* editorialized that ABC was "auctioning" its most desirable prime-time time slot to the program supplier willing to give the network a financial stake, part of a trend that is making it "increasingly clear the broadcast networks are more interested in financial deals than putting the best shows they can find on the air." The trade publication warned that the ratings decline experienced by the networks would accelerate if "financial packages rather than program quality determine what gets on the schedule."[334]

The ratings decline certainly did continue, as integrated ownership of programming increased. As is frequently the case in this sector, many other things were changing that could account for the decline in ratings, but the correlation is notable.

Waterman sees some evidence of the latter effect on the studio side of the business.

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[331] Beilby and Bielby, p. 590.
[332] Beilby and Bielby, p. 593.
[333] Einstein, p. 194-195.
[334] Bielby and Bielby, p. 581.

> [E]xcessive movie budgets and an over reliance on sequels or derivative movies have also been associated unfavorably with conglomerate organization and the mentality of the top executive in charge.[335]

Waterman also notes that the claimed efficiency benefits of conglomeration have come into question.

> When merger plans are announced, industry analysts often cite efficiencies, such as workforce combinations, or marketing advantages, such as the ability to cross-promote movies using television, magazines or other media assets also owned by the conglomerate. Also commonly mentioned are the advantages of vertical integration, such as the ownership of television or cable networks that can serve as guaranteed outlets for movies produced by the conglomerate's studio branch. A related benefit is the ability to consolidate exploitation of a single story idea or character through books, magazines, television shoes, music publishing, Internet web sites, or other media within a single corporation. The economic advantages of such operating efficiencies (often called economies of scope) are plausible. However, real multimedia exploitation within the same conglomerate is apparently infrequent and other efficiency claims have come into recent disrepute – notably in the cases of AOL-Time Warner and the ABC-Disney mergers.[336]

What we may be left with are the market power advantages of a tight oligopoly in the video entertainment space, which do not yield efficiency gains while imposing a heavy price in terms of diversity and quality.

2. Diversity of Television Content

Discussions of quality frequently start and end with the most famous examples of "groundbreaking" shows mentioned above. *All in the Family* and the *Cosby Show* have become famous as independent shows that fought their way into prime time and changed the face of television. Independently, conceived and produced, it was only by having alternative outlets available that these shows were able to preserve their distinct content. It turns out that this is the tip of the iceberg during the Fin-Syn era (see Exhibit V-1).

There can be no doubt that the independents who rose during the period of Fin-Syn shattered the "Ozzie and Harriet" image of America, the image of a lily white, suburban America, where father's worked and knew best and mothers prepared meals. There is a stunning list of independently produced TV shows that reminded the public in prime time and before huge audiences that America was black, white and brown; male and female; married, divorced, widowed, or abandoned; more urban than rural, more working class than not; where single moms of both races worked in interesting and sometimes dangerous occupations while raising families on their own, and older Americans were more than just grandparents fawning

[335] Waterman, p. 30.
[336] Waterman, p. 30; Peltier, Stephanie, "Mergers and Acquisitions in the Media Industries: Were Failures Predictable," *Journal of Media Economics,* 17(4), 2004.

over grand kids, but lived real lives with human appetites and frailties. While the most frequently cited examples, *All in the Family* and *The Cosby Show* appear on the list and they are the most spectacular in their success and their spin-offs, it is the breadth of independently produced shows that should get attention too. Over two dozen shows from almost a dozen different producers broadened and enriched television with different images and issues during the period of Fin-Syn. These shows won over half the Emmys for Best Comedy or Best Drama series in the twenty-year period that Fin-Syn was firmly in place.

Thus, while it may be a bit of an exaggeration to say that most of the groundbreaking, socially relevant diversity in the history of television was brought to the TV screen by independents who owed their opportunity to the implementation of Fin Syn, the list of shows in Exhibit III-16 demonstrates that it is not much of an exaggeration. And, this is not a comprehensive list of successful independent shows, just a list of those that seem to have made a unique contribution to diversity. Indeed, the exhibit emphasizes the possibility of succeeding commercially while contributing to diversity. The exhibit demonstrates that these shows that dealt with important social issues were not only critically acclaimed, but also successful. Many had long runs with long periods in the top thirty rated shows. Over a dozen different producers who were not affiliated with the networks produced this list of shows, giving strong support to the idea that diversity of ownership is crucial to achieving genuine diversity of content.

The quantitative analysis of the quality of television is quite complex. Independents were virtually eliminated from prime time and have little opportunity to bring new product to that space, so before and after comparisons tell us little, other than the fact that they were excluded. Moreover, there is no box office to count. The essential point here is that given the opportunity to appear in the exhibition space, independents held their own.

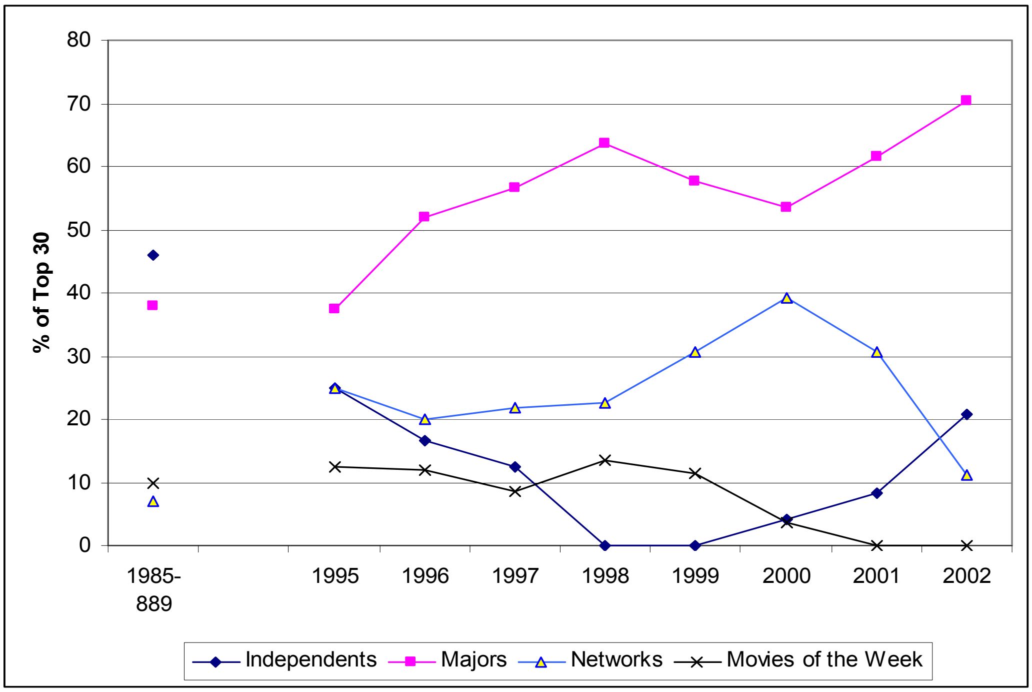
Exhibit III-16: Leading Independent TV Series Contributing to Content Diversity during the Full Implementation of the Financial and Syndication Rules

Series	Start	1st Year in Top 30	Last Year	Number of Years In 1st Run	In Top 30
Mary Tyler Moore	1970	1970	1977	8	6
All in the Family	1971	1971	1983	12	11
Sanford and Sons	1972	1972	1977	6	6
The Waltons	1972	1972	1981	10	6
Maude	1972	1972	1978	7	4
Good Times	1973	1973	1979	7	4
Streets of San Fran.	1972	1973	1977	6	3
Chico & the Man	1974	1974	1978	5	2
Rhoda	1974	1974	1978	5	3
Jeffersons	1975	1975	1985	11	8
One Day at a Time	1975	1975	1982	10	8
Welcome Back Kotter	1975	1975	1979	5	3
Barney Mill	1975	1978	1982	8	4
Tony Randall Show	1976	1976	1978	3	1
Lou Grant	1977	1978	1982	6	2
Benson	1979	1979	1986	7	1
Hill Street Blues	1981	1981	1987	8	3
Kate & Allie	1984	1984	1989	6	4
Cagney and Lacy	1982	1983	1988	6	2
Cosby show	1984	1984	1993	10	10
Golden Girls	1985	2985	1992	8	7
Moonlighting	1985	1985	1989	5	3
A Different World	1987	1987	1993	7	5
Roseanne	1988	1988	1997	10	7
Seinfeld	1990	1992	1998	9	7

Source: shows from William M. Kunz, *Culture Conglomerates* (New York, Rowman and Littlefield, 2007), Chapter 5. Prime Time rankings from Tim Brooks and Earle Marcsh, *The Complete Directory to Prime Time Network and Cable TV Shows: 1946-Present* (New York: Ballantine Books, 2003), Appendices 2 and 3.

Exhibit III-17 compares the source origin of the top thirty shows for two periods: 1985-1989, which is the base period I have been using for the Fin-Syn era, and 1995 to 2002 for the post Fin-Syn period. Ratings are the closest equivalent to theatrical Box Office. I have included all, non-news shows that appeared in the top 30. I have used the same coding approach as in the earlier analysis of all shows on TV. That is, where a major studio is listed in a co-production, it is considered the producer. Where the producer uses both the name of a network and a major studio, it is counted as the major. The details of the counts might change somewhat with a different approach, but the basic patterns would be clear.

Exhibit III-17: Producers of Top 30-Rated TV Shows.



Source: Tim Brooks and Earle Marsh, *The Complete Directory to Prime Time Network and Cable TV Shows: 1946 – Present,* (New York: Ballantine, 2003), Appendix 3; Beta Study System database.

Prior to the repeal of Fin-Sin, independents and major studios dominated the top show. The networks did not even pull their weight. They were somewhat underrepresented in these ratings. After the repeal of Fin-Sin, the vertically integrated oligopoly completely dominates the space. There are very few independents and no non-integrated majors in the top 30 shows. When the independents do return to the top 30 in the early 2000s, it is with reality shows, not scripted entertainments.

I have included the category of Movies of the Week, although I do not have the producers for the actual movies for two reasons. First, as we have seen, in the broader market share analysis, these were almost always independents and majors prior to the repeal of Fin-Sin; afterwards, they almost entirely had vertically integrated majors as producers. Second, the nature of prime time movies changed. Movies of the Week were big events with large budgets and appeared in the top 30 shows consistently, accounting for about 10 percent of the total, until the end of the 1990s. They then drop quickly out of sight. This was the period of the expansion of Basic cable movies.

The pattern of popularity helps to provide background for the analysis of awards – the Emmys. There are a very large number of categories across many different types of shows. The categories also change over time. A separate category for Made for TV Movies was not added until the 1990s, so there is no baseline. For the purposes of this analysis, I focus on the Emmys for Best Comedy and Drama. These are series of scripted shows that most parallel movies and were available to independents for which awards were consistently given.

Over the course of the 1980s there were 20 such awards given for each genre (see Exhibit III-18). The distribution of the awards reflects the market share of the different types of producers closely. The point here is that if these awards represent an independent measure of quality, the independents held their own. The vertical restriction did not cause "inferior" products to be aired. With the repeal of Fin-Syn, independents were banished from these two categories of television entertainment and they disappear from the awards. As I have noted, their presence in prime time is largely restricted to reality shows. The pattern of awards is similar to the other data we have seen in that, as Fin-Syn was under attack in the early 1990s the independents decline, then they are eliminated after repeal.

