contract prohibition.[131] As with the generalized "unfair practices" provision, this is something of a mixed bag as a potential substitute for the exclusivity prohibition.

Inadequacy as Substitute for Exclusivity Ban. Even with clarifications proposed by the Commission, the antidiscrimination provision is no substitute for the exclusive contract prohibition. As the Commission concluded five years ago, a non-price discrimination complaint requires an MVPD to demonstrate that the conduct was "unreasonable," which "can be difficult to establish."[132] From DIRECTV's perspective, the most "difficult" part of making such demonstrations is the cost and effort required to do so in individual cases, not the determination of whether the discrimination it encounters is in fact "unreasonable." Here again, the two-year *AT&T* and *Verizon* proceedings, described above, are instructive.[133] Determining the "reasonableness" or "unreasonableness" of any particular exclusive arrangement would be a highly factual, highly document-intensive, and very lengthy process. And here again, if the Commission concludes based on the evidence in this proceeding that the exclusive arrangements cable-affiliated programmers would engage in are nearly always harmful, it should not then require complainant MVPDs to undertake such efforts in pursuit of a largely preordained outcome.

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[131] *See* 47 U.S.C. § 548(c)(2)(B).

[132] *See 2002 Extension Order,* 17 FCC Rcd at 12153-54, ¶ 65 n.206 ("We do not believe other provisions in the statute—namely, Sections 628(b), 628(c)(2)(A), and 628(c)(2)(B)–are adequate substitutes for the particularized protection afforded under Section 628(c)(2)(D)."); *2007 Extension Order*, 22 FCC Rcd at 17796-97, ¶ 6 and 17834-35, ¶ 62 n.320 (same).

[133] *See Verizon HD Access Review Order*, ¶ 4 (noting that the proceeding had "lasted over two years and involved over a thousand pages of pleadings and studies, extensive discovery, multiple rounds of briefings, and multiple conferences with the parties"); *AT&T HD Access Review Order*, ¶ 4 (2011) (same).

Exclusive Contracts. Regardless of how it rules on the exclusivity prohibition, the Commission should conclude that the nondiscrimination provision actually covers exclusive contracts. As the *Notice* points out, the Commission has held that non-price discrimination includes an unreasonable refusal to license programming to an MVPD.[134] The *Notice* then draws a possible distinction between so-called unilateral exclusive arrangements (in which, for example, a cable-affiliated programmer happens to sell only to its cable affiliate) and exclusive bilateral contracts (under which, for example, the two entities have reduced the arrangement to writing).[135]

The Commission lays out a statutory argument in favor of treating the two situations similarly.[136] Section 628(c)(2)(B)(iv) provides that it is not a violation for a satellite-delivered, cable-affiliated programmer to "enter[] into an exclusive contract that is permitted under [Section 628(c)(2)(D)]."[137] This has been interpreted to pertain to only those exclusive contracts that have been deemed by the Commission to be in the public interest,[138] but the *Notice* asks whether it should also apply to exclusive contracts

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[134] *See Notice*, ¶ 58 (*citing Implementation of Sections 12 and 19 of the Cable Television Consumer Protection and Competition Act of 1992: Development of Competition and Diversity in Video Programming Distribution and Carriage*, First Report and Order, 8 FCC Rcd. 3359 ¶¶ 14, 116 (1993) ("*1993 Program Access Order*")).

[135] *Notice*, ¶¶ 60-61.

[136] The Commission also notes that the decision of a satellite-delivered, cable-affiliated programmer to license its programming to a DBS operator but not to other MVPDs could be challenged as an unreasonable refusal to deal pursuant to Section 628(c)(2)(B). *See Notice*, ¶ 61 and n.209 (citing cases). Were this provision not to apply to decisions to selectively license to cable operators only, the result would be "anomalous" at best. *Id.*

[137] 47 U.S.C. § 548(c)(2)(B)(iv).

[138] *See* 47 U.S.C. § 548(c)(2)(D) (prohibiting specified exclusive contracts "unless the Commission determines (in accordance with [Section 628(c)(4)]) that such contract is in the public interest"); *Implementation of Section 302 of the Telecommunications Act of 1996, Open Video Systems,* Second Report and Order, 11 FCC Rcd. 18223, ¶ 185 n.428 (1996) ("We interpret this provision as providing a safe harbor from challenge under Section

permissible under a sunset.[139] The key point is not so much that it should apply after sunset (although it should) as that it can apply to exclusive contracts generally. So long as an exclusive contract is not "permitted" under the cable exclusivity prohibition, it is also governed by the non-discrimination provision.[140]

Even setting statutory arguments aside, attempting to draw a distinction between unilateral arrangements and bilateral contracts would be unworkable in practice. Particularly where exclusive arrangements occur between affiliates (such as, for example, Comcast SportsNet Philadelphia and Comcast's cable systems), such distinctions are meaningless. There is no such thing as a "unilateral arrangement" among companies under common control.

Exclusive Arrangements. It is even clearer that the Commission's antidiscrimination rules apply to cable-only exclusive arrangements. As described above in Section I.B.2, such an arrangement allows a cable-affiliated programmer to sell its programming to non-overlapping incumbent cable systems (thereby minimizing its lost distribution) but refuse to sell to competing MVPDs. As the Commission put it:

628(c)(2)(B)'s discrimination prohibition to exclusive contracts that the Commission has determined to be in the public interest under Section 628(c)(2)(D).").

139 *See* 47 U.S.C. § 548(c)(5).

