Vertical Integration and Program Access in the Cable Television Industry*

David Waterman**

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Introduction

Effective competition for local monopoly cable systems would seem to offer a natural solution to nagging problems widely attributed to the cable industry, such as high prices and poor service. In regulatory and legislative proceedings leading up to the Cable Television Consumer Protection and Competition Act of 1992,(note 1) however, potential or existing competitors to local cable systems complained that cable programming networks (note 2) either refused to do business with them or offered them programming only on discriminatory terms. (note 3) These competitors include home satellite dish (HSD) owners and program distributors, satellite master antenna system (SMATV) operators, multichannel multipoint distribution system (MMDS) operators, "overbuilt" cable system operators, and operators of direct broadcast satellite (DBS) systems.(note 4) According to these complaints, established cable system operators are to blame for pressuring the networks, many of which are vertically affiliated with those operators, to engage in this discrimination and thus handicap the cable operators' competitors.

As a result of the 1992 Cable Act, the Federal Communications Commission (FCC or Commission) established regulations intended to encourage competition for established cable operators by ensuring that these alternative multichannel video programming distributors (MVPDs) have adequate access to programming. (note 5) As required by Section 19 of the Act, the FCC promulgated regulations on April 1, 1993, that require cable program suppliers in which cable systems have an "attributable interest" to make programming available on the same terms and conditions to all competing delivery systems. (note 6) Based on the language of Section 19, the FCC singles out vertically integrated cable program suppliers—which it defines as those in which any cable operator has a 5 percent or greater equity interest—for specific regulations. (note 7) Among other restraints, the regulations prohibit these integrated program suppliers from any price discrimination in the distribution of cable programming in any market, except for differences the programmer can justify on the basis of costs, volume differences, creditworthiness, or similar factors. Vertically integrated programmers are also prohibited from entering into exclusive dealing contracts (or, implicitly,
from refusing to deal) with any cable operator unless the program supplier can demonstrate to the FCC that those contracts are in the public interest. (note 8) As the FCC notes, Section 19 also prohibits "unfair methods of competition" and "unfair or deceptive acts or practices" by "all cable operators," so that cable operators do not have to be vertically integrated to be subject to a program access complaint. (note 9) Apart from this general language which applies indirectly to the behavior of nonintegrated cable program suppliers, the FCC's program access regulations apply only to vertically integrated programming suppliers.

The 1990 FCC Cable Report on the cable industry expressed a favorable view of industry vertical integration in general, but its conclusions on program access were less sanguine. (note 10) The Report concluded that "vertically integrated cable operators often have the ability to deny multichannel video programming distributors access to cable programming services in which such cable operators hold ownership interests, and there is considerable anecdotal evidence that some have used this ability in anticompetitive ways." (note 11) The singling out of vertically integrated cable programmers in the 1992 Cable Act indicates that Congress reached a similar, if not stronger, conclusion regarding the role of integration in limiting access for alternative MVPDs.

This Article addresses whether the separate treatment of vertically integrated and nonvertically integrated program suppliers in the program access regulations is justified. The analysis is primarily based on the empirical record established by the congressional hearings and FCC proceedings leading up to the 1992 Act. Since October 1993, several complaints and petitions involving program access have been filed, and in June 1994, the Commission began to rule on some of these cases. At the end of this Article, this more recent regulatory activity is discussed.

This Article argues that although there are viable economic models that can explain attempts by established cable operators to bar competing delivery systems from the market by restricting access to programming, the singling out of vertically integrated firms for blame is not justified for two main reasons. First, the record makes clear that both integrated and nonintegrated program suppliers have engaged in the same potentially anticompetitive behavior in question. While vertical integration may facilitate any foreclosure behavior by cable operators, the basic source of the behavior must be horizontal market power at the cable system level, or at the Multiple Cable System Operator (MSO) level, in the market for programming. To the extent that this horizontal market power exists, the empirical record suggests it can be exerted either in the presence or the absence of vertical ownership ties. Second, the record suggests that to the extent cost differences fail to explain variations among programming prices that suppliers charge to different MVPDs, simple variations in outcomes of the network-MVPD bargaining process are more likely to be responsible. Unlike a foreclosure strategy, bargaining outcomes are determined by the horizontal market power of the seller vis-a-vis the buyer. These outcomes have little to do with whether the seller is vertically integrated. (note 12)

This Article concludes that whatever FCC program access regulations there may be, they should apply equally to all program suppliers-regardless of the ownership relations those suppliers may have with cable systems, or with any other MVPDs. Singling out program suppliers that are vertically affiliated with cable operators, as the regulations now do, essentially excludes from control numerous other suppliers having basically the same behavioral incentives to participate in the exclusion of competitors as integrated suppliers. To the extent that the regulations impact sales practices of integrated programming suppliers, evasion of the regulations by means of vertical divestiture will be encouraged. The intent of the regulations would thus be undermined and the playing field tilted arbitrarily in favor of some firms and not others. Whatever the utility of the program access regulations in general, they should be applied without respect to ownership relationships.

Part I of this Article outlines the empirical state of vertical ownership in cable. Part II discusses the economic theory of vertical foreclosure and the role of integration. Part III considers the empirical record and the viability of alternative foreclosure and economic efficiency explanations for this evidence. Part IV concludes with a policy analysis, emphasizing the importance policymakers should place on the origins of market power at the facilities level.