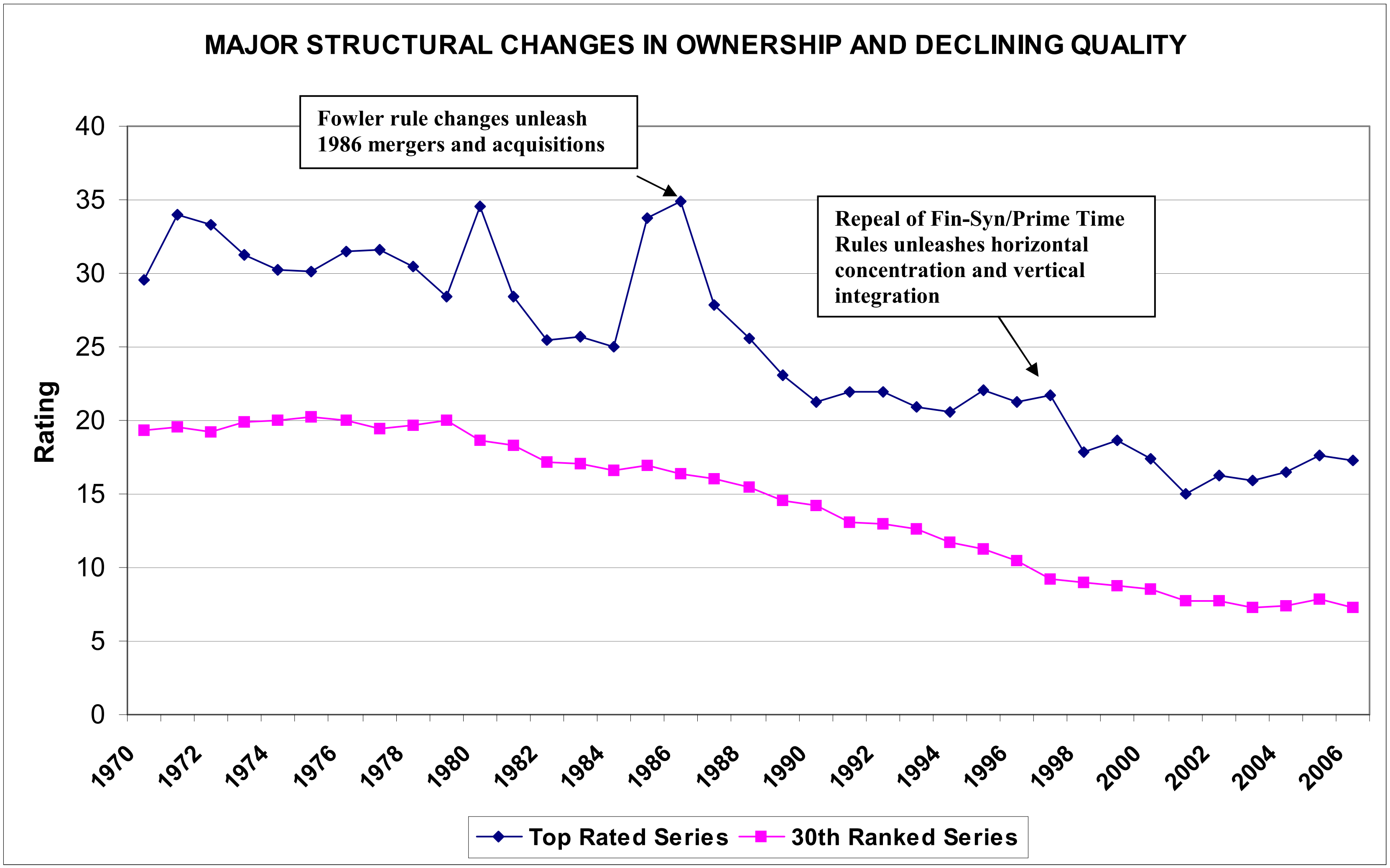
Exhibit III-18:
Emmys for Best Comedy and Drama

Producer	**80-84**	**85-89**	**90-94**	**95-99**	**00-04**
Independents	70	40	20	0	0
Networks	20	40	50	100	60
Majors	10	20	30	0	40

Source: Tim Brooks and Earle Marsh, *The Complete Directory to Prime Time Network and Cable TV Shows: 1946 – Present,* (New York: Ballantine, 2003), Appendix 3; Beta Study System database.

There is one fundamental problem with using awards to measure quality. They are a relative, not an objective, standard. When the envelope is opened, we never hear the words, 'TV shows were not very good this year so was chose not to give an award." A better measure of quality would be whether people watched. Exhibit III-19 shows the audience share for the top rated show and the 30th rated show over the period from 1970 to 2007. There was clearly a decline in share.

Exhibit III-19:



The debate over the impact of vertical integration on quality is difficult to resolve, as many factors were affecting the industry. Still, the pattern of declining ratings observed over a twenty year period is consistent with the claim that self-dealing had an impact. The Exhibit shows the average rating of the top 30 shows for each year. The two periods of significant consolidation activity clearly appear to have had an impact on viewing. Statistical tests of the effect of consolidation support this conclusion, as shown in Exhibit III-20. We analyze the audience for the top ranked show and the 30th ranked show, which would be about the middle of the total rankings. We use the audience, rather than the ranking to account for the fact that the population was growing naturally. We use two alternative covariates to account for underlying trends. In one analysis, we use a simple trend line. In the other analysis we use a one-year lagged variable of the dependent variable. We count post policy change years lagged slightly to allow time for the impact of the policy change to be felt.

The evidence supports the conclusion that the policy changes reduced audiences. All of the coefficients on the policy variables are negative. Several are statistically significant, all but one are larger than their standard errors (which are estimated as robust standard errors). Quality is a complex issue in video production and many factors were changing, but all of the indicators are that independents had performed extremely well in the space that was provided for them and the elimination of independent production from prime time resulted in a decline in quality.

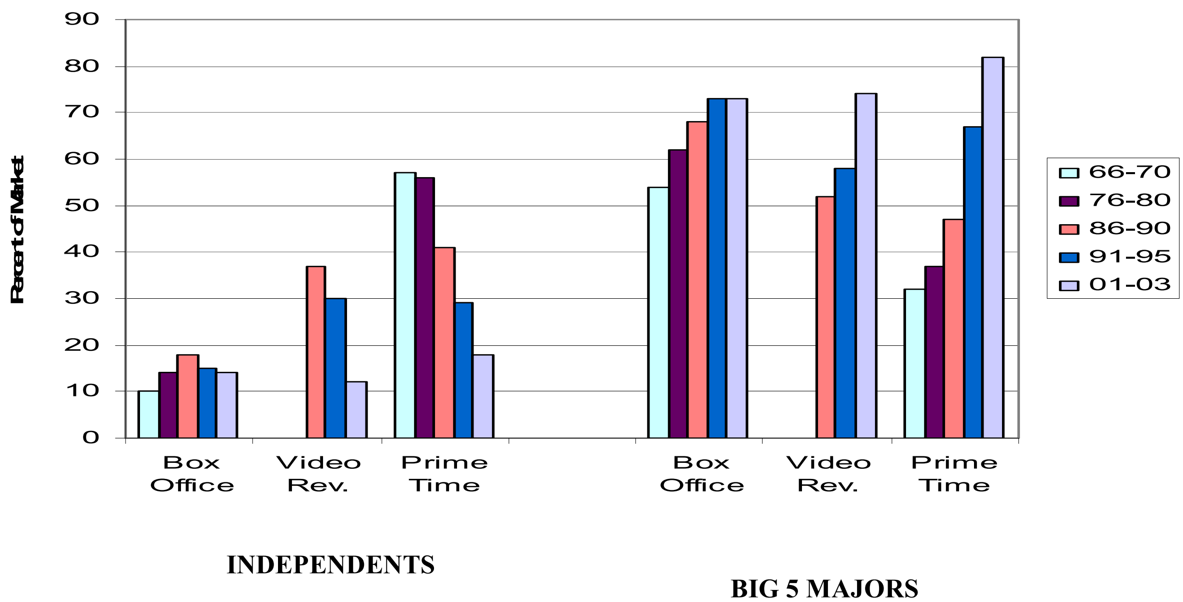
Exhibit III-20: Statistical Test of Impact of Policy Changes on Measures of Quality

Independent	Top Ranked Audience	30th Ranked Audience	Top Ranked Show Rating	30th Ranked Show Rating
Covariate	Lag	Lag	Trend	Trend
Coefficient	.560	-856	74.25	17.32
Std. Error	(.138)	(.066)	(152)	(59.60)
Sig.	.000	.000	.630	.773
Policy Variables				
Fowler Policy				
Coefficient	-1010	-709	-108.8	-1480
Std. Error	(822)	(.167)	(209.9)	(807)
Sig.	.228	.000	.710	.076
FinSyn/1996 Act				
Coefficient	**-.1247**	**-4121**	**-4409**	**-4162**
Std. Error	**(1067)**	**(.325)**	**(1609)**	**(804)**
Sig.	**.251**	**.214**	**009**	**.000**
R^2	**.97**	**.97**	**.32**	**.82**

Rankings from Tim Brooks and Earle March, *The Complete Directory to Prime Time Network and Cable TV Shows: 1946 – Present* (New York: Ballantine, 2007), Appendix 3;
Trend = year 1970 – 2006; Fowler policy 1986 – 2006 = 1; Fin-Syn/ 1996 Act 1996-2006 = 1;
Audience = ratings * TV Households (TV Households from (Research Central, TVBS, based on Nielsen, available at http://www.tvb.org/rcentral/mediatrendstrack/tvbasics/02_TVHouseholds.asp)
.

Objective measures of quality in product in the entertainment space are notoriously difficult to come by. In the movie space, analysts frequently turn to the annual awards ceremonies. The elimination of independent movie producers from TV space also defies the "quality" claims for vertical integration, however. The Oscars and Golden Globe Awards contradict the claim that independents suffered some sort of collapse in the 1990s. In fact, their share of awards has been constant, if not rising. Arguably, a second measure of quality is success. For movies, box office is the predominant measure, although success at the box office reflects many things beyond simple quality, such as the advertising budget. For comparative purposes across time and distribution channels, the market shares in Exhibit III-21 make a simple point. Independents held their market share in the Box Office much better than they did in the other distribution channels, where vertical leverage was most directly exercised.

Exhibit III-21: The Shares of Independent Producers in Box Office, Video Revenue and Prime Time Hours Late 1960s to Early 2000s



Sources: Box Office and Video Revenue are five year averages from David Waterman, *Hollywood's Road to Riches* (Cambridge: Harvard University Press, 2005), pp. 21, 25, 86-90 and 01-03. Big Five Majors are the studios that have been acquired by major TV programmers – Disney/ABC; Fox/20th Century Fox; NBC/Universal; Warner Bros.; CBS/paramount. Other majors (not shown) are MGM/UA and Columbia. Independents are what Waterman calls "the residual." Prime Time is percent of hours in 1989, and 2002 from Mara Einstein, *Program diversity and the Program Selection Process on Broadcast Network Television* (Washington D.C.: Federal Communications Commission, September 2003), pp. 26. First-run syndication is from C. Puresell and C. Ross, "Vertical Integration and Syndication," *Electronic Media,* 22(1): 2003, for 1993 and 2002. It includes only vertical integration and not internal dealing among the big 5.

IV. ANTI-COMPETITIVE PRACTICES IN THE MVPD MARKET*

*** Adapted from, *Open Architecture as Communications Policy* (Stanford Law School, Center for Internet and Society: 2004); "Open Communications Platforms: The Physical Infrastructure as the Bedrock of Innovation and Democratic Discourse in the Internet Age," *Journal on Telecommunications & High Technology Law,* 2:!, 2003.**

Comcast has been involved in a constant stream of disputes over vertical leverage and discrimination in both the delivery of MVPD service over traditional platforms and broadband Internet access service. The long-term pattern of this conduct in the industry, which is reviewed in this section, suggests it is an endemic problem. In reviewing that history, we should recall that Comcast has built it leading role in the MVPD market by acquiring TCI and AT&T, as well as parts of Adelphia that involved swaps of cable systems with Time Warner. In other words, the history of anticompetitive tactics in the industry at large is thoroughly ingrained in Comcast's DNA. Comcast's discriminatory abuse of its control over the broadband network is noteworthy, as it is leading the way in bringing the anticompetitive tactics from the traditional MVPD market to bear on the Internet TV platform.

This Section moves from the specific to the general. It begins with a discussion of the patterns of anticompetitive conduct in the cable industry. General problems of vertical leverage in the communications sector are then examined through the comments of large players who stand on both sides of the issue. Finally, a broad theoretical view is taken from the perspective of vertical leverage in digital industries. The section concludes by drawing a parallel between Comcast's strategy to prevent digital disintermediation from undermining its market power by impeding Internet TV to Microsoft's strategy to prevent the Internet from "commoditizing" its operating system monopoly "cutting off the air supply" of the competing Internet browsers.

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

1. Exercising Regional Market Power to Undermine Competition

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. Comcast has taken the lead in implementing these strategies and the evidence suggests it can impose serious harm on competition.

A GAO analysis found that if a cable system is part of a large national operator, its prices are 5.4 percent higher than if it is not.[337] 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). 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. Being served by one of the mega-multiple system operators who have been expanding their grip on the industry through mergers and clustering drives prices higher by more than 5 percent and perhaps as much as 8 percent.

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

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[337] 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, Appendix IV.

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 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.