140 That section 628(c)(2)(B) does not require a showing of harm but does include a "legitimate business reason" defense for otherwise discriminatory treatment does not change this conclusion. *Notice*, ¶ 62. The "legitimate business reason" defense is a necessary component of any antidiscrimination provision—it is simply another way of saying that treating differently situated MVPDs differently is not in fact discrimination. If one has a legitimate business reason to refuse to sell programming to one MVPD but not another, the two are not similarly situated. *See* Giovanna Shay, "Similarly Situated," 18 GEO MASON L. REV. 581, 583 (2011) (describing origins of term in equal protection jurisprudence). Indeed, on the whole this formulation is more favorable to a respondent than the exclusivity provision, which (as the Commission notes) assumes harm but permits a cable-affiliated programmer to make a showing that such harm does not exist. It makes perfect sense that Congress would create a more categorical regulation (such as the exclusivity prohibition) with a sunset, while leaving a less categorical regulation (such as the antidiscrimination provision) without one.

> [O]ur rules and precedent establish that the discrimination provision in Section 628(c)(2)(B) would prevent a satellite-delivered, cable-affiliated programmer from licensing its content to MVPD A (such as a DBS operator) in a given market area, but to selectively refuse to license the content to MVPD B (such as a telco video provider) in the same area, absent a legitimate business reason.[141]

There is no reason why this should not apply where "MVPD A" is "all cable operators" and "MVPD B" is "all satellite carriers."

This commonsense conclusion would take on more importance were the Commission to fully or partially sunset its exclusivity prohibition. Given the increasing level of coordination among the nation's largest cable MSOs,[142] it is reasonable to expect that coordinated cable-only exclusivity would arise were the cable exclusivity prohibition allowed to sunset.

C. Section 628(c)(2)(A)'s Prohibition Against Improper Influence

Section 628(c)(2)(A) prohibits cable operators from unduly or improperly influencing the decision of an affiliated programmer to sell, or the prices, terms, and conditions of sale of, programming to any unaffiliated MVPD.[143] This, like the provisions discussed above, is of questionable utility in replacing the exclusivity prohibition.

The Commission has long recognized that the concept of undue influence between affiliated firms is closely linked with discriminatory practices and exclusive

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[141] *Notice*, ¶ 64 (*citing 2007 Extension Order*, ¶ 60 n.309 ("[A] vertically integrated programmer that withholds programming from a recent entrant with a minimal subscriber base but chooses to offer the programming to all other competitive MVPDs in the market could be found in violation of the program access rules based on an unreasonable refusal to sell.")).

[142] *See* Section I.B.1, above.

[143] *See* 47 U.S.C. § 548(c)(2)(A).

contracting. The latter two are directly regulated pursuant to Sections 628(c)(2)(B), (C), and (D), based on externally ascertainable pricing and contracting information.

Accordingly, the Commission envisioned that Section 628(c)(2)(A) would "play a supporting role where information is available (such as might come from an internal 'whistleblower') that evidences 'undue influence' between affiliated firms to initiate or maintain anticompetitive discriminatory pricing, contracting, or product withholding."[144] It also found that "such conduct may be difficult for the Commission or complainants to establish."[145] It thus concluded that, other than in the relatively rare case in which information about undue influence becomes public, the prohibition on undue influence would be insufficient to prevent the anticompetitive effects of exclusionary conduct by cable-affiliated programmers.[146]

Nothing has changed in the last five years to disturb these conclusions. Should the Commission sunset the exclusivity prohibition and modify the remaining provisions of Section 628 as discussed above, the provision on undue influence will—and must—retain its "supporting role." But it cannot be relied on alone, or even with the other provisions of Section 628, to take the place of the exclusivity prohibition.

* * *

The Commission has previously found that each of these provisions is not an adequate substitute for the exclusivity prohibition. It should not change that determination here. The Commission's proposed modifications to those other provisions would certainly be useful—particularly adopting a rebuttable presumption with respect to

144 *1993 Program Access Order*, ¶ 145.

145 *Id.*

146 *Id.*

RSN programming delivered via satellite, extending that presumption to other marquee programming, and concluding that the nondiscrimination provision actually covers exclusive contracts. But those modifications are best suited to enhance the cable exclusivity prohibition. They are not sufficient to render these provisions a substitute to the current regime.

V. THE COMMISSION SHOULD HARMONIZE THE *LIBERTY MEDIA ORDER* MERGER CONDITIONS WITH ANY ACTION TAKEN IN THIS PROCEEDING

Since Liberty Media acquired *de facto* control of DIRECTV in 2008 (which it has since relinquished), DIRECTV has operated pursuant to merger conditions under which its ability to enter into certain exclusive distribution arrangements is limited.[147] Because these conditions apply to both national and regional services and do not expire after the passage of a certain period of time, the *Notice* sought comment on whether and how to modify these conditions to conform to any revisions adopted for the cable exclusivity prohibition.[148] For the reasons discussed above, DIRECTV believes that the exclusivity prohibition should be extended in its entirety, in which case no modification of these conditions would be necessary.

If, however, the Commission were to allow the provision to sunset (in whole or in part), conforming modifications would be appropriate. For example, if the Commission were to retain the prohibition only with respect to RSNs and other "must have" programming, the exclusivity conditions on DIRECTV should apply only with respect to such programming. Similarly, if the Commission were to establish a procedure under

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[147] *News Corp., The DIRECTV Group, Inc., and Liberty Media Corp.*, 23 FCC Rcd. 3265, Appendix B, § III (2008).

[148] *See Notice*, ¶ 95.

which a cable operator or cable-affiliated programmer could seek to remove the prohibition on a market-by-market basis, the conditions on DIRECTV should be modified to permit exclusive contracts in any market subject to a successful petition. If the prohibition were allowed to sunset in its entirety, then the exclusivity prohibition in the conditions on DIRECTV should similarly be eliminated in its entirety.

Again, DIRECTV does not believe that a sunset of the exclusivity prohibition (in whole or in part) is warranted under current market conditions. It takes this position despite the fact that such a sunset should result in relief from the conditions imposed in 2008. The fact that DIRECTV stands to benefit from a sunsetting of the rule yet still feels strongly that it should be extended demonstrates how important cable-affiliated programming remains for successful competition in the MVPD market.