I. The Empirical State of Vertical Ownership in Cable

The underlying concerns about cable television's "bottleneck" monopoly power over program suppliers are suggested by the market structure of the MVPD industry. Very few cable subscribers are currently served by overbuilt cable systems. (note 13) and the nationwide penetration of SMATV, MMDS, and DBS aggregate to less than 3 percent of
In terms of subscribership and revenues, vertical integration between cable television networks and cable systems—usually via common corporate ownership ties between MSOs and cable networks—is extensive, though by no means ubiquitous. In its September 1994 report on the status of competition in the cable industry, the FCC reported that 56 of the 106 nationally distributed programming services it identified had vertical ties with MSOs and 50 did not. These data understate the economic significance of vertical integration since MSOs (or their parent companies) held 5 percent or greater equity in 12 of the 15 most widely viewed commercial basic cable networks and in 4 of the 5 largest premium networks. Notably unaffiliated with any cable operators, however, were ESPN and Lifetime—the fourth and seventh most widely viewed basic networks—and the Disney Channel, the third largest national premium network.

Joint ownership of a cable network by more than one MSO was fairly common; the equity of twenty-eight of the fifty vertically affiliated networks reported by the FCC was shared by two or more MSOs or their parent companies. As these data suggest, minority ownership ties between cable networks and MSOs were also common; for 21 of the 50 vertically affiliated networks, no individual MSO (or its parent company) owned greater than a 50 percent share of the network, although in 19 of these 21 cases, the individual minority shares of 2 or more MSOs aggregated to more than 50 percent of the network's equity.

The overwhelming proportion of equity ownership in nationally distributed cable networks was accounted for by the largest twelve MSOs or their parent companies. Eleven of these twelve MSOs (serving 67.4 percent of all U.S. cable subscribers as of March 1994) had a 5 percent interest in at least one cable network. A disproportionate amount of network equity ownership was accounted for by three MSOs. Tele-communications, Inc. (TCI), owner of the largest MSO (serving 24.8 percent of all U.S. cable subscribers), was vertically affiliated with twenty-three nationally distributed cable networks. Time Warner, Inc., owner of the second largest MSO (serving 12.5 percent of all U.S. cable subscribers) was affiliated with sixteen national networks. Finally, Viacom, Inc., owner of the tenth largest MSO (serving 1.9 percent of all U.S. cable subscribers), was also affiliated with sixteen national networks.

These levels of vertical integration reflect relatively little change since the passage of the 1992 Cable Act. Among the larger networks, Viacom's 1994 divestiture of its one-third share in Lifetime left that network unaffiliated with any MSO, and the Viacom-Paramount merger in 1994 resulted in MSO ties to two formerly non-MSO-affiliated networks, USA and the Sci-Fi Channel. The FCC reported that twenty-two new cable networks had entered the industry since passage of the 1992 Cable Act. Ten of these had MSO ownership ties, and thirteen of them did not, thus leaving the overall proportion of MSO-affiliated networks at about the same level.

These data thus indicate that while the FCC's specific nondiscriminatory access provisions apply to most of the larger cable networks, there are many others to which they do not apply. The specific regulations affect most of the largest MSOs, especially TCI, Time Warner, and the cable system holdings of Viacom-Paramount. A major reduction in the extent of vertical integration—and thus in the coverage of the program access provisions—will soon result if Viacom-Paramount's January 1995 announcement that it has agreed to sell its cable system interests to RCS L.P. Intermedia Partners is consummated. This transaction would convert eleven cable networks (including four of the fifteen most widely viewed basic networks) and two of the six largest premium networks, to non-MSO affiliated status.

II. The Economic Theory of Vertical Foreclosure and the Role of Integration

To the extent that local cable operators enjoy monopoly profits, they have an obvious incentive to protect those profits by restricting entry. Leaving aside vertical integration for the moment, one can construct a variety of models that show conditions under which established cable operators could profitably retard the entry of competing multichannel providers—at either the local or the national level—by inducing program suppliers to limit these entrants' access to programming. A necessary condition in such foreclosure models is that the entrant cannot substitute
programming from alternative sources. Although clearly an empirical question, there seems to be a consensus in the industry that the lack of more than one or two of the well-known networks such as ESPN, USA, CNN, and HBO, would seriously handicap a multichannel competitor to an established cable system. (note 32)

One role that vertical integration could play in such models is to facilitate the contracting process necessary to accomplish the foreclosure objective. For reasons comparable to those discussed in the "transactions costs" literature on vertical integration, (note 33) compensating or coercing a supplier to refuse to deal with an entrant is probably easier to carry out if ownership is involved. The risk of opportunistic reneging on the agreement by the network or the MSO is probably reduced, and there may be less risk of legal jeopardy. Also, if a written exclusive dealing contract is involved, integration is likely to smooth its dissolution if it should later become adverse to the interest of one party.

Another role of vertical integration could be to coordinate collusion among networks when more than one network is involved in the entry deterrence. Say, for example, that an established cable system with a potential MMDS competitor in its local market area believes it needs to enlist refusals to deal from at least five networks to prevent or retard entry. The cable system might simply choose five networks and compensate them for this exclusivity. But any perception among the five that the foreclosure strategy might fail, especially if there are "first mover" advantages in signing on with the entrant, implies a risk of defection. (note 34) If the established cable system is vertically integrated with at least some networks, however, then the risks of defection perceived by nonintegrated networks are likely to be reduced, thus facilitating the strategy. (note 35)

Vertical integration might also facilitate collusion among MSOs to enforce foreclosure attempts carried out on a national basis. For locally-based entrants such as MMDS and SMATV, colluding MSOs could instigate a general policy against dealing with program suppliers that did business with entrants in any local market they control. (note 36) DBS, in contrast, is an inherently national technology and threatens all cable operators simultaneously. National MSO collusion might be facilitated if two or more MSOs are common owners of the same network or networks, or if equity in a sufficiently large number of separately owned networks is concentrated in the hands of a relatively few MSOs.