Overbuilders have faced vigorous efforts to prevent competition through exclusion from access to programming and regulatory tactics of incumbent cable operators.[338] Comcast has shifted some sports programming to terrestrial delivery, thereby avoiding the open access requirement of the 1992 statute. As cable operators become larger and more clustered, this strategy will become increasingly attractive to them. Specific areas where such programming has been denied are Phoenix, Kansas City, 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.[339]

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."[340] Comments in the program access proceeding point to an even more stark demonstration of the power of cable to engage in content discrimination.[341]

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%.[342]

> 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

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[338] *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 "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.;

[339] Joint Comments, p. 14.

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

[341] Qwest, 2001, p. 3; Dertouzos and Wildman, 1999. 39 Joint Comments, 2001, p. 9.

[342] Eleventh Annual Report, ¶¶166-169.

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.[343]

Cable operators have concentrated 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.[344] The Eleventh Annual Report also shows that small and rural areas represent distinct markets that are at a competitive disadvantage in acquiring 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.[345]

The FCC identifies fewer than 100 regional cable networks. Sports and news networks dominate the total, with about 40 percent each (see Exhibit IV-1). 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.

Exhibit IV-1: Regional Markets are Dominated by Affiliated News and Sport Programming

PERCENT OF ALL 94 REGIONAL NETWORKS

	CABLE	BROADCAST	INDEPENDENT
NEWS	26	13	5
SPORTS	18	18	5
OTHER	0	0	15

Source: Federal Communications Commission, Video Competition, Eleventh Annual Report, Table C 4; National Cable and Telecommunications Association, Industry Overview.

2. Qualitative evidence

Cable company conduct reflects the exercise of the market power conferred by industry structure. Companies do not conquer markets with innovation, they operate on a monopoly model that frustrates competition by leveraging and defending a franchise. There is a long history of anticompetitive conduct that weighed heavily on Congress as it considered how to protect consumers and promote competition after a disastrous decade of deregulation. The historical tendency of the industry to engage in anticompetitive behavior remains in evidence. Regulators and law enforcement authorities have been repeatedly called up to check these tendencies

[343] Id., p.. 21
[344] Eleventh Annual Report, ¶141-142
[345] Eleventh Annual Report, ¶186 49 CFA/CU, a *la Carte,* Initial Comments.

Integrated MSOs have a long history of granting preferential access to subscribers for affiliated programmers and denying access to those who are not affiliated. Evidence of these problems is both qualitative and quantitative.[346] The dominant, integrated firms get the best deals. For example, large MSOs often secure "most favored nation" clauses from programmers. Such clauses are supposed to guarantee an MSO as good a price as any other operator pays for programming, sometimes excluding Time Warner and TCI.[347]

Other examples of anticompetitive conduct include efforts to impose or obtain exclusive arrangements, price discrimination, and "dial disadvantage." Exclusive arrangements prevent competing technologies from obtaining programming, as well as preventing competition from developing within the cable industry.[348] Price discrimination against competitors and placing competitive programming at a disadvantageous location on the dial (e.g. very high, near other programs with low ratings), have once again become common practice in the cable industry.[349]

The landscape of the cable industry is littered with examples of these anti-competitive practices. These include, for example, exclusive deals with independents that freeze-out overbuilders,[350] refusals to deal for programming due to loopholes in the law requiring non-discriminatory access to programming,[351] tying arrangements,[352] and denial of access to facilities.[353]

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

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

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

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

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

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

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

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

The FTC rejected the Time Warner/Turner/TCI merger proposal and imposed conditions on it. It rejected a preferential deal for TCI's purchase of Time Warner programming and required TCI to reduce its level of ownership in Time Warner to less than 10 percent of nonvoting stock (i.e., a non-attributable, passive level).[354] With respect to the programming market it found:

> Entry into the production of Cable Television Programming Services for sale to MVPDs that would have a significant impact and prevent the anticompetitive effects is difficult. It generally takes more than two years to develop a Cable Television Programming Service to a point where it has a substantial subscriber base and competes directly with the Time Warner Turner "marquee" or "crown jewel" service throughout the United States. Timely entry is made even more difficult and time consuming due to a shortage of available channel capacity.[355]

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

> Entry into the sale of Cable Television Programming Services to households in each of the local areas in which Respondent Time Warner and Respondent TCI operate as MVPDs is dependent upon access to a substantial majority of the high quality, "marquee" or "crown jewel" programming that MVPD subscribers deem important to their decision to subscribe and that such access is threatened by increasing concentration at the programming level, combined with vertical integration of such programming into the MVPD level.[356]

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

> enabling Respondent Time Warner to increase prices on its Cable Television Programming Services sold to MVPDs, directly or indirectly (e.g., by requiring the purchase of unwanted programming). Through its increased negotiating leverage with MVPDs, including through purchase of one or more "marquee" or "crown jewel" channels on purchase of other channels.
>
> enabling Respondent Time Warner to increase prices on its Cable Television Programming Services sold to MVPDs by raising barriers to entry by new competitors or to repositioning by existing competitors, by preventing such rivals from achieving sufficient distribution to realize economies of scale; these effects are likely, because

[354] Federal Trade Commission, In the Matter of Time Warner Inc., Turner Broadcasting Systems Inc., Telecommunications Inc. and Liberty Media Corporation, Complaint, Docket No., September 1997 (hereafter, Time Warner/Turner/TCI).
[355] Time Warner/Turner/TCI, pp. 7.
[356] Time Warner/Turner/TCI, pp. 7.

(1) Respondent time Warner has direct financial incentives as the post-acquisition owner of the Turner Cable Television Programming Services not to carry other Cable Television Programming Services that directly compete with Turner Cable Television Programming Services; and

(2) Respondent TCI has diminished incentives and diminished ability to either carry or invest in Cable Television Programming Services that directly compete with the Turner Cable Television Programming Services because the PSA agreements require TCI to carry Turner's CNN, Headline News, TNT and WTBS for 20 years, and because TCI, as a significant shareholder of Time Warner, will have significant financial incentives to protect all of Time Warner's Cable Television Programming[357]

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

> denying rival MVPDs and any potential rival MVPDs of Respondent Time Warner competitive prices for Cable Television Programming Services, or charging rivals discriminatorily high prices for Cable Television Programming services. [358]

Integrated MSOs wield immense power against smaller cable companies, exploiting loopholes in the program access rules." The incentives to deny programming and the consequences to program diversity are not hypothetical. In circumstances outside of Section 628(c)(2)(D), these incentives are already resulting in denial of programming to small cable companies.[359] 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.[360]

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[357] Time Warner/Turner/TCI, pp. 8.

[358] Time Warner/Turner/TCI, pp. 8.

[359] *American Cable Association, Comments*, In Re Implementation of the Cable Television Consumer Protection & Competition Act of 1992, Development of Competition in Video Programming Distribution: Section 628(c)(5) of the Communications Act: Sunset of Exclusive Contract Prohibition, CS Docket No. 01-290 (filed Dec. 3, 2001) *available at* `http://gullfoss2.fcc.gov/prod/ecfs/comsrch_v2.cgi`.p. 15. , p. 16, elaborates. AT&T/New England Cable News ("NECN"). The Commission is familiar with NECN. In 1994, in response to a petition for exclusivity by Continental Cablevision, the Commission granted a limited waiver of Section 628(c)(2)(D) for NECN.[359] The Order gave NECN an 18-month window to enter into exclusive programming contracts, and the exclusivity terms were to end by June 2001. AT&T is the successor to Continental's attributable interest in NECN. NECN has recently denied access to its service to at least one ACA member based on an exclusive contract with AT&T. The small system seeking access to NECN competes with AT&T in one market. NECN now claims that it is delivered terrestrially, and it cannot provide access to its programming because of its contract with AT&T. "Comments of Braintree Electric Light Department," In the Matter of Implementation of the Cable Television Consumer Protection and Competition Act of 1992, Development of Competition and Diversity in Video Programming Distribution: Section 628 (c)(5) of the Communications Act: Sunset of Exclusive Contract Prohibition, Federal Communications Commission, CS Dkt. No. 01-290, December 3, 2001. BELD (Braintree Electric Light Department] competes in Braintree with AT&T, the USA's largest company, and Echostar/DirecTV, the USA's largest satellite companies. If AT&T and other major MSOs could withhold programming from use, our video business would likely fail and consumers in Braintree would lose the benefits of true facilities-based competition.One major MSO is already denying BELD access to important regional

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.[361]The exclusionary tactics apply not only to head-to-head cable operators and satellite providers, but also to DSL-based providers seeking to put together a package of voice, video, and data products. Bundling is critical to entry into the emerging digital multimedia market.[362]

Third, because the dominant MSOs are so large, they can influence important programmers not to sell to competitors and potential competitors. As the Commission noted, Ameritech and the WCA found that they were cut off from programming.[363]

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

> It is well known, for example, that News Corp. abandoned its 1997 joint venture with DBS operator EchoStar Communications Corporation (EchoStar) after incumbent cable operators responded to the transaction by refusing to discuss carriage of Fox cable programming. Unwilling to put the financial viability of Fox's programming at risk, News Corp. took the path of least resistance, left Echostar at the altar and switched its affections to the cable-controlled PrimeStar DBS service

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programming. BELD's situation provides a clear example of how a major MSO will use program access to thwart a small competitor. NECN [New England Cable News], a regional news network partly owned by AT&T, refuses to sell its service to BELD, purportedly due to an exclusive contract with AT&T. This denies our customers important regional programming and hurts our ability to compete

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

361 Everest, p. 6; . ACA, p. 15. AT&T/DigitalTVLand. AT&T owns Headend in the Sky ("HITS"), a wholesale distributor of digital programming via satellite. HITS services have been instrumental in enabling many smaller systems to expand channel offerings through digital services, and ACA has been a prime supporter of this service. Among the digital services carried by HITS is TVLand, a popular entertainment channel. But of all the channels carried by HITS, ACA members cannot receive digital TVLand from HITS. AT&T apparently has a national exclusive contract for the service

362 "Comments of the Competitive Broadband Coalition," In the Matter of Implementation of the Cable Television Consumer Protection and Competition Act of 1992, Development of Competition and Diversity in Video Programming Distribution: Section 628 (c)(5) of the Communications Act: Sunset of Exclusive Contract Prohibition, Federal Communications Commission, CS Dkt. No. 01-290, December 3, 2001, p. 11. CTN [CT Communications Network Inc.], a registered and franchised cable operator, has been unable to purchase the affiliated HITS transport service from AT&T Broadband, the nation's largest cable operators, despite repeated attempts to do so…. Based on its own experience and conversations with other companies who have experienced similar problems, CTCN believes that AT&T is refusing to sell HITS to any company using DSL technology to deliver video services over existing phone lines because such companies would directly compete with AT&T entry into the local telephone market using both its owns system and the cable plant of unaffiliated cable operators. AT&T simply does not want any terrestrial based competition by other broadband networks capable of providing bundled video, voice and data services

363 FNPRM, para. 28

> "Time Warner, Inc. and [Fox] appear to have entered a symbiotic truce following [Fox's] new proposed affiliation with cable TV industry-owned Primestar Partners L. P. [Fox] originally proposed a merger with EchoStar Communications Corp. to compete with cable TV operators. But according to industry sources, [Fox] received not-so-subtle signals from cable TV operators that its cable TV programming would have trouble finding carriage on their systems if the EchoStar deal went through.
>
> It was also reported that New Corp.'s abandonment of its joint venture with EchoStar was a prerequisite for at least one cable Mao's blessing of Fox's $2 billion acquisition of the Family Channel.[364]

One need only look to the program access proceedings to find ample evidence.[365] And, as Quest points out, the problem is not simply one of complete exclusion. Dominant, vertically-integrated MSOs can inflict "discriminatory or excessively burdensome terms and conditions of programming distribution."[366] Joint Comments note that the "retransmission consent process has provided even more evidence of the economic power that incumbents cable operators hold over programming services, even those owned by NBC, CBS and ABC. "[367] This is consistent with our earlier interpretation of the division of rents between cable operators and unaffiliated programmers. Here, cable market power is evidenced not by pricing, but by the ability to deny content to competing conduit providers. The problem is not limited to small cable operators or new entrant MSOs having difficulty gaining access to programming (conduit discrimination). It extends to programmers having difficulty gaining access to MSO distribution or what we have called content discrimination.

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

In the late 1980s, TCI and Time Warner, both part owners of CNN, refused to carry a new NBC cable news channel when it was proposed. Clearly, a new cable news channel could have had a competitive (which they view as negative) effect on CNN. Instead of considering the benefits for their viewers (an added news voice that creates new stories and perspectives) TCI and Time Warner worked to keep CNN free from competition[368].