CONCLUSION

For the foregoing reasons, the Commission should extend the cable exclusivity ban contained in Section 628(c)(2)(D) in its entirety for another five years.

Respectfully submitted,

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June 22, 2012

EXHIBIT A

REPORT OF PROFESSOR KEVIN M. MURPHY

June 22, 2012

I have been asked by DIRECTV to review and comment on the Notice of Proposed Rulemaking ("*Notice*") released by the Federal Communications Commission ("Commission") on March 20, 2012. In the *Notice*, the Commission sought comments on, among other issues, whether to "retain, sunset, or relax....the prohibition on exclusive contracts involving satellite-delivered cable-affiliated programming" (the "cable exclusivity prohibition").[1] In this report, I comment on several economic factors that I believe the Commission should take into account in deciding the future of the cable exclusivity prohibition. To summarize:

1. Congress and the Commission are concerned that cable-affiliated program suppliers can use exclusive arrangements to harm competition. One way to test this theory is to determine whether non-integrated suppliers commonly use exclusives.

2. Evidence shows that the use of exclusives by non-integrated program suppliers is rare, while use of exclusives by cable-affiliated suppliers is more common when it is permitted. Since non-integrated suppliers are free to enter into exclusive arrangements with cable companies or other multichannel video programming distributors ("MVPDs"), economic theory predicts that non-integrated suppliers would use exclusives if they are efficient. The fact that they rarely do so suggests that such arrangements rarely are efficient.

3. The rarity of exclusive distribution agreements, either through contract or ownership (for non-cable MVPDs), is not surprising. It is consistent with economic theory and evidence. In particular, the types of services provided by MVPDs do not fit common efficiency theories of exclusives, so those theories do not predict that exclusives between program suppliers and MVPDs would be common. In addition, the types of programs that have been chosen for exclusives to date (Regional Sports Networks ("RSNs") in particular) also do not fit efficiency-driven theories of exclusivity.

[1] *Revision of the Commission's Program Access Rules*, 27 FCC Rcd. 3413, at ¶ 1 (2012) ("*Notice*").

4. The use of exclusives by vertically integrated suppliers also is not expected from efficiency-driven theories of exclusivity. Although there may be benefits to an MVPD from vertical integration into programming (such as the elimination of double-marginalization), these types of efficiencies can be achieved without exclusivity.[2]

5. Under widely accepted economic explanations for exclusives (such as internalizing free-riding and providing promotional and investment incentives), vertically integrated suppliers would have less need for exclusives than would non-integrated firms. Vertical integration substitutes for exclusivity as a way to align supplier and distributor incentives. The fact that cable-affiliated suppliers are more likely than non-integrated suppliers to use exclusives when they are allowed to do so (such as through the terrestrial loophole) implies that cable-affiliated suppliers must be responding to other incentives.

6. Employing an economic model that builds on the framework I used (and the Commission adopted) in the *Comcast-NBCU* proceeding, I find that, without the cable exclusivity prohibition, vertically integrated cable companies would find it profitable in certain circumstances to withhold some programming from competitors. Moreover, vertically integrated suppliers would find it in their interest to withhold programming *precisely when withholding has the worst price impacts for consumers*: that is, when making it available means (1) the price charged consumers by the vertically integrated MVPD would fall the most and (2) its competitors' prices would increase the least.

7. Available empirical evidence suggests that, when given access to programming previously not available to them, competing MVPDs take the majority of their resulting gains in the form of subscriber growth rather than higher prices.

[2] Indeed, under the most common framework used to evaluate the incentive effects of vertical integration between content suppliers and MVPDs, the incentive effects that generate procompetitive benefits from vertical integration also generate incentives to raise prices and/or deny content to rivals.

I conclude that, absent a contrary showing by vertically integrated cable companies or others, economic theory and empirical evidence suggest that there would be little if any loss of efficiency from continuing the cable exclusivity prohibition. However, continuation could provide non-cable MVPDs with important programming that they otherwise would lose, and could benefit consumers by preventing withholding in those cases where program access would have the largest competitive benefits.

I. Background on the Proceeding and the Exclusivity Rules

As part of the Cable Television Consumer Protection and Competition Act of 1992, Congress adopted program access provisions to address the "imbalance of power, both between cable operators and program vendors and between incumbent cable operators and their multichannel competitors" that resulted in "the development of competition among MVPDs [being] limited and consumer choice [being] restricted."[3] According to the *Notice*, the "program access provisions afforded several protections to MVPDs in their efforts to compete in the video distribution market."[4]

In 1992, when the program access provisions were adopted, DBS was just emerging as a competitor, there were no strong wireline (telco) MVPDs, and local cable operators were the dominant suppliers of MVPD services. But MVPD competition has changed since 1992. The two national DBS competitors that began operations in the mid-1990s now reach homes throughout the entire United States, and two important telco MVPDs operate in many local areas. The FCC has taken such increased MVPD competition into consideration in its periodic review (first in 2002 and then in 2007) of whether to extend the cable exclusivity prohibition. Both times it decided to do so, concluding that the prohibition remained "necessary."[5]

The program access rules have several elements, and impose restrictions on firms that both supply programming and own cable systems ("vertically integrated cable firms").[6] One

[3] *Notice,* ¶6.
[4] *Notice,* ¶7.
[5] *Notice,* ¶12. Certain cable MVPDs appealed the Commission's 2007 decision, but the D.C. Circuit Court affirmed. *Notice,* ¶16.
[6] As a condition of FCC approval of its acquisition by News Corp. and Liberty Media, DIRECTV also is prohibited from refusing to license programming it owns or controls to other MVPDs. *News Corp. and the DIRECTV Group,*

element is a general prohibition on exclusive contracts between a cable operator and a cable-affiliated programmer. A vertically integrated cable firm cannot restrict the supply of its programming to only its own or another cable system, but also must offer that programming (on nondiscriminatory terms) to other MVPDs, including those against which it competes.[7] Vertically integrated cable firms can apply to the FCC for exemptions to the exclusivity prohibition,[8] but only two such exemptions have been granted (for two local news networks) since the enactment of the 1992 Act twenty years ago.[9]

