BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of	)	
	)	
Reexamination of the Effective	)	
Competition Standard for the	)	
Regulation of Cable Television	)	
Basic Service Rates	)	MM Docket No. 90-4
	)	
Carriage of Television	)	
Broadcast Signals by	)	
Cable Television Systems	)	

Reply Comment of the Staff of the Bureau of Economics and the San Francisco Regional Office of the Federal Trade Commission*

November 26, 1991

* This reply comment represents the views of the staff of the Bureau of Economics and the San Francisco Regional Office of the Federal Trade Commission. They are not necessarily the views of the Commission or those of any individual Commissioner. Inquiries regarding this comment should be directed to Michael Vita (202-326-3493) of the FTC's Bureau of Economics or John Wiegand (415-744-7920) of the FTC's San Francisco Regional Office.

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Executive Summary

Signal carriage ("must-carry") rules compel cable systems to carry local broadcast signals. In this Second Further NPRM, the FCC seeks to determine whether signal carriage requirements should now be adopted.

In this reply comment, the staff of the FTC recommends that the FCC take account of the welfare of consumers in assessing the desirability of new signal carriage requirements. Under conventional economic criteria for measuring consumer welfare, new must-carry rules could be justified only if three conditions are met. First, non-carriage of local signals should be shown to occur and potentially to raise sufficient concern to require a broad-based regulatory remedy. There would be little reason to compel cable systems to carry local signals if profit-seeking behavior induces them to carry the vast majority of these signals voluntarily. Second, if significant non-carriage of local signals occurs, it should be demonstrated to be the consequence of some market failure, such as the exercise of market power by the cable system. If instead non-carriage reflects cable systems' efforts to offer consumers a preferred array of programs, must-carry rules could impair the systems' ability to serve their customers. Finally, and related to the first point, if non-carriage results from market failure or market power, it should be shown that the net effect of the proposed remedy would likely benefit consumers.

This comment uses information from three sources to address these issues. These are: (1) the FCC's 1988 Cable System Broadcast Carriage Survey Report; (2) the 1990 GAO/FCC Follow-Up National Survey of Cable Television Rates and Services; and (3) the staff of the FTC's 1986 analysis of the carriage decisions of private cable systems (i.e., "SMATVs"). A review of this empirical evidence shows that most cable systems voluntarily carry all of their former must-carry stations. Most episodes of non-carriage appear to have involved distantly-located (and duplicated) network signals and relatively low-rated commercial independent stations. Such actions would be consistent with competitively-determined carriage decisions, and would suggest generally that non-carriage decisions have not been motivated by anticompetitive considerations, such as the acquisition of market power in advertising markets. If this inference is correct, requiring systems to carry all local broadcast signals could displace programming cable subscribers value more highly and could reduce incentives to develop cable programming. Under these circumstances, consumer interests would unlikely be served by reimposing must-carry obligations on cable television systems.

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Reply Comment of the Staff of the Bureau of Economics and the San Francisco Regional Office of the Federal Trade Commission[1]

November 26, 1991

I. Introduction

The staff of the Federal Trade Commission appreciates this opportunity to submit a reply comment in response to the Federal Communications Commission's Report and Order and Second Further

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Notice of Proposed Rulemaking[2] ("Second Further NPRM") concerning reinstituting signal carriage requirements ("must-carry" rules) for cable television systems.

The previous must-carry rules compelled cable systems to carry local broadcast signals. They were first adopted more than twenty years ago, when cable television's principal function was to provide improved reception of local television signals (i.e., "antenna service"). These rules were held unconstitutional.[3] The purpose of the Second Further NPRM is to determine whether signal carriage requirements are needed in the marketplace now, and if so, whether they could be crafted to overcome constitutional objections.[4]

In this reply comment the staff of the FTC reviews evidence bearing on cable systems' carriage choices in the absence of must-carry regulation. This evidence suggests that although must-carry rules have not been in effect for several years, most of the broadcast stations that would have been entitled to must-carry status are still carried by the cable systems that formerly were required to carry them. Further, the local broadcast

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[2] See Report and Order and Second Further Notice of Proposed Rulemaking In the Matter of Reexamination of the Effective Competition Standard for the Regulation of Cable Television Basic Service Rates and the Carriage of Television Broadcast Signals by Cable Television Systems, Docket Nos. 90-4 and 84-1296, July 12, 1991.

[3] See Century Communications Corp. v. FCC, 835 F.2d 292 (D.C. Cir. 1987), cert. denied, 486 U.S. 1032 (1988); and Quincy Cable TV, Inc. v. FCC, ("Quincy") 768 F.2d 1434 (D.C. Cir. 1985), cert. denied, 476 U.S. 1169 (1986).

[4] Second Further NPRM, ¶111.

signals that were dropped from carriage tend to be either those of relatively remote (and duplicated) network stations, or local stations that few viewers watch. These findings are consistent with the proposition that cable systems are trying to carry the programming their customers most want to watch. If so, requiring cable systems to carry unwanted broadcast signals could displace programming cable subscribers value more highly and could reduce incentives to develop cable programming.