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[364] "Joint Comment," p. 8.

[365] "Comments of Qwest Broadband Services," and the Seventh Annual Report, 90.

[366] Qwest, p. 3; see also James N. Dertouzos and Steven S. Wildman, *The Economics of License Fee Discounts,*

[367] Joint Comments, p. 9.

[368] Joint Commenters. P. 8. Recent comments in the program access proceeding summarize these events aptly:
It is also well known that Fox News Channel ("FNC") owes its very existence to Telecommunications, Inc. ("TCI," since acquired by AT&T), whose agreement to carry FNC on systems serving 90% of TCI's subscribers was critical to the successful launch of the network. Not coincidentally, Fox made FNC available to incumbent cable operators on an exclusive basis. Like the saga of News Corp./EchoStar, FNC's launch and subsequent exclusivity to the cable MSOs is a case study of how the largest incumbent cable operators control the destiny of new programming services, and why programmers sell to cable's competitors at their own risk

A similar situation arose in the early 1990s and persisted throughout the decade vis-à-vis Rupert Murdoch, head of News Corp., who tried for years to get TCI and Time Warner to carry his conservative-slanted Fox News Channel so he could reach their tens of millions of viewers[124]. The operator goliaths already carried other News Corp. programming but refused to carry Fox News[125] because of the competition it would have created for their news channel and the opposing political stance the station would have taken. Without access to the viewers that TCI and Time Warner controlled, Murdoch saw that launching Fox News was not a worthwhile venture. In effect, he was prohibited from delivering his content.

Fox fought a similar battle with Time Warner. In 1996, Time Warner (which owned a 20% stake in CNN's parent company, Turner Broadcasting) refused to allow any other cable network to compete with CNN on its cable systems.[127] The nation's largest cable operator at the time, TCI, also owned a stake in CNN and, as a result, would also not allow any competitive news services on its systems.

The FTC consent decree[128] required the merged company to make available to at least 50% of its cable subscribers a second 24-four hour news channel in which it held no financial interest.

Another instance of operators' tampering with programming revolved around the home shopping network boom. The early 90s were spent consolidating this branch of cable TV after the initial channels exploded with profits. What started as 35 channels, owned and operated by various people, was transformed into four channels (Home Shopping Network, HSN II, QVC, and QVC Fashion) all run by cable operators, with TCI owning a major stake in all four.[136] When nearly three-dozen home shopping channels existed, the home shopping industry resembled a mall, with choices galore and price differentiation. Unfortunately, such a consumer-friendly environment did not appeal to the cable operators who stood to profit far more from a viewer's inability to find a lower price. With TCI owning part of all four channels, it effectively was positioned to limit the competitiveness of these channels.

AT&T/Comcast and their experts cited the ongoing dispute between Yankee Entertainment Sports and Cablevision as testimony that satellite is an alternative to cable. YES does not see it quite that way.[369] The suit is much more a testimonial to the discriminatory and anticompetitive practices of the industry. YES alleges and provides facts to support its claim that the refusal to provide nondiscriminatory carriage is part of a scheme to prevent competition in sports programming and preserve Cablevision's local monopoly in distribution. It documents a history of threats to foreclose markets as a lever against programmers that goes back to the 1980s. The demands of the operator include demands for equity and exclusivity. "Bargaining" with a dominant distribution incumbent involves take-it-or-leave-it-threats of inferior placement, discriminatory prices, or exclusion from carriage. Programmers have little bargaining power,[7] particularly because denial of access to 40% of the market renders new programming unworkable.

The market structure that conveys the power to distributors is precisely described in the YES proceeding. There is little direct competition in distribution – Cablevision has a 90% market share, which remains insulated behind barriers to entry. Market power has been acquired

[369] Yankee Entertainment Sports (2002).

and reinforced by acquisition of distribution and programming. Regional market power through clustering plays a critical role,[152] particularly for advertising markets. Dominating specific programming categories generates both high profits and provides leverage to undermine competitors.[154] Cable operators have recently added bundling of high-speed Internet to their arsenal of anticompetitive practices[155] and have reinforced it with anticompetitive contracts.[156]

Even the BBC was stymied by MSOs who had other cable news programming interests.[370] The BBC was prevented by cable MSOs from establishing a cable news channel as far back as 1991. In 1998, the BBC announced it hoped to form agreements with cable operators to carry BBC World, its international news service, within the next two or three years. A CNN spokesman, Steve Haworth, is quoted as saying, "Competition is always good for journalism, but I think that the BBC will find this to be a very tough marketplace for them. Remember, this is a second attempt for them," referring to BBC World's unsuccessful first attempt to gain US cable distribution. BBC World was launched in 1991 but only made its first appearance in the United States in 1997 after it made a deal with 25 public television stations for them to carry daily news bulletins. BBC, as the Commission knows, was only able to secure some digital distribution after it partnered with MSO-linked Discovery Channel, creating the BBC America channel.

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

3. Quantitative Evidence

In a rigorous econometric analysis, the GAO found that cable operators were 64 percent more likely to carry their own programming.[371] 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 the proceeding at the FCC. 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.[372] Owners of premium services foreclose competitors and sell more of their own programming, but offer fewer services at higher prices.[373]

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[370] Heidi Przybyla, "BBC uses D.C. as Beachhead for American Invasion," *Washington Business Journal,* characterizes the incident as described in this paragraph.

[371] 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.

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

[373] Chipty, 2000, p. 429.

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 IV-2). 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 affiliated. Affiliated programmers are nine times as likely to gain carriage as independent programmers.

Exhibit IV-2: Independent Programmers are at A Disadvantage in Gaining Carriage

	INDEPENDENT	AFFILIATED	INDEPENDENT	AFFILIATED
National	#	#	%	%
Total	114	19	100	100
Total Carriage	12	20	11	105
Type of Carriage				
Standard				
Comcast	1	3	1	16
Time Warner	1	4	1	21
Premium				
Comcast	6	8	5	42
Time Warner	4	5	4	26

Source: "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 5.

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 IV-3). 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.

Exhibit IV-3: New National Affiliated Programs Receive Extreme Preference in Carriage from Dominant Cable Operators

SUBSCRIBER NETWORKS LEVEL UNAFFILIATED	NUMBER OF NETWORKS		PERCENTAGE OF	
	AFFILIATED	UNAFFILIATED	AFFILIATED	
	#	#	%	%
70 MILLION OR MORE	40	4	91	9
50 TO 70 MILLION	11	3	79	21
25 TO 50 MILLION	24	5	83	17
20 TO 25 MILLION	5	4	56	44

Source: "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, Exhibit 1.

One need not posit collusion to explain this pattern of discrimination. On the contrary, it takes place in the context of a market 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. Beyond collusion,[374] 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.[375] 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.[376]

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374 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.

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

376 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).

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.

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.[377] 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 IV-4). 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.

Exhibit IV-4: Program Suites of Firms with Carriage Rights

	ABC	NBC	CBS	TW	LIBERTY	FOX	COMCAST
GENERAL	ESPN Lifetime	USA	NICK TNT	TBS	Discovery	Fox Sports	Regional Sports
NEWS	ABC news	CNBC MSNBC	CBS	CNN	BBC America	FOX News	Regional News
EMERGING MASS	Family	SciFi	TV Land	Court Travel			Style
OLDER TRENDING	Bravo History A&E			TCM	Discovery Health Discovery Home	FMC	
YOUNGER TRENDING	Disney Toon Dis		Comedy MTV NickToons	TOON	Discovery Kids GSN	FX	Outdoor Life E! Sprout
EMERGING NICHE ESPN2	LMN ESPN Class Soapnet	CMT VH1	BET Jazz Spike VH1 Class VH1 Count MTV2 MTV Espan MTV Hits Nick Gas Noggins	Oxygen	Discovery Military Science	Speed Nat Geog	G4 Golf TVOne

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"Comments of American Cable Association," *Inquiry Concerning A La Carte, Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems,* MB Docket No. 04-207, July 12, 2004; 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; Federal Communications Commission, *Video Competition,* Eleventh Annual Reports

B. BROADER IMPLICATIONS OF VERTICAL LEVERAGE IN COMMUNICATIONS NETWORKS

One of the most interesting ways to appreciate the harm that abuse of vertical leverage can do is to listen to what the big firms say when they find themselves on the wrong side of the lever. The analysis in this section relies on a variety of analyses and complaints from participants in the sector including AT&T as a long distance carrier, before it became a cable owner,[378] AOL as an ISP, before it became a cable owner,[379] analyses prepared by experts for local[380] and long distance telephone companies,[381] when they were not effectuating mergers of their own, Wall Street analyses of the business models of dominant, vertically integrated cable firms,[382] and observations offered by independent ISPs[383] and small cable operators.[384]

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[378] AT&T in Canada before it became the nation's largest cable company. S*ee* AT&T Canada Long Distance Services, *Comments of AT&T Canada Long Distance Services Company*, REGULATION OF CERTAIN TELECOMMUNICATIONS SERVICE OFFERED BY BROADCAST CARRIERS, the Canadian Radio-television and Telecommunications Commission, Telecom Public Notice CRTC 96-36: (1997). The AT&T policy on open access after it became a cable company was first offered in a Letter from David N. Baker, Vice President, Legal & Regulatory Affairs, Mindspring Enterprises, Inc., James W. Cicconi, General Council and Executive Vice President, AT&T Corp., and Kenneth S. Fellman, Esq., Chairman, FCC Local & State Government Advisory Committee, to William E. Kennard, Chairman of FCC (Dec. 6, 1999), *available at* http://www.fcc.gov/mb/attmindspringletter.txt. Virtually no commercial activity took place as a result of the letter, which was roundly criticized. Subsequently their activities were described in Peter S. Goodman, *AT&T Puts Open Access to a Test: Competitors Take Issue with Firm's Coveted First-Screen Presence,* WASH. POST, Nov. 23, 2000, at E1. AT&T in the U.S. in situations where it does not possess an advantage of owning wires, *see AT&T Corp., Reply Comments*, DEPLOYMENT OF WIRELINE SERVS. OFFERING ADVANCED TELECOMMS. CAPABILITY CC Docket No. 98-147 (1998); *see AT&T Corp., Reply comments,* OPPOSITION TO SOUTHWESTERN BELL TEL. CO. SECTION 271 APPLICATION FOR TEX., APPLICATION OF SBC COMMUNICATIONS INC., SOUTHWESTERN BELL TEL. CO., & SOUTHWESTERN BELL COMMUNICATIONS SERVS., INC. D/B/A SOUTHWESTERN BELL LONG DISTANCE FOR PROVISION OF IN-REGION INTERLATA SERVICES. IN TEXAS (2000), *at* `http://gullfoss2.fcc.gov/ prod/ecfs/comsrch_v2.cgi`;

[379] *America Online, Inc., Comments*, TRANSFER OF CONTROL OF FCC LICENSES OF MEDIAONE GROUP INC., TO AT&T CORP., CS Docket 99-251 (filed Aug. 23, 1999) (providing, at the federal level, AOL's most explicit analysis of the need for open access); America Online Inc., *Open Access Comments of America Online, Inc*., before the DEPARTMENT OF TELECOMMUNICATIONS AND INFORMATION SERVICES, SAN FRANCISCO, October 27, 1999 (on file with author).

[380] Jerry A. Hausman, et al., *Residential Demand for Broadband Telecommunications and Consumer Access to Unaffiliated Internet Content Providers,* 18 YALE J. ON REG. (2001);

[381] John B. Hayes, Jith Jayaratne, and Michael L. Katz, *An Empirical Analysis of the Footprint Effects of Mergers Between Large ILECS*, citing "Declaration of Michael L. Katz and Steven C. Salop," submitted as an attachment to PETITION TO DENY OF SPRING COMMUNICATIONS COMPANY L.P, IN AMERITECH CORP. & SBC COMMUNICATIONS, INC., FOR CONSENT TO TRANSFER OF CONTROL*,* CC Dkt. No. 98-141 (filed Oct. 15, 1998) and PETITION TO DENY OF SPRING COMMUNICATIONS COMPANY L.P, IN GTE CORPORATION AND BELL ATLANTIC CORP. FOR CONSENT TO TRANSFER OF CONTROL, CC Docket. No. 98-184 (filed Nov. 23, 1998) (on file with author).