The rules also prohibit discriminatory pricing by vertically integrated cable firms of the programming that they supply. This element prevents firms from charging different prices to MVPDs that do and do not compete with them directly. Other provisions implement the Cable Act's prohibition on "unfair methods of competition" and "undue influence" on the prices that the programming division of a vertically integrated firm charges other MVPDs.[10]

As it did in 2002 and 2007, the Commission now must consider whether to extend or amend the cable exclusivity prohibition. The Commission will consider the current state of competition in video distribution and programming, as well as economic theory and its own

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Inc., Transferors, to Liberty Media Corp., Transferee, 23 FCC Rcd. 3265, Appendix B, § III (2008) ("*Liberty Media Order*").

[7] Until recently, this prohibition applied only to satellite-delivered programming, not to programming delivered terrestrially. This allowed some cable systems to refuse to offer terrestrially delivered RSNs to MVPD competitors. This "loophole" was closed in 2010. (*Review of the Commission's Program Access Rules and Examination of Program Tying Arrangements*, 25 FCC Rcd. 746, ¶ 1 (2010) ("*2010 Program Access Order*").) *See also* Press Release, *FCC Issues Order Promoting Competition In The Video Distribution Market* (Jan. 20, 2010), *available at* http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-295842A1.pdf ("The Order concludes the Commission has authority under Section 628(b) of the Communications Act to take action if a cable operator engages in unfair acts with respect to terrestrially delivered, cable affiliated programming that significantly hinder a multichannel video programming distributor from providing satellite cable programming to consumers").

[8] *Notice*, ¶8 ("An exclusive contract is permissible if the Commission determines that it is 'in the public interest'").

[9] *Id.*

[10] *Notice*, ¶7 ("Sections 628(b), 628(c)(1), and 628(d) of the Act grant the Commission broad authority to prohibit 'unfair acts' of cable operators, satellite cable programming vendors in which a cable operator has an attributable interest, and satellite broadcast programming vendors that have the 'purpose or effect' of 'hinder[ing] significantly or prevent[ing]' any MVPD from providing 'satellite cable programming or satellite broadcast programming to subscribers or consumers'"); ¶67 ("Section 628(c)(2)(A) precludes a cable operator that has an attributable interest in a satellite cable programming vendor or a satellite broadcast programming vendor from 'unduly or improperly influencing the decision of such vendor to sell, or the prices, terms, and conditions of sale of, satellite cable programming or satellite broadcast programming to any unaffiliated [MVPD]'").

predictive judgment.[11] If past proceedings in which the Commission considered sunsetting the cable exclusivity prohibition are prologue, I would expect some vertically integrated cable MVPDs to argue that there no longer is a need (if indeed there ever was) for the prohibition or for program access rules more generally, and that an extension will create inefficiencies and possibly weaken competition. The Commission's task, as it explained in the *Notice*, is to evaluate such claims in light of all the evidence it has available, and then to decide whether the rules continue to be necessary to preserve and protect competition and diversity in the distribution of video programming, or whether they are "excessively burdensome."[12]

II. Changes in the Industry

The Commission noted in the *Notice* that it considered several types of evidence during previous proceedings on extending the cable exclusivity prohibition, including the number of MVPD subscribers nationwide and in particular local markets, national and local market shares by type of MVPD (e.g., cable market share), and the number of national and regional programming networks and the percentage of these networks that are cable-affiliated.[13] The *Notice* provides recent data that show that the number and share of MVPD subscribers attributable to cable operators has declined nationally since 2007, while the number of DBS subscribers has increased since that time.[14]

However, changes since 2007 in the number and shares of subscribers to individual MVPDs and types of MVPDs is not sufficient evidence of how competition has changed since 2007 and is likely to evolve in the future. Changes in the marketplace during the recent past and

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[11] The Commission noted that it considered these factors in 2007. Notice, ¶13 ("[I]n considering the applicable standard of review, the Commission determined that it may use its predictive judgment, economic theory, and specific factual evidence in determining whether, 'in the absence of the prohibition, competition and diversity in the distribution of video programming would not be preserved and protected'" (footnote omitted)). It also noted that some of the relevant factual evidence is other conditions imposed in the past. For example, in its approval of the Comcast/NBCU transaction, the Commission imposed a requirement for baseball-style arbitration "that allows an aggrieved MVPD to submit a dispute with Comcast-NBCU over the terms and conditions of carriage of programming to commercial arbitration." *Notice,* ¶20. Other "protections that the program access rules afford to competitive MVPDs in their efforts to compete in the video distribution market" include rules for filing complaints over alleged "unfair acts" that hinder the MVPDs ability to provide programming and filing price and non-price discrimination complaints. *Notice,* ¶¶26-67.

[12] *Notice,* ¶1.

[13] *Notice,* ¶22.

[14] *Notice*, Appendix A.

anticipated changes in the near future likely have a mixed effect on the degree of competition that local cable MVPDs face, and the balance of these effects is unlikely to be uniform across local markets.