Concerns about nationally coordinated collusion among vertically integrated MSOs are implicit in the 1992 Cable Act. They are also implicit in the FCC's subsequent decision to prohibit any non-cost-based pricing by vertically integrated program suppliers in any market, regardless of whether the transaction takes place in a market where the supplier in question has a vertical relationship. (note 37)

In summary, then, the theoretical role of vertical integration in the above foreclosure models is to facilitate the exercise of horizontal market power, either at the network or at the facilities level. At the facilities level, such power might in theory be exercised by an established cable system or by coordinated action involving numerous systems by one or more MSOs.

III. The Empirical Record

A. Foreclosure or Efficiency?

The question becomes whether these foreclosure models, and vertical integration's role in them, are plausible in the cable industry. As the FCC and many others have pointed out, the motives and effects of exclusive dealing between cable operators and cable networks can often promote business efficiency. (note 38) In the 1990 FCC Cable Report, for example, the FCC cited complaints by SMATV, MMDS, and overbuilt cable operators that TNT's policy of granting exclusive rights to established cable operators diminished the complainants' ability to compete with those established operators. But the FCC also noted TNT's claim that the exclusivity offer was designed to induce skeptical cable operators to accept TNT during the year following its 1987 launch, thus reducing the uncertainty of TNT's market value. (note 39) The Commission further noted a policy of Cablevision Systems—a large MSO having equity interests in several networks. Cablevision's programming subsidiary required wireless cable operators to renegotiate their affiliation agreements with its vertically integrated networks once their market penetration reached 2 percent. (note 40) Cablevision argued such requirements were intended to prevent (among other things) "free riding" on the marketing efforts of cable systems in the same market area. (note 41)
These counterclaims about cable network marketing practices reflect classic economic arguments that exclusive contracting generally promotes efficiency. The circumstances under which exclusive contracting either promotes efficiency or serves as an aid to market foreclosure is a subject of intense debate in the economic literature.(note 42)

Given the evident incentives of established cable systems to retard competitive entry if they can, it would be surprising not to observe attempts at foreclosure behavior involving program access. In fact, the media offer a long history of attempts by established firms to stop the advance of technology by restricting access to programming. In the 1920s, when commercial radio was beginning to emerge, some newspaper members of the Associated Press (AP) tried to prevent radio stations from buying news information from the AP.(note 43) In the 1950s, motion picture theater operator trade associations repeatedly tried to organize boycotts against movie studios that sold old films to emerging broadcast television stations.(note 44) Broadcast stations and theater operators later joined forces to pressure studios not to supply movies to experimental subscription television (STV) and pay cable systems in the 1960s and 1970s.(note 45) Furthermore, extensive antitrust litigation—much of it resulting in plaintiff victories—has been directed at alleged attempts by motion picture theater chains to prevent independently operated movie theaters from obtaining the films of major studios.(note 46) Some of these instances have involved vertical integration, and others have not.

It is speculative to assess the extent of foreclosure behavior involving program access that has occurred in the cable industry. However, the record shows that both integrated and nonintegrated cable firms have engaged in the same range of potentially anticompetitive behavior. It is also true that the charging of higher programming prices to an existing or potential entrant can be essentially equivalent in motive and effect to an exclusive contract or an outright refusal to deal. The role of vertical integration in differential pricing may be quite different from that of exclusive dealing, however, so these practices are considered separately.

B. Vertical Integration and Exclusive Dealing in Cable

Many of the program access claims cited in the 1990 FCC Report involving exclusivity or alleged refusals to deal have involved vertically integrated firms. These include TNT, Bravo, AMC, and a number of the regional sports networks.(note 47) Among nonvertically integrated networks, however, the Report cited ESPN as having contracts prohibiting wireless cable operators from distributing ESPN within any cable franchise area. Also cited were assertions by Telesat, an operator of overbuilt cable systems in Florida, that the Nashville Network (then nonintegrated) refused to renew affiliation agreements with Telesat in its overbuilt markets.(note 48) The cases cited in the Report involved both localized incidents as well as the national contracting policies of certain vertically affiliated networks, such as TNT. Because the MSOs which owned equity in Turner Broadcasting System (the parent company of TNT) serve much less than 100 percent of U.S. cable subscribers, however, many of TNT's transactions were with unaffiliated MSOs.

Other evidence corroborates the involvement of both integrated and nonintegrated networks in claims of programming unavailability. In its 1988 report on the cable industry, the National Telecommunications and Information Administration (NTIA) cited data provided by the Wireless Cable Association (WCA) on the availability to its members of twenty-nine national cable networks. Of seventeen vertically integrated networks, seven were reported "available" and ten "unavailable," while of twelve nonintegrated networks, eight were "available" and four "unavailable."(note 49) Virtually all the major nonintegrated as well as integrated national networks have been mentioned in complaints about program access at one time or another. Examples of such complaints involving nonintegrated networks include the Disney Channel, Cable Video Store, A&E, the Weather Channel, Home Shopping Network, USA, ESPN, and FNN.(note 50)

By the time the 1992 Cable Act became law, the prevalence of exclusive contracts and claims of other outright refusals to deal with alternative MVPDs had apparently diminished. In its March 1993 comments to the FCC, for example, the Wireless Cable Association noted that "[a]lthough TNT and many regional sports services remain holdouts . . . most other programming services now will do business with wireless cable."(note 51) As the WCA also noted, political (or legal) pressures were very likely responsible for this shift.(note 52) However, since the FCC's program access regulations have come into effect, several new access claims involving exclusivity or refusal to deal have been filed.
The legal proceedings leading up to the FCC's program access regulations nevertheless showed no apparent diminution in claims that many programmers charge higher prices to MMDS, SMATV, overbuilt cable systems, HSD owners, and HSD program distributors. (note 53)