[382] Sanford C. Bernstein and McKinsey and Company, *Broadband!*, January, 2000 (on file with author); Merrill Lynch, AOL *Time Warner*, February 23, 2000; Paine Webber, *AOL Time Warner: Among the World's Most Valuable Brands*, March 1, 2000; Goldman Sachs, *America Online/Time Warner: Perfect Time-ing*, March 10, 2000 (on file with author).

[383] Earthlink, the first ISP to enter into negotiations with cable owners for access, has essentially given up and is vigorously seeking an open access obligation. *See* Notice of Ex Parte, Presentation Regarding the Applications of America Online, Inc. & Time Warner Inc. for Transfers of Control CS Docket No 00-30 (filed Oct. 18, 2000), *available at* http://gullfoss2.fcc.gov/prod/ecfs/comsrch_v2.cgi; NorthNet, Inc., An Open Access Business Model For Cable Systems: Promoting Competition & Preserving Internet

Current theoretical literature provides an ample basis for concerns that the physical layer of the communications platform will not perform efficiently or in a competitive manner without a check on market power. In this layer, barriers to entry are substantial, and go far beyond simple entrepreneurial skills that need to be rewarded.[385] At the structural level, new entry into these physical markets is difficult. AOL argued that the small number of communications facilities in the physical layer could create a transmission bottleneck that would lead directly to the problem of vertical leverage or market power. "[A] vertically integrated broadband provider such as AT&T will have a strong incentive and opportunity to discriminate against unaffiliated broadband content providers."[386]

Problems caused by vertical integration are particularly troubling in communications markets because a communications provider with control over essential physical facilities can exploit its power in more than one market. Whether we call them essential facilities,[387] choke points[388] or anchor points,[389] the key leverage point of a communications network is controlling access to facilities.

> The key, after all, is the ability to use "first mile" pipeline control to deny consumers direct access to, and thus a real choice among, the content and services offered by independent providers. Open access would provide a targeted and narrow fix to this problem. AT&T simply would not be allowed to control consumer's ability to choose service providers other than those AT&T itself has chosen for them. This would create an environment where independent, competitive service providers will have access to the broadband "first mile" controlled by AT&T – the pipe into consumers' homes – in order to provide a full, expanding range of voice, video, and data services requested by consumers. The ability to stifle Internet-based video competition and to restrict access to

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Innovation On A Shared, Broadband Communications Network, Ex Parte, *Application of America Online Inc. & Time Warner, Inc. for Transfers of Control*, F.C.C., CS-Docket No. 0030, October 16, 2000

384 *See American Cable Association, Comments*, In Re Implementation of the Cable Television Consumer Protection & Competition Act of 1992, Development of Competition in Video Programming Distribution: Section 628(c)(5) of the Communications Act: Sunset of Exclusive Contract Prohibition, CS Docket No. 01-290 (filed Dec. 3, 2001) *available at* `http://gullfoss2.fcc.gov/prod/ecfs/comsrch_v2.cgi`.

385 *See* Legal Rights Satellite Org., *Communications Convergence of Broadcasting and Telecommunications Services* (arguing that there were barriers to entry into physical facilities), at http://www.legal-rights.org/Laws/convergence.html (last visited Jan. 17, 2003):

386 Hausman, et al., *Residential Demand for* Broadband, at 129, 134.

387 Langlois, *Technology Standards,* at 195.

388 Mark Cooper, *Open Access to the Broadband Internet: Technical and Economic Discrimination in Closed, Proprietary Networks*, 71 U. COLO. L. REV. 1013 (2000).

389 Bernstein, *Broadband!*, at 18, 21. [T]he current set of alternatives for reaching customers with broadband connections is inadequate. At least for the time being, cable is closed, meaning that much of the value is, in effect, ceded to the platform rather than captured by the content/applications providers…[B]roadband access platforms are the anchor points for much of the value at stake and vehicles for accessing new revenue streams. Furthermore, access is currently a bottleneck, and access winners have the potential to leverage their privilege positioned to ensure long-term value creation.

providers of broadband content, commerce and other new applications thus would be directly diminished.[390]

Experts for the local telephone companies, in opposing the merger of AT&T and MediaOne, made this point arguing that "the relevant geographic market is local because one can purchase broadband Internet access only from a local residence"[391] and that "a dominant market share is not a necessary condition for discrimination to be effective."[392] "[A] hypothetical monopoly supplier of broadband Internet access in a given geographic market could exercise market power without controlling the provision of broadband access in neighboring geographic markets."[393]

The essential nature of the physical communication platform was the paramount concern for AT&T long distance in determining interconnection policy for cable networks in Canada.[394] AT&T attacked the claim made by cable companies that their lack of market share indicates that they lack market power, arguing that small market share does not preclude the existence of market power because of the essential function of the access input to the production of service.[395] AT&T further argued that open access "obligations are not dependent on whether the provider is dominant. Rather they are necessary in order to prevent the abuse of market power that can be exercised over bottleneck functions of the broadband access service."[396]

AT&T maintained that the presence of a number of vertically integrated facilities owners does not solve the fundamental problem of access that nonintegrated content providers face, pointing out that since independent content providers will always outnumber integrated providers, competition could be undermined by vertical integration. In order to avoid this outcome, even multiple facilities owners must be required to provide non-discriminatory

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390 That is exactly what AOL said about AT&T, when AOL was a nonaffiliated ISP. *See AOL, Transfer of Control*, at 13.

391 Hausman, et al., *Residential Demand for Broadband,* at 135.

392 *Id.* at 156.

393 *Id.* at 135.

394 AT&T Canada Long Distance Services, *Comments of AT&T Canada Long Distance Services Company*, REGULATION OF CERTAIN TELECOMMUNICATIONS SERVICE OFFERED BY BROADCAST CARRIERS, the Canadian Radio-television and Telecommunications Commission, Telecom Public Notice CRTC 96-36: (1997), at 12 .Each of these pronouncements made by regulators, policy makers and individual members of the industry reflects the strongly held view that access to the underlying facilities is not only necessary because of the bottleneck nature of the facilities in question, but also because it is critical for the development of competition in the provision of broadband services. AT&T Canada LDS shares this view and considers the control exercised by broadcast carriers over these essential inputs is an important factor contributing to the dominance of broadcast carriers in the market for access services.

395 Id. at 8-9. By contrast, the telephone companies have just begun to establish a presence in the broadband access market and it will likely take a number of years before they have extensive networks in place. This lack of significant market share, however, is overshadowed by their monopoly position in the provision of local telephony services. [I]n any event, even if it could be argued that the telephone companies are not dominant in the market for broadband access services because they only occupy a small share of the market, there are a number of compelling reasons to suggest that measures of market share are not overly helpful when assessing the dominance of telecommunications carriers in the access market….Id. at 9 (emphasis in original).

396 Id. at 24.

access.[397] This also applies in the ISP arena. AOL also believed that the presence of alternative facilities did not eliminate the need for open access.[398]

Two or three vertically integrated facilities in the broadband arena will not be enough to ensure vigorous competition. It is also important to note the consensus that cable is the dominant and preferred technology.[399] Cable's advantages are substantial, and DSL is not likely to be able to close the gap.[400]

Content discrimination has been the focal point of concern in relation to high-speed Internet services. Content discrimination involves an integrated provider "insulating its own affiliated content from competition by blocking or degrading the quality of outside content."[401] It benefits the vertically integrated entity "by enhancing the position of its affiliated content providers in the national market by denying unaffiliated content providers critical operating scale and insulating affiliated content providers from competition."[402]

AT&T identified four forms of anticompetitive leveraging—bundling, price squeeze, service quality discrimination, and first mover advantage.[403] It describes the classic vertical leveraging tools of price squeezes and quality discrimination as content discrimination. The experts for the local telephone companies identified a similar series of tactics that a vertically integrated broadband provider could use to disadvantage competing unaffiliated content providers.

> First, it can give preference to an affiliated content provider by caching its content locally. . . Such preferential treatment ensures that affiliated content can be delivered at faster speeds than unaffiliated content.

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[397] *Id*. at 12. Because there are and will be many more providers of content in the broadband market than there are providers of carriage, there always will be more service providers than access providers in the market. Indeed, even if all of the access providers in the market integrated themselves vertically with as many service providers as practically feasible, there would still be a number of service providers remaining which will require access to the underlying broadband facilities of broadcast carriers.

[398] AOL*, Comments, Transfer of Control*, at 14.[A]n open access requirement] would allow ISPs to choose between the first-mile facilities of telephone and cable operators based on their relative price, performance, and features. This would spur the loop-to-loop, facilities-based competition contemplated by the Telecommunications Act of 1996, thereby offering consumers more widespread availability of Internet access; increasing affordability due to downward pressures on prices; and a menu of service options varying in price, speed, reliability, content and customer service. Another indication that the availability of alternative facilities does not eliminate the need for open access policy can be found in AOL's conclusion that the policy should apply to both business and residential customers. If ever there was a segment in which the presence of two facilities competing might alleviate the need for open access requirement, the business segment is it. AOL rejected the idea. *Id*. at 1-2.

[399] Mark Cooper, "Breaking the Rules," attached to Petition to Deny of Consumers Union, Consumer Federation of America and Media Access Project, Applications for Consent to Transfer of Control of Licenses, MediaOne Group, Inc. Transferor to AT&T Corp., Transferee, CS 99-251 (filed August 23, 1999) (on file with author).

[400] Bernstein, *Broadband!*, at 30, 33, 50-51.

[401] Hausman et al., *Residential Demand for Broadband*, at 158.

[402] *Id.* at 159.

[403] *AT&T Canada*, *Comments of AT&T Canada*, *supra* note 50.

> Second, a vertically integrated broadband provider can limit the duration of streaming videos of broadcast quality to such an extent that they can never compete against cable programming . . .Third, a vertically integrated firm such as AT&T or AOL-Time Warner could impose proprietary standards that would render unaffiliated content useless. . .Once the AT&T standard has been established, AT&T will be able to exercise market power over customers and those companies trying to reach its customers.[404]

Even after AT&T became the largest cable TV company in the U.S., its long distance division criticized local telephone companies for abusing their monopoly control over their telephone wires. AT&T complained about bottleneck facilities, vertical integration, anticompetitive bundling of services, and the distortion of competition when it opposed the entry of SBC into the long distance market in Texas.[405] These are the very same complaints AOL made about AT&T as a cable company at about the same time.[406] AOL expressed related concerns about the manipulation of technology and interfaces, complaining about "allowing a single entity to abuse its control over the development of technical solutions – particularly when it may have interests inconsistent with the successful implementation of open access… It is therefore vital to ensure that unaffiliated ISPs can gain access comparable to that the cable operators choose to afford to its cable-affiliated ISP.[407]

Long distance companies and competitive local exchange carriers have similar concerns about the merging local exchange carriers. Their experts argued in the proposed SBC-Ameritech and Bell Atlantic-GTE mergers that large size gave network owners an incentive to discriminate. "The economic logic of competitive spillovers implies that the increase in [incumbent local exchange carrier (ILEC)] footprints resulting from these proposed mergers would increase the

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[404] Hausman et al., *Residential Demand for Broadband*, *supra* note 52, at 160-62.

[405] *AT&T Corp., Reply comments,* Opposition to Southwestern Bell Tel. Co. Section 271 Application for Tex., Application of SBC Communications Inc., Southwestern Bell Tel. Co., & Southwestern Bell Communications Servs., Inc. d/b/a Southwestern Bell Long Distance for Provision of In-Region InterLATA Services. in Texas (2000), *at* `http://gullfoss2.fcc.gov/prod/ecfs/comsrch_v2.cgi`.

[406] AT&T Canada, Comments of AT&T Canada, at 15-16.

The dominant and vertically integrated position of cable broadcast carriers requires a number of safeguards to protect against anticompetitive behaviour. These carriers have considerable advantages in the market, particularly with respect to their ability to make use of their underlying network facilities for the delivery of new services. To grant these carriers unconditional forbearance would provide them with the opportunity to leverage their existing networks to the detriment of other potential service providers. In particular, unconditional forbearance of the broadband access services provided by cable broadcast carriers would create both the incentive and opportunity for these carriers to lessen competition and choice in the provision of broadband service that could be made available to the end customer . . .The telephone companies also have sources of market power that warrant maintaining safeguards against anticompetitive behaviour. For example, telephone companies are still overwhelmingly dominant in the local telephony market and, until this dominance is diminished, it would not be appropriate to forebear unconditionally from rate regulation of broadband access services.