An important change in the market since 2007 has been the entry of wireline-based MVPDs (most prominently, AT&T with U-verse and Verizon with FiOS) into many geographic areas. In part, the decline in the national market share of cable MVPDs and in their share in some DMAs reflects this telco entry. However, telco entry has not occurred in all DMAs, and telco MVPD service within a DMA typically is available only to some households.[15]

While cable MVPDs now face an additional competitor in areas served by telco MVPDs that they did not face in 2007, the pace of telco entry into local markets has slowed. "AT&T and Verizon pulled back on video expansion" in the first quarter of 2012,[16] and AT&T has decided "to halt an expansion of the U-verse footprint."[17] Thus, telco expansion has declined, telco MVPDs have not entered many areas, and Verizon and AT&T have announced that they do not plan much if any further expansion.[18]

[15] *See Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, 26 FCC Rcd 14091, ¶ 2 & n.8 (2011) (noting that Verizon reported 3.5 million FiOS customers and AT&T reported nearly 3 million U-Verse customers); *see also* Verizon FiOS Fact Sheet, http://newscenter.verizon.com/kit/fios-symmetrical-internet-service/all-about-fios html (noting that as of the end of 2011 FiOS is available in 12 states and the District of Columbia and 15.8 million premises are passed by the FiOS network), Press Release, *Best-Ever Mobile Broadband Sales and Strong Cash Flows Highlight AT&T's Fourth-Quarter Results; Stock Buyback Begins on Previous 300 Million Share Authorization*, Jan. 26, 2012, http://www.att.com/gen/press-room?pid=22304&cdvn=news&newsarticleid=33762 (noting AT&T U-verse passes 30 million living units. For the 20 DMAs in which FiOS is offered and the 65 DMAs in which U-Verse is offered, only about 40% of homes in those DMAs are passed by the provider. Centris National Tracking Study, April 2012.

[16] SNL Kagan, *Video growth enjoys seasonal lift in Q1; service providers notch sub gains*, May 16, 2012, *available at* http://www.snl.com/InteractiveX/article.aspx?id=14904936&KPLT=2.

[17] *Id.*

[18] *AT&T's CEO Discusses Q4 2011 Results – Earnings Call Transcript*, Seeking Alpha (Jan. 26, 2012), http://seekingalpha.com/article/322378-at-t-s-ceo-discusses-q4-2011-results-earnings-call-transcript?part=qanda ("[W]e've got the U-verse build complete or essentially complete. We will continue to do a little bit more here and there, but we've past 30 million homes, so now we have a full 30 million home capability to sell into"). *See also*, Cecilia Kang, *Verizon ends satellite deal, FiOS expansion as it partners with cable*, WASH POST, Dec. 8, 2011; ("Verizon Chief Executive Lowell McAdam said the telecom giant … will stop its buildout of FiOS television and Internet services in the next couple years"); AT&T Inc., Annual Report (Form 10-K), at 2 (Feb. 24, 2012) ("As of December 31, 2011, we reached our deployment goal of 30 million living units and have now passed 30.3 million living units (constructed housing units as well as platted housing lots). We are marketing U-verse services to 78% of those units and had 3.8 million subscribers by year-end 2011. During 2012, we will continue our efforts to increase sales to this base"); Verizon, Inc., Annual Report (Form 10-K), at 8 (Feb. 24, 2012) ("As of December 31, 2011, FiOS Video is available to approximately 13 million homes across 12 states, as well as the District of Columbia").

A second important change in the MVPD industry is the growth of bundled offerings (e.g., "triple plays") of video, high speed Internet, and phone service by cable and telco MVPDs.[19] This and related technological advances that have provided cable MVPDs more, and more flexible, capacity (such as DOCSIS 3.0) give cable MVPDs a competitive advantage over the DBS MVPDs.[20] DBS firms have marketed "synthetic" bundles that combine video services with other companies' Internet and phone service, but these bundles have had limited commercial success and have become even less viable in areas where potential contributors to a DBS bundle (for example, digital subscriber line services from Verizon or AT&T) now market their own video services and "triple plays" and so view DBS as a direct competitor,[21] and where cable has rolled out DOCSIS 3.0.

The importance of the triple play may be reflected in the fact that, in areas where there is no telco competition, cable's share of total TV households has declined much more slowly since the last Commission review in 2007. Between 2007 and 2011, cable MVPDs' share of pay TV households declined by 11.4 percent in areas where wireline-based competitors entered, compared with a decline of only 4.3 percent in areas where they did not. The corresponding changes since 2008 are 9.6 percent and 1.5 percent.[22]

The Commission concluded in 2007 that, "even with [substantial] developments in the programming and distribution markets, the concerns upon which Congress based the program access provisions persist in the marketplace, and thus we find the exclusive contract prohibition continues to be necessary to preserve and protect competition and diversity in the distribution of

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[19] See, e.g., SNL Kagan, *Video growth enjoys seasonal lift in Q1; service providers notch sub gains*, May 16, 2012 ("Approximately 68% of FiOS video customers are opting in for triple-play packages").

[20] Comcast Corporation, 2011 Annual Review Letter to Shareholders, at 1 (Apr. 20, 2012) ("Key to our strong operating performance has been our technological leadership in cable. With the major platform initiatives of DOCSIS 3.0, All Digital, and our Content Delivery Network now complete, we are leveraging these investments to deliver better products and more innovation, faster than ever before"); Time Warner Cable Inc., Annual Report (Form 10-K), at 4 (Feb. 27, 2012) ("Utilizing DOCSIS 3.0 technology, TWC offers Wideband and Extreme to subscribers in the majority of its service areas"); Charter Communications, Inc., Annual Report (Form 10-K), at 6 (February 27, 2012) ("We completed the roll out of DOCSIS 3.0 to 93% of our homes passed in 2011").

[21] Trefis Team, *Dish Can't Compete With Telcos But Stock Can Glide To $26*, FORBES Nov. 3, 2010) ("DBS operators don't offer phone service and have tied up with telcos like AT&T in the past to create synthetic bundles... However, synthetic bundles have not been very effective. Further, as telcos continue with the planned roll-out of their video services, they have been weaning away satellite customers, more worryingly, from synthetic bundle households").