C. Vertical Integration and Input Price Differentials in Cable

1. The Available Evidence

While data are not conclusive, some rate comparisons submitted in earlier congressional and FCC proceedings suggest the extent of input price differentials between MSOs and MVPDs at issue. The 1990 FCC Report cites data provided by WCA for seven networks serving MMDS systems. These data (reproduced in Table 1) indicate that certain MMDS systems pay premiums for programming over the rates charged to comparably sized cable systems between 36.4 percent to 78.6 percent. (note 54) Data from the National Satellite Programming Network, Inc., a trade organization for SMATV systems, reported premiums ranging from 32 percent to 209 percent for nine networks available to certain SMATV systems. (note 55) The FCC Report also noted claims by National Rural Telecommunications Cooperative (NRTC), a distributor of cable programming to HSD owners, that while all networks were available to it, NRTC had to pay, on the average, rates 460 percent higher than did cable operators for access to eighteen basic cable networks. (note 56) Finally, Cross Country Cable, Inc., an MMDS operator, submitted data indicating that a package of seventeen basic cable networks available both to MMDS and to "the largest cable MSO's" cost approximately 200 percent more for the MMDS operators than for the MSOs. (note 57)

In nearly all cases indicated in Table 1, both affiliated and unaffiliated networks reportedly charged lower rates to cable systems than to alternative MVPDs. But while these input price differences seem substantial, the data indicate no discernible tendency for integrated programmers to be more inclined than nonintegrated programmers to charge higher prices to alternative MVPDs.

Evidence of price differentials was generally undisputed by program suppliers in FCC and other policy proceedings. A main reason for the differences cited by both integrated and nonintegrated programming suppliers was that serving noncable system customers is more costly. Among reasons cited were a higher frequency of bad debts, higher marketing costs, higher advertising costs, and poor signal quality. (note 58)

While such factors are clearly plausible contributors to input price differences, two other explanations are possible. One explanation is that established cable operators are attempting to prevent entry or to raise the costs of existing rivals by inducing program suppliers to charge the rivals higher prices than they otherwise would. A fringe competitor such as an MMDS system would thus be prevented from gaining a stronger foothold or forced to exit the market. Or, the price differences could be a short term "raising rivals' costs" strategy. In the latter model, higher programming costs paid by a fringe competitor create a price umbrella under which the established firm can continue to charge monopoly prices to consumers. (note 59) That is, the higher consumer prices charged by the fringe competitor reduce the competitive pressure on the established cable operator to lower its own subscription prices.

While a possible explanation for the cable network price differentials, the policing of input price collusion among numerous networks, even in the presence of the fairly extensive vertical relationships in the cable industry, seems very discouraging to this model. Network-affiliate contracts specify confidentiality and are complex, often defining sliding scale input pricing formulas and other terms and conditions such as the sharing of marketing responsibilities. (note 60) The likelihood of undetected discounts to the entrant under these circumstances is high. Of course, an individual MSO should have little difficulty controlling the input price terms charged by a network in which it has a majority ownership investment. The minority ownership relationships prevalent between MSOs and many networks, however, would be less conducive to such price control, as would the absence of any ownership control over other cable networks. Even if only a single MSO or cable system were attempting to orchestrate the collusion among networks in a localized area, these coordination problems would seem forbidding. For several MSOs to coordinate this process would be even more difficult. (note 61)

2. Monopsony Power
A second, alternative explanation for the input price differences is variations in outcomes of bargaining between individual networks (or commonly owned network groups) and the various MVPDs. Just as operators of different delivery systems are likely to have different credit risks, it is also apparent that they have different degrees of bargaining—i.e., monopsony-power in the input market. (note 62) Less established services such as SMATV and MMDS can be expected to hold relatively little sway over cable networks since their retail distribution of those networks accounts for a relatively marginal share of those networks' profits. The larger MSOs, however, are able to threaten a given program supplier with the loss of a relatively large share of its potential revenues, and would thus be likely to negotiate more favorable programming price terms. (note 63)

The record of congressional testimony and comments to the FCC is consistent with the theory that programming price differences reflect differential bargaining power. Small cable operators, in fact, make essentially the same complaints about discriminatory pricing as do SMATV, MMDS, and HSD owners. In its 1989 Comments to the FCC, the National Cable Television Cooperative, a cooperative formed to secure programming in bulk for small cable operators, complained of the "lack of good terms" for cable network programming. (note 64) In its 1993 Comments to the Commission, the Community Cable Television Association (CATA), a trade association of mostly rural cable operators, complained to the FCC about unfair terms and practices from both integrated and nonintegrated cable networks. (note 65)

Although systematic data are unavailable, anecdotal evidence also suggests the presence of significant monopsony power of larger MSOs in the programming market. Drawing on press reports, for example, a 1988 NTIA report on the cable industry cited input price differentials larger than one would expect from transactions costs savings (note 66) for large versus small MSOs. (note 67) The trade and financial press has also reported several cable industry incidents in recent years, some of them brought out in congressional hearings, that might be explained by monopsony power. (note 68)

One could respond to the explanation that monopsony power determines input price differentials by arguing that the entry-retarding effect on emerging technologies of higher input prices is basically the same as that of foreclosure behavior. This distinction is important for purposes of this Article, however, because vertical integration has little to do with bilateral bargaining over input prices. The role of integration in this context is limited to providing contracting efficiencies, or possibly giving a program buyer that is integrated with one network a strategic advantage in negotiating with another. (note 69) The effect of these factors on input prices is obviously minor relative to the large differences reported here.