[407] America Online Inc., *Open Access Comments of America Online, Inc.*, before the DEPARTMENT OF TELECOMMUNICATIONS AND INFORMATION SERVICES, SAN FRANCISCO, October 27, 1999 (on file with author, at 8.

ILECs' incentive to disadvantage rivals by degrading access services they need to compete, thereby harming competition and consumers."[408]

Wall Street analysts point out that the key to controlling the supply side is controlling essential functions through proprietary standards.[409] Independent ISPs point out that cable operators like AOL use control over functionalities to control the services available on the network.[410] Cable operators have continued to insist on quality of service restrictions by unaffiliated ISPs, which places the ISPs at a competitive disadvantage.[411] Cable operators must approve new functionalities whether or not they place any demands on the network.

Price squeeze and extraction of rents are apparent in the implementation of closed platforms. Thomas Hazlett and George Bittlingmayer cite Excite@Home executive Milo Medin describing the terms on which cable operators would allow carriage of broadband Internet to AOL (before it owned a wire) as follows:

> I was sitting next to [AOL CEO] Steve Case in Congress during the open access debates. He was saying that all AOL wanted was to be treated like Excite [@]Home. If he wants to be treated like us, I'm sure he could cut a deal with [the cable networks], but they'll take their pound of flesh. We only had to give them a 75 percent equity stake in the company and board control. The cable guys aren't morons.[412]

In the high speed Internet area, conduit discrimination has received less attention than content discrimination. This is opposite to the considerable attention it receives in the cable TV video service area. Nevertheless, there are examples of conduit discrimination in the high speed Internet market.

In implementing conduit discrimination, the vertically integrated company would refuse to distribute its affiliated content over competing transmission media. In so doing, it seeks to drive consumers to its transmission media and weaken its rival. This is profitable as long as the revenue gained by attracting new subscribers exceeds the revenue lost by not making the content available to the rival. Market size is important here, to ensure adequate profits are earned on the distribution of service over the favored conduit. Although some argue that "the traditional

[408] Hayes, et al., *Empirical Analysis*, at 1.

[409] *See* Bernstein, *Broadband!*, at 57. Thus, the real game in standards is to reach critical mass for your platform without giving up too much control. This requires a careful balance between openness (to attract others to your platform) and control over standards development (to ensure an advantaged value-capture position). Of course, the lessons of Microsoft, Cisco, and others are not lost on market participants, and these days no player will willingly cede a major standards-based advantage to a competitor. Therefore, in emerging sectors such as broadband, creating a standards-based edge will likely require an ongoing structural advantage, whether via regulatory discontinuities, incumbent status, or the ability to influence customer behavior.

[410] Bernstein, *Broadband!*, at 57.

[411] Hausman et al.,*Residential Demand for Broadband*, at 133.

[412] Thomas W. Hazlett & George Bittlingmayer, *The Political Economy of Cable "Open Access,* (AEI-Brookings Joint Center for Regulatory Studies, Working Paper No. 01-06, 2001), *available at* http://www.aei.brookings.org/publications/working/ working_01_06.pdf., at 17 n.47 (quoting Jason Krause & Elizabeth Wasserman, *Switching Teams on Open Access?*, THE INDUSTRY STANDARD, Jan. 24, 2000, *available at* http://www.thestandard.com/article/display/1,1153,8903,00.html).

models of discrimination do not depend on the vertically integrated firm obtaining some critical level of downstream market share,"[413] in reality, the size of the vertically integrated firm does matter since "a larger downstream market share enhances the vertically integrated firm's incentive to engage in discrimination."[414]

AT&T has been accused of conduit discrimination in the high speed Internet market.[230] The AOL-Time Warner merger has also raised similar concerns. The significance of AOL's switch to cable-based broadband should not be underestimated. This switch has a powerful effect on the hoped-for competition between cable modems and DSL.[415] Although telephone companies are reluctant to admit that their technology will have trouble competing, their experts have identified the advantages that cable enjoys.[232] Fearing that once AOL became a cable owner it would abandon the DSL distribution channel, the FTC required AOL to continue to make its service available over the DSL conduit.

The focal point of a leveraging strategy is bundling early in the adoption cycle to lock in customers. AOL has also described the threat of vertically integrated cable companies in the U.S.[416] Once AT&T became the largest vertically integrated cable company selling broadband access in the U.S., it set out to prevent potential competitors from offering bundles of services. Bundles could be broken up either by not allowing Internet service providers to have access to video customers, or by preventing companies with the ability to deliver telephony from having access to high-speed content. For the Wall Street analysts, bundling seems to be the central marketing strategy for broadband.[417]

AOL argued that requiring open access early in the process of market development would establish a much stronger structure for a pro-consumer, pro-competitive market.[418] Early intervention prevents the architecture of the market from blocking openness, and thus avoids the difficult task of having to reconstruct an open market at a later time.[419] AOL did not hesitate to

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413 Hausman et al., *Residential Demand for Broadband*, at 156 (footnote omitted). The ACA provides the calculation for cable operators.

414 Hausman et al., *Residential Demand for Broadband*, at 156 (footnote omitted).

415 Bernstein, *Broadband!*, at 12-14; Merrill Lynch, AOL *Time Warner,* at 33.

416 AOL has argued: At every key link in the broadband distribution chain for video/voice/data services, AT&T would possess the ability and the incentive to limit consumer choice. Whether through its exclusive control of the EPG or browser that serve as consumers' interface; its integration of favored Microsoft operating systems in set-top boxes; its control of the cable broadband pipe itself; its exclusive dealing with its own proprietary cable ISPs; or the required use of its own "backbone" long distance facilities; AT&T could block or choke off consumers' ability to choose among the access, Internet services, and integrated services of their choice. Eliminating customer choice will diminish innovation, increase prices, and chill consumer demand, thereby slowing the roll-out of integrated service; AOL*, Comments, Transfer of Control*, at 11.

417 Goldman Sachs, America Online/Time Warner, at 14, 17.AOL Time Warner is uniquely positioned against its competitors from both technology and media perspectives to make the interactive opportunity a reality. This multiplatform scale is particularly important from a pricing perspective, since it will permit the new company to offer more compelling and cost effective pricing bundles and options than its competitors. Furthermore, AOL Time Warner will benefit from a wider global footprint than its competitors" ". . .[W]e believe the real value by consumers en masse will be not in the "broadband connection" per se, but rather an attractively packaged, priced, and easy-to-use service that will bundle broadband content as an integral part of the service.

418 AOL*, Comments, Transfer of Control*..

419 Jonathan Krim, *FCC Rules Seek High-Speed Shift; Phone Firms Would Keep Cable Rights*, WASH. POST, Feb. 15, 2002, at E1 (on the higher cost of addressing problems *ex post*).

point out the powerful anticompetitive effect that integrating video services in the communications bundle could have. AOL argued that, as a result of a vertical merger, AT&T would take an enormous next step toward its ability to deny consumers a choice among competing providers of integrated voice/video/data offerings – a communications marketplace that integrates, and transcends, an array of communications services and markets previously viewed as distinct.[420]

Wall Street saw the first mover advantage both in the general terms of the processes that affect network industries, and in the specific advantage that cable broadband services have in capturing the most attractive early adopting consumers.[421] First mover advantages have their greatest value where consumers have difficulty switching or substituting away from the dominant product.[422] Several characteristics of Broadband Internet access are conducive to the first mover advantage, or "lock-in."

The local telephone companies have outlined a series of concerns about lock in.[423] High-speed access is a unique product.[424] The Department of Justice determined that the broadband Internet market is a separate and distinct market from the narrowband Internet market.[425] There are switching costs that hinder competition, including equipment (modems) purchases, learning costs, and the inability to port names and addresses. Combining a head start with significant switching costs raises the fear among the independent ISPs that consumers will be locked in. In

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[420] AOL, Comments, Transfer of Control, at 9-10.

[421] Merrill Lynch, AOL *Time Warner,* at 38 ("If the technology market has a communications aspect to it, moreover, in which information must be shared [spreadsheets, instant messaging, enterprise software applications], the network effect is even more powerful."); Bernstein, *Broadband!*, *supra* note 54, at 26: "Thus, if the MSOs can execute as they begin to deploy cable modem services in upgraded areas, they have a significant opportunity to seize many of the most attractive customers in the coming broadband land grab. These customers are important both because they represent a disproportionate share of the value and because they are bell weathers for mass-market users."

[422] Merrill Lynch, AOL *Time Warner,* at 38 ("If the technology market has a communications aspect to it, moreover, in which information must be shared [spreadsheets, instant messaging, enterprise software applications], the network effect is even more powerful."); Bernstein, *Broadband!*, *supra* note 54, at 26: "Thus, if the MSOs can execute as they begin to deploy cable modem services in upgraded areas, they have a significant opportunity to seize many of the most attractive customers in the coming broadband land grab. These customers are important both because they represent a disproportionate share of the value and because they are bell weathers for mass-market users."

[423] Hausman, et al., *Residential Demand for Broadband*, at 164. "Due to the nature of network industries in general, the early leader in any broadband Internet access may enjoy a "lock-in" of customers and content providers – that is, given the high switching costs for consumers associated with changing broadband provider (for example, the cost of a DSL modem and installation costs), an existing customer would be less sensitive to an increase in price than would a prospective customer."

[424] Hausman, et al., *Residential Demand for Broadband*, at 136-48; Bernstein, *Broadband!*, 54, at 8; *AT&T Canada*, at 12. "AT&T Canada notes that narrowband access facilities are not an adequate service substitute for broadband access facilities. The low bandwidth associated with these facilities can substantially degrade the quality of service that is provided to the end customer to the point where transmission reception of services is no longer possible."

[425] Amended Complaint of the Dep't of Justice at 6, U.S. v. AT&T Corp., 2000 WL 1752108 (D.C. Cir. 2000) (No. 1:00CV01176), *available at* http://www.usdoj.gov/atr/ cases/indx4468.htm.

Canada, AT&T argued that the presence of switching costs could impede the ability of consumers to change technologies, thereby impeding competition.[426]

C. THE CRITICAL ROLE OF VERTICAL LEVERAGE IN DIGITAL INDUSTRIES

Antitrust authorities reviewing mergers or evaluating complaints of anticompetitive conduct and Communications Act authorities considering obligations of interconnection must consider anticompetitive conduct because dominant firms in the critical layers of the platform may have the incentive and ability to protect and promote their interests at the expense of competition and the public. These considerations take on particular importance in digital networks, where facilities-based competition is feeble at best and bottlenecks take on particular importance in affecting the flow of communications and commerce.

The vertical nature of the digital communications platform raises new concerns about these anticompetitive behaviors. Competition within a given layer, the equivalent of traditional horizontal competition, can take place without competition across layers.[427] The type of behavior across layers is very important, both because it can promote dynamic change and because it can involve powerful anticompetitive leverage. If it is procompetitive, it can move the whole platform to a higher level of production. If it is anticompetitive, it can be very dangerous. It can pollute a competitive layer and it can undermine the best basis for introducing competition in a layer that had not hitherto been competitive.

In old economy industries, vertical leverage is exploited by business practices. Companies vertically integrate to internalize transactions. Where concerns about vertical integration have traditionally been raised, they focus on integration for critical inputs across markets. Vertically integrated companies may withdraw business from the open market, driving up the cost of inputs for competitors, or deny supply to the market.[428] If they constitute a large

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[426] AT&T Canada, Comments of AT&T Canada, at 12.The cost of switching suppliers is another important factor which is used to assess demand conditions in the relevant market. In the case of the broadband access market, the cost of switching suppliers could be significant, particularly if there is a need to adopt different technical interfaces or to purchase new terminal equipment for the home or office. Given the fact that many of the technologies involved in the provision of broadband access services are still in the early stages of development, it is unlikely that we will see customer switching seamlessly form one service provider to another in the near-term.