[22] Annual changes are calculated based on data for the first quarter of each year. Telco entry in each DMA was measured based on subscription data for first quarter, 2011. Centris National Tracking Study, 2007q1-2011q1.

video programming,"[23] and it concluded in 2010 that "cable firms withhold affiliated programming from competitors when not barred from doing so"[24] these concerns may still apply given limitations on the ability of DBS firms to compete with the bundles of services that consumers increasingly prefer, and the strategic (and perhaps commercial) limitation on expansion of telco MVPDs. In particular, DBS firms' current national market shares likely overstate their role in providing a competitive constraint on cable MVPDs in the future, both in general and in particular local markets. In markets without competition from wireline-based MVPDs, there has not been any entry of substantial new suppliers to offset the impact of the increased advantage cable suppliers have gained from improved technologies (such as DOCSIS 3.0) and the growing importance of the triple-play.

III. Exclusive Programming Arrangements are Rare

A common method that economists use to evaluate whether contracting and other business practices enhance efficiency is to see if they are widely used. Practices that are widely used in contexts where market power is not a concern are generally presumed to have efficiency benefits. Practices that are not used or are used very infrequently in such contexts likely do not enhance efficiency.

This empirical framework can help determine the potential for exclusivity in program licensing to enhance efficiency, and thus how efficiency might be affected by the cable exclusivity prohibition. The program access rules prohibit one type of exclusive arrangement – between a cable MVPD and cable-affiliated programmers.[25] However, the rules and Commission policy generally leave marketplace participants free to negotiate other exclusive

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[23] *Implementation of the Cable Television Consumer Protection and Competition Act of 1992 – Development of Competition and Diversity in Video Programming Distribution: Sunset of Exclusive Contract Prohibition*, 22 FCC Rcd. 17791, ¶ 16 (2007) ("*2007 Extension Order*"), *aff'd sub nom. Cablevision Sys. Corp. v. FCC*, 597 F.3d 1306 (D.C. Cir. 2010) ("*Cablevision I*").

[24] *2010 Program Access Order*, ¶ 30.

[25] I note that cable operators and cable-affiliated programmers have the right under the Communications Act to petition the Commission for authority to enter into exclusive arrangements that would serve the public interest, yet only 10 such petitions have ever been filed, and none in the last 15 years (*Notice*, ¶*8*, n. 28). *See also* Brief for Petitioners at 50, *Cablevision Sys. Corp. v. FCC* , 2008 WL 6201083 at 10 (C.A.D.C., filed Oct. 8, 2008)) ("The current rules do not prohibit cable operators from entering into exclusive agreements with the many video-programming services that are not affiliated with any cable operator. Yet, there have been few instances in which such agreements occurred").

arrangements that could prevent competing and other MVPDs from licensing attractive programming. In particular:

- Cable MVPDs can negotiate exclusive licenses with unaffiliated programmers;
- DBS and telco firms can negotiate exclusive licenses with unaffiliated programmers;
- DISH and telco firms are free to refuse to license affiliated programming.[26]

Examining the use of exclusivity by MVPDs and programmers that are free to engage in exclusive programming arrangements provides considerable insight into the economic reasons for and the likely impact of the behavior of their vertically-integrated cable counterparts.

There appear to be very few examples of voluntarily negotiated exclusive agreements involving non-integrated program suppliers. (NFL Sunday Ticket is an important exception, and I explain later in my report why economic theory and the specifics of that arrangement are consistent with the very limited efficiency benefit from exclusive arrangements generally).

The examples of exclusive agreements I have seen almost always involve cable-affiliated programming suppliers. Of those, the most important networks (in terms of revenue and viewership) that have been withheld from a competitor are terrestrially delivered RSNs.[27] Until 2010, cable MVPDs could refuse to license these networks to MVPD competitors because they were delivered terrestrially and not by satellite (and thus not clearly covered by the program access rules). In Philadelphia, San Diego, and Charlotte, the cable-affiliated RSNs were not

[26] DIRECTV's licensing freedom is more restricted by merger conditions imposed by the Commission in approving its transactions with News Corp. and Liberty Media. *See Liberty Media Order*, Appendix B, § III.
[27] *See 2010 Program Access Order*, ¶¶ 30.

licensed to DBS firms;[28] while in New York, the cable-affiliated RSN did not license the HD feed of its programming to Verizon.[29]

However, there is no evidence that Fox – which is not affiliated with an MVPD and which owns 16 RSNs – has licensed any of its RSNs on an exclusive basis to any MVPD or refused to license any of them to any MVPD.[30] Fox is free to do so if it found it more profitable and/or more efficient to do so. Instead, unlike its vertically integrated counterparts that could exploit the terrestrial loophole, Fox has found that it realizes the greatest value from its RSNs by licensing them widely to MVPDs that compete with each other.

IV. Economic Theory Explains Why Exclusive Agreements Between Unaffiliated MVPDs and Programmers Are Rare

Economists long have studied economic incentives for exclusive vertical agreements. The explanation for observed exclusive arrangements differs according to the context in which they arise, but economists have identified both procompetitive (efficiency and competition-enhancing) and anticompetitive motivations for why a distributor will enter into an exclusive arrangement with a supplier.[31]

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[28] "There are three DMAs where [RSNs that offer] the games of some of the local professional sports teams are not available to DBS subscribers: Charlotte, Philadelphia, and San Diego," *MEMORANDUM OPINION AND ORDER In the Matter of Applications for Consent to the Assignment and/or Transfer of Control of Licenses Adelphia Communications Corporation, (and subsidiaries, debtors-in-possession), Assignors, to Time Warner Cable Inc (subsidiaries), Assignees; Adelphia Communications Corporation, (and subsidiaries, debtors-in-possession), Assignors and Transferors, to Comcast Corporation (subsidiaries), Assignees and Transferees; Comcast Corporation, Transferor, to Time Warner Inc., Transferee; Time Warner Inc., Transferor, to Comcast Corporation, Transferee ("Adelphia Order")*, MB Docket No. 05-192, 7/21/2006.