D. Summary

It is evident that vertical integration could facilitate foreclosure attempts involving program access that may occur in the cable industry. However, both integrated and nonintegrated cable program suppliers engage in the same range of potentially anticompetitive behavior involving exclusive dealing. Empirical evidence that program suppliers charge consistently higher input prices to alternative MVPDs appears unrelated to vertical integration. To the extent that cost factors are not responsible for these input price differences, they can be explained by variation in outcomes of the bilateral input price-setting process between program suppliers and MVPDs having varying degrees of monopsony power in the programming market.

IV. Policy Analysis

A. Overall Conclusions

There may be many questions about the wisdom of the FCC's program access regulations in general. The rules are bound to infringe, for example, on whatever efficiency benefits that exclusive dealing may bring. One can also cite administrative burdens on the FCC, and especially, one can question whether the FCC has the necessary expertise and information to make appropriate judgments in access cases.
In the long run, however, the nondiscriminatory access requirements should increase competition with established cable systems. If competition is effectively established, consumer prices should fall, and if alternative delivery systems sufficiently expand total consumer demand, the amount and the variety of programming should increase as well. (note 70)

The main point of this Article is that whatever the net benefit of program access regulations, one cannot make a reasonable case for separate treatment of vertically integrated and nonintegrated firms. Any program access requirements should apply equally to integrated and nonintegrated program suppliers. (note 71) If the FCC's program access regulations prove effective in constraining the behavior of vertically integrated program suppliers, then vertical divestiture—or in the case of an entering program service, avoidance of MSO affiliations—is likely to result. (note 72) If program access regulations are in fact desirable from a public policy perspective, then this divestiture would be the worst possible case. The effectiveness of the rules would be undermined, their enforcement would be arbitrarily unbalanced, and the benefits of vertical integration to programming innovation and financial support, extolled by the FCC, (note 73) would be diminished.

B. FCC Program Access Rulings to Date

At this writing, the volume of program access cases before the FCC has apparently been light. The Commission reported in September 1994 that twenty-one cases had come under consideration by that date, and that eleven of them had been ruled upon. (note 74)

Two of these eleven rulings are significant in indicating how the Commission intends to apply the Section 19-based regulations with respect to exclusive contracting. In one of these cases, Time Warner Cable was denied the right to withhold its vertically affiliated network, Court TV, from Liberty Cable Co., an MMDS operator competing with Time Warner cable franchises in the Manhattan area. (note 75) In the other case, New England Cable News (NECN), a regional news channel launched in 1992, was permitted to maintain exclusivity agreements with several cable operators for the next eighteen months, after which it would have to petition the FCC to continue the agreements. (note 76) NECN is half-owned by an MSO, Continental Cablevision.

In both rulings, the FCC made clear that its decision was intended to balance the benefits from encouraging competition by alternative MVPDs, with the benefits program exclusivity could have in encouraging entry and investment in new cable program services. In the Court TV instance, the Commission argued that the network was already well-established, so that the balance was in favor of encouraging alternative MVPDs. (note 77) In the NECN case, the Commission argued that the network was not established enough to ensure its survival, so that the balance was in favor of encouraging competition in program supply. (note 78) The Commission has thus taken a rather straightforward "infant firm" approach to program access, nurturing newer competitors upstream and downstream.

One can take issue with the source of the FCC's wisdom in deciding which cable firms are most in need of nurturing, either with respect to their financial stability or their potential benefits to subscribers. Under the circumstances, however, these rulings seem reasonable from the perspective of concerns with vertical ownership. Earlier in 1994, the trade press reported that some nascent local cable news channels were threatened by the program access regulations, with some entry plans stalled. (note 79) The article speculated that "third party packagers" were likely to take the place of MSO ownership due to the vertical integration language in the regulations. (note 80) By affirming the exclusivity provision in the NECN case, pressures toward ownership separation between MSOs and entering program suppliers are presumably reduced. It also seems reasonable that a relatively new program service is unlikely to be a good foreclosure weapon. Conversely, relatively established networks such as Court TV would probably be more effective foreclosure devices. As of September, the Commission had yet to make substantive rulings on any price discrimination cases or cases not involving vertically integrated programming suppliers. (note 81)

C. A Concluding Remark

The choice by Congress to impose specific program access regulations only on vertically integrated cable firms reflects a misunderstanding of industrial economics similar to that which has characterized antitrust decisions for several
decades, though less so in recent years. This misperception is that vertical relationships are the fundamental source of anticompetitive behavior in industry.

Economic analysis has demonstrated that vertical integration is not necessarily benign, and the analysis of this Article suggests that the cable industry is probably no exception. The focus by Congress on the potentially anticompetitive effects of vertical relationships in cable, however, diverts attention from the more fundamental source of whatever excessive market power that may exist in this industry-horizontal market power at the MSO level. Without the bargaining power to induce program suppliers to grant explicit or tacit exclusivity agreements which might have foreclosure effects, or to force input prices to anticompetitively low levels, it is unlikely that cable operators could effectively use program access restraints to stop the entry of alternative MVPDs, with or without vertical integration. An individual local cable system may have bargaining leverage over local or regional program suppliers, whether that system is affiliated with a large MSO or not. Bargaining leverage over nationally distributed cable networks, however, is unlikely without control over a substantial proportion of all U.S. cable subscribers.

If effective competition for established cable systems successfully develops, most of the cable industry problems with which Congress has been concerned will disappear or diminish. The issue upon which policymakers must focus in achieving that objective is not vertical integration, but the sources of market power at the MSO level.