[427] Michael L. Katz & Carl Shapiro, *System Competition and Network Effects*, 8 J. ECON. PERSPECTIVES 93, 105-6 (1994), argue that competition between incompatible systems is possible, depending on consumer heterogeneity. Paul Belleflamme, *Stable Coalition Structures with Open Membership and Asymmetric Firms*, 30 GAMES & ECON. BEHAVIOR 1, 1-3 (2000), and Berd Woeckener, *The Competition of User Networks: Ergodicity, Lock-ins, and Metastability*, 41 J. ECON. BEHAVIOR & ORG. 85, 86-7 (2000), reach a similar conclusion in a different theoretic framework. Timothy F. Bresnahan & Shane Greenstein, *Technological Competition and the Structure of the Computer Industry*, 47 J. INDUSTRIAL ECON. 1, 5-8 (1999), envision a great deal of competition within the layers of a platform and across layers in relatively short periods of time. The description of IBM's mainframe platform provided by Franklin M. Fisher, *The IBM and Microsoft Cases: What's the Difference?*, 90 AM. ECON. REV. 180, 183 (1999), stresses both these points. See also Daniel L. Rubinfeld, *Antitrust Enforcement in Dynamic Network Industries,* 43 ANTITRUST BULL. 859, 873-75 (1998); Willow A. Sheremata, *New Issues in Competition Policy Raised by Information Technology Industries*, 43 ANTITRUST BULL. 547, 573-74 (1998); Timothy Bresnahan, *The Economics of the Microsoft Case* (available from the author); Steven C. Salop and R. Craig Romaine, *Preserving Monopoly: Economic Analysis, Legal Standards, and Microsoft*, GEO. MASON L. REV. (1999).

[428] William G. Shepherd, THE ECONOMICS OF INDUSTRIAL ORGANIZATION (3d ed., 1990), at 289-90.

share of the market or refuse to buy or sell intermediate inputs (or raise the costs to rivals) the impact can be anticompetitive. By integrating across stages of production, incumbents can create barriers to entry by forcing potential competitors to enter at more than one stage, making competition much less likely due to increased capital requirements.[429] Exclusive and preferential deals for the use of facilities and products compound the problem. They "reduce the number of alternative sources for other firms at either stage, [which] can increase the costs of market or contractual exchange."[430] Integrated firms can impose higher costs on their rivals, or degrade their quality of service to gain an advantage. "[F]or example, the conduct of vertically integrated firms increase[s] risks for nonintegrated firms by exposing downstream specialists to regular or occasional price squeezes."[431] Vertical integration facilitates price squeezes and enhances price discrimination.[432]

The platform nature of digital communications creates unique new sources of vertical leverage. The code and physical layers that lie at the bottleneck of the platform makes threats to the openness of the network very potent. They have great leverage because of their critical location. In a platform industry, vertical leverage can take a more insidious form, technological integration/manipulation.[433] Introduction of incompatibilities can impair or undermine the function of disfavored complements. The ability to undermine interoperability or the refusal to interoperate is an extremely powerful tool for excluding or undermining rivals and thereby short circuiting competition, as is the withholding of functionality. The mere threat of incompatibility or foreclosure through the refusal to interoperate can drive competitors away.[434]

The dominant players in the physical and code layers have the power to readily distort the architecture of the platform to protect their market interests.[435] They have a variety of tools to create economic and entry barriers such as exclusive deals, retaliation, manipulation of standards,

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429 *See* Martin K. Perry, *Vertical Integration: Determinants and Effects*, in HANDBOOK OF INDUSTRIAL ORGANIZATION (Richard Schmalensee & Robert D. Willigs, eds., 1989), at 183, 247; F. Michael Scherer & David Ross, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE (1990), at 526.

430 Martin K. Perry, *Vertical Integration: Determinants and Effects*, in HANDBOOK OF INDUSTRIAL ORGANIZATION (Richard Schmalensee & Robert D. Willigs, eds., 1989), at 246; s*ee* also WILLIAM G. SHEPHERD, THE ECONOMICS OF INDUSTRIAL ORGANIZATION (3d ed. 1990), at 294.

431 F. Michael Scherer & David Ross, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE (1990), at 526.

432 Other behavior effects may occur, for example, collusion, mutual forbearance and reciprocity may exist where the small number of interrelated entities in the industry recognize and honor each others' spheres of influence. The final behavioral effect is to trigger a rush to integrate and concentrate. Being a small independent entity at any stage renders the company extremely vulnerable to a variety of attacks. *See* Shepherd, ECONOMICS, at 290.

433 Richard N. Langlois, *Technology Standards, Innovation, and Essential Facilities: Toward a Schumpeterian Post-Chicago Approach*, in DYNAMIC COMPETITION & PUB. POLICY: TECHNOLOGY, INNOVATIONS, AND ANTITRUST ISSUES (Jerry Ellig, ed., 2001), *available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=204069* (last visited Jan. 24, 2003) at 52, "The owner of a dominant standard may thus want to manipulate the standard in ways that close off the possibilities for a competitor to achieve compatibility. This has a tendency to retard the generational advance of the system."

434 Tim Wu & Lawrence Lessig, *Ex Parte Submission* in CS DOCKET *No. 02-52,* August 22, 2003, at 7-8.

435 *See id. See* also Franklin M. Fisher, *Innovation and Monopoly Leveraging,* in DYNAMIC COMPETITION AND PUBLIC POLICY: TECHNOLOGY, INNOVATION, AND ANTITRUST ISSUES 138 (Jerry Ellig, ed., 2001).

and strategies that freeze customers.[436] Firms can leverage their access to customers to reinforce their market dominance by creating ever-larger bundles of complementary assets.[437] As the elasticity of demand declines over the course of the product life cycle, market power lodged in the physical layer results in excessive bundling and overpricing of products under a variety of market conditions.[438] Control over the product cycle can impose immense costs by creating incompatibilities, forcing upgrades, and by spreading the cost increases across layers of the platform to extract consumer surplus.[439]

Scale and scope economies may be so strong in the critical layers of the platform that they may give rise to a unique characteristic of a market called tipping. Interacting with network effects and the ability to set standards, the market tips toward one producer. Firms seek to accomplish technological "lock-in."[440] These processes create what has been called an 'applications barrier to entry.' After capturing the first generation of customers and building a

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[436] Joseph Farrell & Garth Saloner, *Installed Base and Compatibility: Innovation, Product Preannouncements, and Predation*, 76 AM. ECON. REV. 940, 948-51 (1986); Michael L. Katz & Carl Shapiro, *Product Introduction with Network Externalities*, 40 J. INDUS. ECON. 55, 73 (1992); Richard Makadok, *Can First-Mover and Early-Mover Advantages Be Sustained in an Industry with Low Barriers to Entry/Imitation?,* 19 STRATEGIC MGMT. J. 683, 685-86 (1998); Ulrich Witt, *"Lock-in" vs. "Critical Masses"– Industrial Change Under Network Externalities*, 15 INT'L J. INDUS. ORG. 753, 768-69 (1997); Robin Mansell, *Strategies for Maintaining Market Power in the Face of Rapidly Changing Technologies*, 31 J. ECON. ISSUES 969, 970 (1997); Melissa A. Schilling, *Technological Lockout: An Integrative Model of the Economic and Strategic Factors Driving Technology Success and Failure*, 23 ACAD. MGMT. REV. 267, 276 (1998); Willow A. Sheremata, "*New" Issues in Competition Policy Raised by Information Technology Industries*, 43 ANTITRUST BULL. 547, 560-561, 573-74 (1998); Glenn A. Woroch et al., *Exclusionary Behavior in the Market for Operating System Software: The Case of Microsoft*, in OPENING NETWORKS TO COMPETITION: THE REGULATION AND PRICING OF ACCESS 221 (David Gabel & David F. Weiman, eds., 1998); *see* also Charles H. Ferguson, HIGH ST@KES, NO PRISONERS: A WINNER'S TALE OF GREED AND GLORY IN THE INTERNET WARS (1999), at 307; Mark A. Lemley & David McGowan, *Could Java Change Everything? The Competitive Propriety of a Proprietary Standard,* ANTITRUST BULL., 43 (1998), at 715, 732-33; Joseph P. Guiltinan, *The Price Bundling of Services: A Normative Framework,* J. MKTG. 74 (April 1987); Lester Telser, *A Theory of Monopoly of Complementary Goods*, 52 J. BUS. 211 (1979); Richard Schmalensee, *Gaussian Demand and Commodity Bundling*, 57 J. BUS. 211 (1984).

[437] Makadok, *First-Mover and Early-Mover Advantages,* , at 685; David B. Yoffie, *CHESS and Competing in the Age of Digital Convergence,* in COMPETING IN THE AGE OF DIGITAL CONVERGENCE (David B. Yoffie, ed., 1997), at 1, 27; *see* also Robert E. Dansby & Cecilia Conrad, *Commodity Bundling*, 74 AM. ECON. REV. 377 (1984).

[438] Carmen Matutes & Pierre Regibeau, *Compatibility and Bundling of Complementary Goods in a Duopoly*, 40 J. INDUS. ECON. 37 (1992); Joseph P. Guiltinan, *The Price Bundling of Services: A Normative Framework,* J. MKTG. 74 (April 1987); Lester Telser, *A Theory of Monopoly of Complementary Goods*, 52 J. BUS. 211 (1979); Richard Schmalensee, *Gaussian Demand and Commodity Bundling*, 57 J. BUS. 211 (1984).

[439] Jay Pil Choi, *Network Externality, Compatibility Choice, and Planned Obsolescence*, 42 J. INDUS. ECON. 167, 171-73 (1994); Glenn Ellison & Drew Fudenberg, *The Neo-Luddite's Lament: Excessive Upgrades in the Software Industry*, 31 RAND J. ECON. 253 (2000); Drew Fudenberg & Jean Tirole, *Upgrades, Trade-ins, and Buybacks*, 29 RAND J. ECON. 235, 235-36 (1998); K. Sridhar *Segmentation, Self Selection, and Product Lines Design*, 3 MKTG. SCI. 256 (1985); Marcel Thum, *Network Externalities, Technological Progress, and the Competition of Market Contract*, 12 INT. J. INDUS. ORG. 269 (1994).

[440] Schilling, *Technological Lockout,* at 267, 268, 270; Willow A. Sheremata, *Barriers to Innovation: A Monopoly, Network Externalities, and the Speed of* Innovation, 42 ANTITRUST BULL. 937, 941, 964, 967 (1997); Robin Cowan, *Tortoises and Hares: Choice Among Technologies of Unknown Merit*, 101 ECON. J. 807, 808 (1991); Dominique Foray, *The Dynamic Implications of Increasing Returns: Technological Change and Path Dependent Efficiency*, 15 INT. J. INDUSTRIAL ORG. 733, 748-49 (1997); Joseph Farrel & Garth Saloner, *Standardization, Compatibility, and* Innovation, 16 RAND J. ECON. 70-83 (1986).

customer base, it becomes difficult, if not impossible, for later technologies to overcome this advantage.[441] Customers hesitate to abandon their investments in the dominant technology and customer acquisition costs rise for latecomers.

This creates an immense base of monopsony power for dominant players in the critical layers. We use the term monopsony broadly to refer to the ability to control demand. If a firm is a huge buyer of content or applications or can dictate which content reaches the public through control of a physical or code interface (a cable operator that buys programming or an operating system vendor who bundles applications), it can determine the fate of content and applications developers. In fact, network effects are also known as demand side economies of scale. To the extent that a large buyer or network owner controls sufficient demand to create such effects, particularly in negotiating with sellers of products, they have monopsony power.

These anti-competitive behaviors are attractive to a dominant new economy firm for static and dynamic reasons.[442] Preserving market power in the core market by erecting cross-platform incompatibilities that raise rivals' costs is a critical motivation. Preventing rivals from achieving economies of scale can preserve market power in the core product and allow monopoly rents to persist. Profits may be increased in the core product by enhanced abilities to price discriminate. Conquering neighboring markets has several advantages. By driving competitors out of neighboring markets, market power in new products may be created or the ability to preserve market power across generations of a product may be enhanced by diminishing the pool of potential competitors.

The growing concern about digital information platform industries derives from the fact that the physical and code layers do not appear to be very competitive.[443] There are not now nor are there likely to be a sufficient number of networks deployed in any given area to sustain vigorous competition. Vigorous and balanced competition between operating systems has not been sustained for long periods of time. Most communications markets have a small number of

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441 Jeffrey Church & Neil Gandal, *Complementary Network Externalities and Technological Adoption*, 11 INT'L J. INDUS. ORG. 239, 241 (1993); Chou Chien-fu & Oz Shy, *Network Effects Without Network Externalities*, 8 INT'L J. INDUS. ORG. 259, 260 (1990).