[29] *See Verizon Tel. Companies and Verizon Svcs. Corp. v. Madison Square Garden, L.P and Cablevision Sys. Corp.*, 26 FCC Rcd. 13145 (MB 2011) ("Verizon HD Access Order"), *aff'd*, 26 FCC Rcd. 15849 (2011) ("*Verizon HD Access Review Order*"); *AT&T Svcs. Inc. and Southern New England Tel. Co. d/b/a AT&T Connecticut v. Madison Square Garden, L.P. and Cablevision Sys. Corp.*, 26 FCC Rcd. 13206 (MB 2011) ("*AT&T HD Access Order*"), aff'd, 26 FCC 15871 (2011) ("*AT&T HD Access Review Order*").

[30] Fourteen years ago, when Fox's sports networks were affiliated with Liberty (and, through Liberty, to TCI cable), Fox was accused of price discrimination, but not withholding. *EchoStar Comm's Corporation v. Fox/Liberty Networks LLC*, 13 FCC Rcd. 21841 (CSB 1998).

[31] Economists have also studied reasons for vertical integration, which is a related but distinct phenomenon. The benefits of vertical integration (such as problems with the appropriation of specific investments) can differ from those of exclusivity. (*see*, for example, Sanford J. Grossman and Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 JOURNAL OF POLITICAL ECONOMY 691(1986)). In other cases, vertical integration and exclusives can be alternative ways of solving the same problem or achieving the same objective (such as incentivizing downstream investments in market development or product promotion). The concern in this proceeding is with exclusivity and, in particular, with the impact of the use of exclusivity by cable-

A general finding is that exclusive agreements between firms at different stages of the vertical chain are a common business practice that arises from the desire of both parties to increase their joint profitability. As with other business arrangements, the increased profits from such arrangements can arise either from procompetitive or anticompetitive effects. The economic literature on exclusive dealing can help sort out the likely rationale for a given arrangement. In connection with the Commission's inquiry here, it can help assess whether or not the cable exclusivity prohibition is likely to reduce economic efficiency by preventing efficiency-enhancing exclusive contracts.

A. Exclusivity Provisions Can Increase Efficiency and/or Competition

Economists have identified several procompetitive effects of exclusive vertical arrangements. In general, economic theories rely on how such arrangements change the market-based incentives faced by one of the parties to the arrangement. In essence, the parties attempt to align their incentives through exclusive arrangements, rather than attempting to contract over individual elements of performance. Such solutions are particularly attractive when the desired conduct is difficult to specify and enforce contractually, and when the parties' incentives can be changed by making the vertical relationship exclusive.

Exclusive distribution, where a supplier chooses a single distributor to market its products in a given area or to a given group of consumers, changes distributor incentives by allowing the distributor to capture a greater fraction of the benefits from serving this set of customers. This is particularly important when the supplier wants the distributor to make investments or engage in promotion that enhances the appeal of the product to its customer base beyond making a particular sale. Many examples fit this framework, such as the prevention of free-riding on promotion or incentivizing investments in developing a customer base.[32] Such

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affiliated suppliers. (I do not address the issue of whether it is efficient for firms to vertically integrate – an issue that would require a separate analysis.)

[32] A useful survey of these examples is in Michael L. Katz, *Vertical Contractual Relations*, HANDBOOK OF INDUSTRIAL ORGANIZATION, Vol. 1, at 655-721 (Elsevier, Amsterdam, 1989). A survey of U.S. distribution managers found that "firms are more likely to use exclusive dealing when there is a potential that other manufacturers can free ride on the services they provide" (Jan B. Heide, Shantanu Dutta and Mark Bergen, *Exclusive Dealing and Business Efficiency: Evidence From Industry Practice*, 41 J. LAW AND ECONOMICS 387 (1998).

arrangements can be procompetitive and benefit consumers.[33] I discuss each of these benefits in turn.

1. Creating incentives for expanding the customer base

A distributor will have no incentive to invest in developing its supplier's customer base unless that distributor can capture enough of the benefits of that expansion to make that investment profitable. When several distributors serve the same customer base, the benefits of expanding the customer base are shared across the distributors. This weakens the incentive of any individual distributor to make the required investments. In contrast, when one distributor has an exclusive contract to serve a set of customers, it will capture a greater fraction of the benefits from increasing customer demand and therefore will make more of the desired investments.

Incentives to use exclusives will be greatest when it is easy to assign customers to particular distributors and customers have no strong innate preference to be served by a particular distributor. These considerations explain why salesmen and wholesale distributors frequently are assigned exclusive territories by their supplier. A distributor and/or salesman essentially acquires the exclusive right to serve a set of customers on a relatively long-term basis, which provides an incentive for the distributor/salesman to provide high-quality service and to engage in other activities or "investments," such as product promotion and product demonstrations, that produce future as well as current sales. When it is difficult to measure, and thus to contract for, specific performance, the motivation for entering into exclusive arrangements is enhanced.

For example, consider a wholesale beer distributor that serves a geographic area where the amount of the manufacturer's beer demanded by customers in that area increases when the distributor increases its advertising, marketing, and distribution investments. Granting the

[33] *See also* Francine Lafontaine and Margaret Slade, *Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy*, HANDBOOK OF ANTITRUST ECONOMICS (2007) (based on a survey of the literature, "we find that in the setting that we focus on, namely manufacturer/retailer or franchisor/franchisee relationships, the empirical evidence ...is surprisingly consistent. Specifically, it appears than when manufacturers choose to impose [vertical] restraints, not only do the make themselves better off, but they also typically allow consumers to benefit from higher quality products and better service provision")).

distributor exclusive rights to serve this area encourages it to identify and execute successful market development activities, because the distributor will earn a quasi-rent stream that ensures that it can appropriate the returns to such activities through additional sales. Since there is no intrinsic reason to prefer one distributor over another (for a given level of service), there is no customer preference to overcome when limiting the supply to one distributor.