### Table 1

#### Input Price Comparisons: Available Data From Public Documents

**A. Sample Rate Comparisons Between Wireless Cable and Cable (cents per subscriber)**

*Information obtained in the comments of the Wireless Cable Association*

<table>
<thead>
<tr>
<th>Top Wireless Rate</th>
<th>Top Cable Rate</th>
<th>Wireless Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>CNN</td>
<td>$.50</td>
<td>$.28</td>
</tr>
<tr>
<td>USA</td>
<td>.38</td>
<td>.23</td>
</tr>
<tr>
<td>Nickelodeon</td>
<td>.35</td>
<td>.22</td>
</tr>
<tr>
<td>MTV</td>
<td>.35</td>
<td>.22</td>
</tr>
<tr>
<td>Nashville</td>
<td>.35</td>
<td>.20</td>
</tr>
<tr>
<td>A&amp;E</td>
<td>.15</td>
<td>.11</td>
</tr>
<tr>
<td>Headline News</td>
<td>.50</td>
<td>.00</td>
</tr>
</tbody>
</table>


**B. Rate Comparisons: Mid-Atlantic Communications' Cable Systems vs. SMATVs**

*Information obtained from the comments of the National Satellite Programming Network, Inc., et al.*

<table>
<thead>
<tr>
<th>Programmer</th>
<th>SMATV</th>
<th>Cable System</th>
<th>SMATV Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>HBO*</td>
<td>$6.25 per sub**</td>
<td>$4.00/mo. per sub***</td>
<td>56.2%</td>
</tr>
<tr>
<td>Cinemax*</td>
<td>6.50 per sub**</td>
<td>3.86/mo. per sub</td>
<td>94.5%</td>
</tr>
<tr>
<td>Nick*</td>
<td>0.29 per sub</td>
<td>0.17 per sub</td>
<td>70.5%</td>
</tr>
<tr>
<td>MTV*</td>
<td>0.29 per sub</td>
<td>0.17 per sub</td>
<td>70.5%</td>
</tr>
<tr>
<td>USA</td>
<td>0.18 per passing</td>
<td>0.18 per sub</td>
<td>not comparable</td>
</tr>
<tr>
<td>FNN</td>
<td>0.17 per sub</td>
<td>0.055 per sub</td>
<td>209%</td>
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<td>HTS</td>
<td>1.50 per sub</td>
<td>0.75 per sub</td>
<td>100%</td>
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<td>American Movie Classics*</td>
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<td>Arts &amp; Entertainment</td>
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<td>$0.070</td>
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<tr>
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<td>$0.040</td>
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<tr>
<td>CNN*</td>
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<td>$0.195</td>
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<td>Nashville</td>
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<td>The Disney Channel</td>
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* Indicates presence of a vertical relationship with a cable operator.
** Prices "we believe to be charged by the largest cable MSOs," compared to "prices [for MSOs] supplied to us by the Wireless Cable Association."

Source: Letter from George Remy, Chairman & Chief Executive Officer, Cross County Cable, to the Honorable Alfred C. Sikes, Chairman, Federal Communications Commission 4 (April 4, 1990) (on file with the Federal Communications Commission). Indications of a vertical ownership relationship are added by Author.

Notes

- This Article is based on David Waterman & Andrew A. Weiss, Vertical Integration in Cable Television (Sept. 17, 1993) (unpublished monograph, American Enterprise Inst.). A recent version of this Article was presented at the Telecommunications Policy Research Conference, Solomon's Island, Md., October 1994. Return to text

- Associate Professor, Department of Telecommunications, Indiana University, (812) 855-6170. I am grateful to Michael L. Katz, and especially to J. Gregory Sidak and Andrew A. Weiss, for their comments and contributions to this work. I remain responsible for all shortcomings. Return to text

2. Throughout this Article, the term "network" is used to refer to program suppliers, as distinct from a network of hardware serving communications needs at the facilities level—such as local exchange carriers, satellite master antenna television systems, or even cable systems themselves. Facilities-level firms that offer or might offer video services are either termed "cable systems" or following FCC parlance, as "alternative multichannel video programming distributors (MVPDs)."


4. As a result of the FCC's 1992 "video dialtone" decision, local exchange carriers are also beginning to offer common carrier video services and could soon be allowed to enter the market as full-fledged providers of cable services. In re Telephone Co.-Cable TV Cross-Ownership Rules, 63.54-63.58, Memorandum Opinion and Order on Reconsideration, 7 FCC Rcd. 5069, para. 269 n.15 (1992) [hereinafter Video Dialtone Order].


6. Id.

7. Id. para. 11.

8. Id. paras. 16, 62-67. This same provision also applies to "all satellite broadcast programming vendors" (that is, superstations), whether integrated or not. Id. para. 10.

9. Id. para. 10.

10. See 1990 FCC Cable Report, supra note 3.

11. Id. para. 128.

12. The argument of this Article—that differences in input prices can be explained as variations in bilateral bargaining outcomes—could also be explained from the seller's point of view as unilateral price discrimination. Here, the argument is framed in terms of bargaining outcomes because neither buyer nor seller in this market is necessarily a price maker.

13. In re Implementation of Section 19 of the Cable TV Consumer Protection and Competition Act of 1992, First Report, 9 FCC Rcd. 7442 (1994) [hereinafter 1994 Cable First Report]. The FCC reported in 1990 that there were 41 to 49 "overbuilt" systems out of a national total of approximately 10,000 and that the extent of overbuilding "seems to have remained quite limited." Id. paras. 55, 60.