442 Michael Katz & Carl Shapiro, *Antitrust and Software Markets*, in COMPETITION, INNOVATION AND THE MICROSOFT MONOPOLY: ANTITRUST AND THE DIGITAL MARKETPLACE, (Jeffrey A. Eisenach & Thomas M. Lenard, eds., 1999), at 70-80; Lansuz A. Ordover & Robert D. Willig, *Access and Bundling in High Technology Markets*, in COMPETITION, INNOVATION AND THE MICROSOFT MONOPOLY: ANTITRUST AND THE DIGITAL MARKETPLACE (Jeffrey A. Eisenach & Thomas M. Lenard, eds., 1999); Rubinfeld, *Antitrust Enforcement*, at 877-81; Steven C. Salop, *Using Leverage to Preserve Monopoly*, in COMPETITION, INNOVATION AND THE MICROSOFT MONOPOLY: ANTITRUST AND THE DIGITAL MARKETPLACE (Jeffrey A. Eisenach & Thomas M. Lenard, eds., 1999).

443 Daniel L. Rubinfeld & John Hoven, *Innovation and Antitrust Enforcement*, in DYNAMIC COMPETITION AND PUBLIC POLICY: TECHNOLOGY, INNOVATION, AND ANTITRUST ISSUES (Jerry Ellig, ed., 2001), at 65, 75-76. T. Randolph Beard, George S. Ford & Lawrence J. Spiwak, *Why ADCo? Why Now: An Economic Exploration into the Future of Industry Structure for the "Last Mile" in Local Telecommunications Markets (*Phoenix Center, November 2001); Computer Science and Telecommunications Board, National Research Council, BROADBAND, BRINGING HOME THE BITS (2002), at 23; 152-154; Anupam Banerjee & Marvin Sirvu, "Towards Technologically and Competitively Neutral Fiber to the Home (FTTH) Infrastructure," paper presented at *Telecommunications Policy Research Conference, 2003; Stagg Newman, "Broadband Access Platforms for the Mass Market,* paper presented at *Telecommunications Policy Research Conference, 2003.*

competitors. In the high speed Internet market, there are now two main competitors and the one with the dominant market share has a substantially superior technology.[444] When or whether there will be a third, and how well it will be able to compete, is unclear. This situation is simply not sufficient to sustain a competitive outcome.

The emerging model for closed communications platforms is one in which the firm with a dominant technology at the central layers of the platform can leverage control to achieve domination of applications and content. Given the hourglass shape of the platform, the critical layers are at the waist of the platform. Proprietary control of network layers in which there is a lack of adequate alternatives allows owners to lock in consumers and squeeze competitors out of the broader market. The observable behavior of the incumbent wire owners contradicts the theoretical claims made in defense of closed platforms. For the last several decades of the 20th century, general analysis concerning vertical integration in market structure was muted. However, a number of recent mergers in the communications industries, between increasingly larger owners of communications facilities, have elicited vigorous analysis of the abuse of vertical market power (e.g. Comcast/Adelphia (TimeWarner swaps)/AT&T/MediaOne/TCI, AOL/Time Warner/Turner, SBC Communications Inc. (SBC)/Ameritech/SNET/Pacific Bell and Bell Atlantic/GTE/NYNEX). As one former antitrust official put it, "[t]he increasing number of mergers in high-technology industries has raised both horizontal and vertical antitrust issues . . . the interest in and analysis of vertical issues has come to the forefront.[445]

D. CUTTING OFF THE AIR SUPPLY OF INTERNET VIDEO COMPETITION

1. The Browser Wars as a Model for the Battle over IMVPD

An easy way to understand the threat to the Internet platform for multi-channel video programming distribution (IMVPD) posed by the Comcast-NBC merger is to recall the Department of Justice case against Microsoft.[446] The case grew out of what was known as the "browser wars" between Microsoft's Internet Explorer and Netscape's Navigator. Navigator had entered the new market for web access and grown rapidly as the leading browser, with a commitment to "write once, work anywhere." Bill Gates, Microsoft CEO, declared that " a threat is born on the Internet." The threat was the possibility that browsers could provide a platform for accessing the Internet that would work with any operating system, thereby rendering Microsoft's near monopoly over operating systems much less important. "A new competitor "born" on the Internet is Netscape… They are pursing a multi-platform strategy… to commoditize the underlying operating system."[447]

The strategy Microsoft used to undercut this threat was described with the colorful phrase "we will cut of their air supply."[448] Microsoft set out to saturate the market with its own

[444] National Research Council, BROADBAND..

[445] Daniel L. Rubinfeld & Hal. J. Singer, *Open Access to Broadband Networks: A Case Study of the AOL/Time Warner Merger*, 16 BERKELEY TECH. L.J. 631 (2001).

[446] United States v. Microsoft Corp., 84 F.Supp. 2d 9 (D.D.C. 1999).

[447] Government Exhibit #20.

[448] Rajiv Chandrasekaran, "Microsoft Attacks Credibility of Intel Exec,"*Washington Post,* Friday, November 13, 1998; Page B1, "The Microsoft antitrust trial turned into a tense sparring match over the credibility of a witness from Intel Corp. yesterday, with a lawyer for Microsoft accusing the executive

browsers by bundling them with the operating system software and giving them away for free. It took steps to undermine the quality of the competing browser and reinforced this strategy by offering a number of inducements to computer manufacturers (known as original equipment manufacturers or OEMs), who decide which software to put onto the computer, to pre-load only Internet Explorer.

With access to low cost distribution through the OEM channel secured for Internet Explorer and free distribution, Navigator would be denied revenues and forced to use more expensive ways to try to distribute its product. Starved of cash, Navigator would shrivel. "Microsoft could still defray the massive costs it was undertaking to maximize usage share with the vast profits earned by licensing Windows. Because Netscape did not have that luxury, it could ill afford the dramatic drop in revenues from Navigator, much less to pay for the inefficient modes of distribution to which Microsoft consigned it. The financial constraints also deterred Netscape from undertaking technical innovations that it might otherwise have implemented in Navigator."[449] Free browsers might seem like a good deal for consumers in the short run, but in the long run this strategy of eliminating competition has a heavy cost.[450] It preserves and extends the Microsoft monopoly in the operating system market and undermines innovation and development in browsers or other products that might compete with Microsoft's core products, keeping the cost of Microsoft's core product far higher than it should be. It denies consumers alternatives that better suit their needs, and forces consumers to buy products in inconvenient ways, there by imposing high costs on consumers.

2. Internet Multi-channel Video Program Distribution

Comcast's current strategy is to cut off the air supply of the Internet as a platform for competing with Comcast's core franchise business, multi-channel video programming distribution (see Exhibit IV-5). It which will impose the similar costs on consumers, allowing Comcast to continue to raise cable prices and retarding the ability of the Internet to support alternative distribution models.

- Comcast is proposing to bundle online video with physical space video by requiring physical subscription to get access to online video.

Exhibit IV-5: Strategies to Undermine Nascent Competition on the Internet

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of concocting some of his most colorful testimony and the government producing several documents to support the witness's claims. On the witness stand was Steven McGeady, an Intel vice president called by the government. He testified earlier this week that Microsoft Corp. had threatened to withhold crucial technical support from Intel if the chipmaker did not stop developing software that would compete with Microsoft's products. He also made the dramatic allegation that a senior executive at Microsoft told him of an intent to "extinguish" rival Netscape Communications Corp. and to "cut off Netscape's air supply…With McGeady's credibility hanging in the balance, Justice Department lawyer David Boies set out to rehabilitate his image in the afternoon. On a large screen in the courtroom, he played several segments of a videotaped deposition by McGeady's boss, Ron Whittier. On the tape, Whittier said that he recalled the term "smother" being used to describe Microsoft's strategy at the meeting in question."

[449] United v. Microsoft Corp., 84 F Supp. 2d 9 (D.D.C. 1999)

[450] Mark Cooper, "Antitrust as Consumer Protection in the New Economy: Lessons from the Microsoft Case," *Hastings Law Journal,* 52:4) April 2001.

BROWSER WARS STRATEGY	ATTACK INTERNET MVPD PLATFORM
Bundle IE browser and operating system	Bundle online video with physical space video by requiring physical subscription to get access to online video
	Keep set top box closed, forcing IMVPD to find non-Comcast hardware
Raise entry costs through incompatibility	Keep set top box closed, forcing IMVPD to find non-Comcast hardware
Incent OEMs to preload IE not Navigator	Pressure incumbent MVPDs to participate in TV Everywhere, shrinking the market of competing platforms
Degrade the quality of Navigator	Withhold valuable marquee content to undermine the quality or raise the cost of content available on the Internet platform.
	Pressure content providers to not make their product available on the Internet by offering favorable conditions for physical space distribution to those who deny Internet access to content
Make using Nav. a "jolting experience"	Use the ability to block or degrade the quality of service of specific application and Internet Service Providers, forcing IMVPD to rely on non-Comcast broadband ISP

- It is pressing content providers to not make their product available on the Internet by offering favorable conditions for physical space distribution to those who deny Internet access to content.
- The acquisition of NBC will give it a new set of immensely powerful weapons to strengthen the attack on the Internet.
- Comcast-NBC will have a much more valuable set of marquee content to undermine the quality or raise the cost of content available on the Internet platform.
- Comcast-NBC will have a much more valuable set of marquee content to raise the cost of and squeeze the profits of content available on the Internet platform.
- Comcast has demonstrated the ability to degrade the quality of service of specific application and Internet Service Providers. This could make it far more difficult for an alternative IMVPD to enter the market, as it would have to build its audience on broadband subscribers who are not Comcast subscribers.

The combination of these five strategies, pursued by the largest broadband Internet access provider and the largest cable provider, will suck the air out of the space available for the Internet multi-channel video program distribution.

Just as in the Microsoft case, we should view the 'the separate categories of conduct… viewed, as a single, well-coordinated course of action" to see the does "the full extent of the violence that would be done to the competitive process itself.'[451] Just as in the Microsoft case, the nascent character of that competition does not render it less of a cause for concern. Indeed, in the case of cable market power, which has persisted for so many years, nascent or potential competition should be carefully husbanded by antitrust authorities.

Some of the elements of this anticompetitive strategy are already being applied by Comcast to the Internet; all have been used by the company in various forms in the past. Moreover, merger review requires the Department of Justice to make reasonable projections about the potential and likely abuse of market power. Unlike a monopolization case, which must prove past bad behavior and seek to remedy it, merger review is prophylactic, seeking to prevent future abuse.

Digital technology plays two key roles in these strategies to undermine competition that call for heightened scrutiny by antitrust officials. Digital technology gives the dominant incumbent two key assets to undermine competition.

- The ability to achieve low cost mass distribution of a critical technology platform (by preloading the operating system in the case of Microsoft, putting up a web site in the case of Internet TV).
- Immense power to control network functionality by controlling the critical choke point (controlling the APIs in the case of the browser; controlling access to the consumer in the case of Internet TV).

E. CONCLUSION

As shown in Exhibit IV-6, over half a dozen of the policies that have been in place to control horizontal consolidation and vertical integration at one time or another over that period are implicated in the Comcast NBC Universal merger.

The exhibit includes the rules that have been in place at some point in the past two decades to control the threat of abuse of market power in the video sector. There is a lot of policy in this space precisely because video plays an important part in both the national economy and the polity. Moreover, the fact that a *per se* ban on certain types of acquisitions or activities has been abandoned by the Congress or the Commission or the courts have concluded that the FCC did adequately justify such a ban, does not mean that the FCC or the DOJ should not give close scrutiny to these matters on a case-by-case basis. On the contrary, the fact that such activity has been a focal point of policymaker concern suggests that they be given at least as much scrutiny as other aspects of the merger, if not more scrutiny.

[451] United States v. Microsoft Corp., 87 F.Supp. 2d 9 (D.D.C. 1999).

Exhibit IV-6: Horizontal & Vertical Implicated by the Comcast-NBC Universal Merger

Market	Cable	Broadcast	Internet
Distribution	*Ban on Telco entry*	Duopoly	Discriminatory Access
	Ban on Cross Ownership		
Content	Program Access	Retrans Rights *Fin-Syn*	Exclusives

***Italics* are rules that have been repealed**

The density of the rules in the video market reflects the intersection of two critical public policy problems, the tendency for bottlenecks to convey market power in a sector whose importance goes far beyond its economic value. Video has become the dominant means of information dissemination and political communications. The Internet is rapidly taking on a similar role. The failure of past policies to control cable market power in traditional MVPD markets now threatens to be carried over into the Internet.

This analysis of the anticompetitive practices in the industry adds the final element in the case against the merger. Comcast has the incentive, ability and willingness to engage in anticompetitive practices that will impede competition and harm the public in a very short period of time.