2. Preventing free-riding on promotional efforts

Exclusive distribution also can help prevent free riding. When multiple distributors sell to the same customer base, distributors can free-ride on the promotional efforts of competing distributors. For example, a distributor can undercut its rivals by offering products at discounted prices, and then explicitly or implicitly encouraging customers to obtain promotional or other services from competing distributors. This problem, brought to prominence by Lester G. Telser,[34] can be solved by exclusive distribution that prevents a distributor from relying on the promotional efforts of its rivals, or equivalently by allowing distributors that provide the desired promotion to reap the benefits of that promotion.

3. Facilitating negotiation of lower prices

Exclusive distribution can allow the distributor to obtain lower prices from suppliers by forcing suppliers to compete for the contract rather than for individual sales.[35] Exclusives can effectively bundle many customers' demands, making these suppliers' demand curves more elastic at the margin. For example, restaurants and venues often offer only one brand of cola – either Pepsi or Coke – but not both. If both brands were available, then suppliers might have an incentive to price high enough to capture sales only from customers with a strong demand for their brand over the other brand, which would result in elevated wholesale and retail prices relative to what can be achieved through competition for the contract. If, however, the restaurant or venue invites Coca-Cola and PepsiCo to bid for an exclusive to supply cola to the outlet, then each has an incentive to offer a lower price because, by doing so, it can win the right to supply

[34] Lester G. Telser, *Why Should Manufacturers Want Fair Trade?,* 3 J. L.& ECON. 86 (1960).
[35] Benjamin Klein and Kevin M. Murphy, *Exclusive Dealing Intensifies Competition for Distribution,* ANTITRUST L. J (2008); Hans Zenger, *When Does Exclusive Dealing Intensify Competition for Distribution? Comment on Klein and Murphy*, 77 ANTITRUST L. J (2010).

all the cola sold through that outlet (correspondingly, if it bids too high it will lose sales to everyone purchasing at the outlet).[36]

In this way, competition for exclusives changes suppliers' pricing incentives, resulting in lower prices that increase output.

B. Exclusives are More Attractive When They Do Not Limit End-Users' Access to Products

An important feature of many exclusive vertical arrangements is that they do not limit end-users' access to the product. Rather, they simply concentrate distribution in a way that creates value *without restricting consumer access.*

In wholesale distribution exclusives, the manufacturer often grants exclusive geographic territories to its distributors, but assures that all customers have access to the product by covering the entire relevant geographic area (such as the United States or a region within the United States) with exclusive but non-overlapping territories. Consider, for example, the hypothetical given above in which a beer company chooses an exclusive distributor for its beer within a specified geographic area. The intent is not to limit which consumers can purchase that brand of beer, but rather to create incentives for the sole distributor serving a particular territory to expand its marketing efforts in order to increase the brand's penetration and sales. By granting an exclusive territory, the beer manufacturer wants to compete more effectively against other brands of beer within each geographic area (i.e., sell more beer to more consumers), not restrict output. Similarly, exclusive retail distribution is common when final customers can shop across retail outlets (e.g., car dealers, gasoline) since in such cases the supplier can improve incentives without significantly limiting customer access to its product.

The degree to which consumers are willing to switch across distributors has a substantial effect on the incentives to use exclusives as a means of improving efficiency. The greater the

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[36] These types of arrangements typically involve exclusivity restrictions in the other direction, where the downstream firm limits the number of suppliers it will use rather than the supplier limiting the number of distributors. The lower prices negotiated as a result of suppliers bidding for the exclusive then expand output. Also, as outlined by Klein and Murphy (2008), these types of contracts typically arise when they involve products that are close substitutes (e.g., alternative brands of tortillas or spices). In contrast, most exclusives used by cable-affiliated MVPDs involve products with few close substitutes (such as RSNs).

customer preference for a particular distributor, the less the benefit and the higher the cost of exclusivity. On the benefit side, when customers have a strong preference for a particular distributor, that distributor will receive more of the benefits of its investments and promotion because the demand it generates likely will stay with it even in the absence of an exclusive. The problems with free-riding, and thus the potential benefits of exclusives, are correspondingly reduced. At the same time, the cost of using exclusives is higher since moving to exclusive distribution will involve a greater loss of customer satisfaction and access. Thus, all else equal, we expect exclusives to be less attractive when consumers are reluctant to move across distributors to obtain access to the product in question. This will commonly be the case when consumers frequently purchase multiple products from the same retailer. In such cases, it can be costly or impractical for a consumer to shop across retailers to find the mix of products he desires.

C. Procompetitive Incentives for Exclusive Vertical Agreements are Unlikely to Motivate Exclusive Programming Arrangements with MVPDs

The economic theory of efficient exclusives shows that procompetitive exclusive arrangements generally create enhanced incentives for distributors to expand sales in situations where exclusives do not limit substantially the supplier's access to customers. This implies that there likely is limited competitive benefit from restricting competing MVPDs' access to programming.

MVPDs are like multiproduct supermarkets; consumers (or viewers) frequently shop for all their needs (in this case programming) at only one multiproduct supermarket (MVPD), so those consumers will not have the opportunity to purchase (view) products (networks) not available in that store (MVPD). Indeed, the limiting effect of exclusives is even greater for MVPDs than for supermarkets. While consumers do sometimes shop at multiple supermarkets, consumers very rarely contract for video services with more than one MVPD.[37]

[37] *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Eleventh Annual Report, 20 FCC Rcd. 2755, App. B, table B-1, note (ii) ("[T]he number of households subscribing to more than one MVPD is expected to be low").