15. *1994 Cable First Report, supra* note 13, paras. 73-74. Return to text

16. *Id.* para. 161 n.434. Return to text

17. *Id.* app. G, tbl. 8. Return to text


19. *Id.* app. G, tbl. 8. Return to text

20. *Id.* app. G, tbl. 4. Return to text

21. *Id.* app. G, tbs. 9-10. Return to text

22. *Id.* Return to text

23. *Id.* app. G, tbs. 1, 2, 9-10. Return to text

24. *Id.* app. G, tbl. 2. Return to text

25. *Id.* app. G, tbl. 1A. Return to text

26. *Id.* para. 165. Return to text

27. *Id.* para. 164. Return to text

28. *Id.* para. 166. Return to text

29. *Id.* app. G, tbs. 3-4. Return to text


31. The essential feature of one such model is that an established cable operator has made a sunk cost investment in constructing a physical plant on the expectation that over time operating revenues will cover not only operating expenses, but also amortization of the plant. Leland L. Johnson, *Common Carrier Video Delivery by Telephone Companies* 4547 (1992). But now assume that a potential multichannel competitor later arrives on the scene. Because its existing plant is otherwise useless, the established operator will find it worthwhile to expend resources to prevent entry all the way up to the point that only its operating costs are covered. The result is that even if the potential entrant has a superior technology and programmers could expand their subscribership with the new technology, the established operator may still be able to compensate program suppliers for a grant of exclusive rights by more than the entrant could profitably bid for those rights, thus preventing the entry. This model implicitly assumes as well that the entrant is unable to hold on as long as the established cable operator.

One could also posit a "reprisal" model of entry deterrence at the system level. In this case, the incumbent cable system does not compensate networks to induce them to refuse sales to competing delivery systems. Rather, the system keeps networks in line by establishing a reputation for punitive action (for example, by moving channel position or refusing to promote) against any network that might do business with the entrant. The basis for this model follows from David M. Kreps & Robert Wilson, *Reputation and Imperfect Information*, 27 J. Econ. Theory 253 (1982) and Paul Milgrom & John Roberts, *Predation, Reputation and Entry Deterrence*, 27 J. Econ. Theory 280 (1982). Return to text

32. See *1990 FCC Cable Report, supra* note 3, para. 181 (testimony of Robert Thompson, Vice President of TCI,
from the FCC Los Angeles Cable Television Field Hearing, Feb. 12, 1990); Comments of the Wireless Cable Association International, Inc. to FCC in MM Dkt. No. 92-265 (Jan. 25, 1993). The "contestability" of program supply at the actual production level is more likely because individual firms do not tend to develop brand names or consumer loyalties. For this reason, integration between cable systems and movie studios (as in the case of Time Warner, via its ownership of the studio, Warner Bros., Inc. as well as cable systems) is not likely to be a concern unless a large share of the market for program production were to be accumulated. Return to text


34. For example, the first networks that an entering MVPD offers to its subscribers are likely to benefit by accumulating subscriber loyalty or from subscriber switching costs. Return to text

35. Such potential facilitation of collusion was the central rationale for the Justice Department's successful opposition to the merger in the early 1980s of Showtime and the Movie Channel under joint ownership of five corporate entities, including three of the major motion picture studios. The Justice Department's main rationale was that the new venture would facilitate collusion among the three motion picture producer-distributors upstream. See Lawrence J. White, Antitrust and Video Markets: The Merger of Showtime and the Movie Channel as a Case Study, in Video Media Competition: Regulation, Economics, and Technology 338 (Eli M. Noam ed., 1985). Return to text

36. Similarly, the MSOs could discriminate against a network that is carried, such as by refusing to promote it to subscribers, or by moving it to an inferior channel position. Such strategies are, of course, likely to be less successful with more established networks such as CNN or USA. Return to text

37. Similar concerns were also a basis for settlements in 1994 of federal and state antitrust suits against Primestar Partners, a joint venture among ten firms-including the five largest vertically integrated MSOs-formed in 1990 to offer medium power DBS services in the United States. United States v. Primestar Partners, L.P., 1994-1 Trade Cas. (CCH) 70,562 (S.D.N.Y. April 4, 1994). The Primestar system utilizes transmission from an existing satellite transmitting in a low-frequency portion of the Ku-band and requires a home receiving dish 18 to 36 inches in diameter. More advanced "true" DBS systems use a higher-powered satellite transmitting in the upper Ku-band and will require a smaller home dish. Some provisions of these settlements parallel the Cable Act by enjoining the defendants' majority owned programming services from engaging in various exclusive contracting and discriminatory pricing practices. Another proposed consent decree filed in 1994 by the Justice Department, United States v. Telecommunications, Inc. and Liberty Media Corporation, Proposed Final Judgment and Competitive Impact Statement, 59 Fed. Reg. 24,723-24 (1994), approves the remerger of these two firms but constrains the program services in which they have ownership interests from similar pricing and exclusivity practices. Return to text

38. 1990 FCC Cable Report, supra note 3, paras. 116-117. Return to text

39. Id. para. 114(a). Return to text

40. Id. para. 114(b). Return to text

41. Id. Return to text

42. This debate is beyond the scope of this Article. For a survey of these arguments, most of which rely on the "free rider" marketing problem or other moral hazard problems in the relationship between manufacturers and dealers, see Katz, supra note 33. For a recent survey of the economic justifications for exclusivity in antitrust cases, see
Gregg Frasco, Exclusive Dealing: A Comprehensive Case Study (1991). Some recent economic models claim that exclusive dealing may have anticompetitive effects. See in particular, Michael H. Riordan & David J. Salant, Exclusion and Integration in the Market for Video Programming Delivered to the Home (July 7, 1994) (paper presented at the AEI Telecommunications Summit: Competition and Strategic Alliances). Riordan and Salant argue specifically that exclusive dealing in the cable television industry may have negative welfare consequences, in part because economies of scale in the distribution of programming are not realized. *Id.*


48. *Id.*


50. *Id.* (Disney Channel); Comments of Telesat Cablevision to FCC in MM Dkt. No. 89-600, at 26-27, 30 (1990) (Cable Video Store, A&E, Weather Channel, Home Shopping Network); *In re Competition, Rate Deregulation and the Commission's Policies Relating to the Provision of Cable Television Service, Reply Comments of NCTC in MM Dkt. No. 89-600, at 2 (1990) (FNN); *FCC Los Angeles Cable Television Field Hearing (Feb. 12, 1990) (USA, ESPN).*

51. Comments and Reply Comment to FCC in MM Dkt. No. 92-265 (the Wireless Cable Association, Peoples Choice TV, NRTC, and the National Private Cable Association), at 17-18 (Jan. 29, 1993) [hereinafter Wireless Cable Comments].

52. Such pressures, for example, are suggested by an instance involving HBO. In the mid-1980s, HBO announced it would offer cable operators the right of "wireline exclusivity" within their local market areas for a rate surcharge of 25 per subscriber. HBO's announcement was met with a questioning letter from Senator Kerry (D-Mass.) regarding its effects on potential competitive video providers. HBO's offer was later dropped. *Cable Competition Hearings, supra* note 3, at 152-74.

53. *See generally Wireless Cable Comments, supra* note 51.


55. *Id.* app. G, tbl. 12.

56. *Id.* app. G, tbl. 9.

57. *Id.* para. 114(b).

58. *Id.* paras. 116-17.

59. *See Krattenmaker & Salop, supra* note 33, at 238-40. The relevant model in this case is the "cartel ringmaster."
For a discussion of cable industry contracts, see David Waterman & Andrew Weiss, Vertical Integration in Cable Television, ch. 3 (Sept. 17, 1993) (unpublished monograph, American Enterprise Inst.).

The 1994 Primestar decrees provide some perspective. The Primestar Partners' original contract contained a "most favored nation" (MFN) clause which required the involved program suppliers to offer their programming to the Primestar DBS system at prices no higher than were charged to any other entity. The government interpreted this clause to be conducive to input price collusion among these suppliers for the possible purpose of preventing entry of a competing DBS system. See generally In re Implementation of Section 19 of the Cable Television Consumer Protection and Competition Act of 1992, Notice of Inquiry, 9 FCC Rcd. 2896, paras. 85-87 (1994). While this theory recognizes the incentive these firms would have to coordinate input prices, the government's theory behind the decrees' prohibition of MFN price clauses is that even though all the participants were vertically integrated firms, a written document would be instrumental in coordinating the collusion. Obviously, such written documents have not been the rule in the cable industry.

In general, monopsony power means the power to force the price of an input (in this case a cable network) below competitive levels, and thus make excess profits. Monopsony is defined as "a market situation in which there is a single buyer for a given product or service from a large number of sellers." Webster's Third New International Dictionary 1463 (3d ed. 1981).

Such a result follows from basic principles of bilateral bargaining theory. For a formal exposition, see David Waterman, Local Monopsony and Free Riders (1994) (paper prepared for presentation to the American Law and Economics Association Annual Convention, May 12-13, 1995, Berkeley, California).

For a variety of reasons, contracting between a buyer and seller is likely to be less expensive, less risky, or otherwise more efficient than is arms length contracting between unaffiliated parties. For a general analysis, see Oliver E. Williamson, Vertical Integration of Production: Market Failure Considerations, 61 Am. Econ. Rev. 112 (1971).

Among specific examples cited by NTIA are a 2 per subscriber per month rate for CNN paid to MSOs with over 5 million subscribers compared to 29 for MSOs with under 500,000 subscribers. In addition, 90 per subscriber was paid for HBO by the largest MSO, TCI, Inc., compared to $5.00 paid by "small" MSOs. As NTIA points out, however, transaction economies are one factor determining these rates, or these may be incomplete descriptions of more complex pricing structures. See NTIA, supra note 49, at 80-82.


69. See Riordan & Salant, *supra* note 42. Return to text


71. The Primestar settlements, particularly those at the state level, appear to overlap substantially with the FCC's nondiscriminatory program access requirements. The proposed settlements, however, apply only to the seven vertically integrated MSO defendants. At least in the federal case they would affect only program suppliers that are controlled by means of a 50% or greater equity share held by one MSO or in common by more than one MSO. The state decrees require programming to be made available to other MVPDs on "reasonable" terms, while the Primestar agreement essentially only controls collusion among the MSOs or their controlled entities, involving one or more party. See *In re* Implementation of the Cable TV Consumer Protection and Competition Act of 1992, *Memorandum Opinion and Order on Reconsideration of the First Report and Order*, 76 Rad. Reg. 2d (P & F) 1177 (Dec. 23, 1994). Return to text

72. While the program access regulations could be a factor in the recent attempts by Paramount-Viacom to divest of its cable system interests, the need for cash to finance the merger is widely reported to be a primary motive. See, e.g., John M. Higgins, *TCI Eyes Viacom Buy*, Multichannel News, Apr. 4, 1994, at 1, 50. Return to text

73. 1990 FCC Cable Report, *supra* note 3, paras. 82-86. Return to text

74. 1994 Cable First Report, *supra* note 13, paras. 174-74. Return to text


77. *Courtroom TV Memorandum*, *supra* note 75, para. 37. Return to text

78. *New England Cable Memorandum*, *supra* note 76, para. 36. Return to text


80. *Id*. Return to text


Of the other eight rulings, one waived Walt Disney Co. from program access regulations in distributing to hotel pay-per-view systems. *In re Petition of Walt Disney Co. for Waiver of Program Access Rules*, *Memorandum Opinion and Order*, 9 FCC Rcd. 4007 (1994). The other seven were dismissed on procedural grounds or as a result of private settlements. Return to text