The FCC adopted the previous must-carry rules in response to two concerns. First, the FCC viewed a cable system's failure to carry local broadcast stations as an "unfair competitive practice."[5] Second, the FCC believed that such a failure would adversely affect the growth of local broadcast stations as outlets for local expression.[6]

This comment addresses certain issues raised by the first concern -- whether non-carriage is now a competition problem that calls for a regulatory solution. We do not address other policies, such as the relationship between non-carriage and the vitality of outlets for local expression, that may be important to the FCC.[7] We note, however, that in recent policy statements, the FCC appears to have taken account of similar

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[5] In re CATV, 2 FCC 2d 725, 736 (1966) (Rulemaking, Second Report and Order).

[6] Id.

[7] Specifically, this comment addresses issues relating to economic efficiency and competition, using price theory and welfare economics as understood in the interpretation and enforcement of the antitrust laws.

factors through a competitive, consumer-welfare centered approach. For example, in Policies Regarding Detrimental Effects of Proposed New Broadcast Stations on Existing Stations,[8] the FCC announced that economic harm to existing stations would no longer be considered relevant to the decision to grant a license to a new station.[9] In National Association of Broadcasters v. FCC,[10] this principle was applied to issues involving competition among different methods of signal transmission (direct broadcast satellite service and local broadcast service).[11] In addition, recent interpretations of the FCC's responsibility to allocate radio facilities under § 307(b) of the Communications Act[12] suggest that this obligation should be fulfilled by considering the needs of consumers in all localities.[13]

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[8] 3 F.C.C. Rec. 638 (1988).

[9] The FCC had earlier adopted this policy in a limited set of matters. See, e.g., Application of Satellite Television Corp., 91 F.C.C. 2d 953, 976 (1982); Revision of FM Assignment Policies & Procedures, 90 F.C.C. 2d 88, 98 (1982); see also National Association of Independent Television Producers & Distributors v. FCC, 502 F.2d 249, 256 (2d Cir. 1974) (FCC must incorporate the nation's policy favoring competition in its regulation of broadcasting).

[10] 740 F.2d 1190 (D.C. Cir. 1984).

[11] 740 F.2d 1190, 1198 (D.C. Cir. 1984) ("existing systems [of broadcasting] . . . have no entitlement that permits them to deflect competitive pressure from innovative and effective technology").

[12] 47 U.S.C. § 307(b) ("localism policy").

[13] See, e.g, National Association of Broadcasters v. FCC, 740 F.2d 1190, 1198 (D.C. Cir. 1984) ("The ultimate touchstone (continued...)

II. Expertise of the Staff of the FTC

The FTC is an independent regulatory agency responsible for maintaining competition and safeguarding the interests of consumers.[14] In response to requests by federal, state, and local government bodies, the staff of the FTC often analyzes regulatory or legislative proposals that may affect competition or the efficiency of the economy. In the course of this work, as well as in antitrust and consumer protection research, nonpublic investigations, and litigation, the staff applies established principles and recent developments in economic theory to competition and consumer protection issues. The staff of the FTC previously has commented on various issues before the FCC on matters relating to cable television.[15]

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[13](...continued)
for the FCC is thus the distribution of service, rather than of licenses or stations; the constituency to be served is people, not municipalities."); Main Studio & Program Origination Rules, 1 F.C.C. Rec. 536 (1986) ("Primary emphasis should be on whether the station is serving the needs of the community and not where the program originates.").

[14] 15 U.S.C. §§ 41 - 59.

[15] See, e.g., Comment of the Staff of the Bureau of Economics and the San Francisco Regional Office In the Matter of Reexamination of the Effective Competition Standard for the Regulation of Cable Television Basic Service Rates, MM Docket No. 90-4, April 24, 1991; Comment of the Staff of the Bureau of Economics and the San Francisco Regional Office In the Matter of Competition, Rate Deregulation, and the Commission's Policies Relating to the Provision of Cable Television Service, MM Docket No. 89-600, April 20, 1990 ("FTC Staff Cable Comment"); and Reply Comments of the Bureaus of Competition, Economics, and Consumer Protection in the Matter of Part 76 of the Commission's Rules Concerning the Carriage of Television Broadcast Signals by Cable Television Systems, MM Docket No. 85-349, February 25, 1986.

In assessing competitive consequences of actions and policies, antitrust analysis is most concerned about the welfare of consumers. An analysis based on conventional economic criteria for measuring consumer welfare[16] would set three conditions to be met before concluding that must-carry rules are justified. First, non-carriage of local signals should be shown to occur and potentially to raise sufficient concern to require a broad-based regulatory remedy. There would be little reason to compel cable systems to carry local signals if profit-seeking behavior induces them to carry the vast majority of these signals voluntarily. Second, if significant non-carriage of local signals occurs, it should be demonstrated to be the consequence of some market failure, such as the exercise of market power by the cable system. If instead non-carriage reflects cable systems' efforts to offer consumers a preferred array of programs, must-carry rules could impair the systems' ability to serve their customers. Finally, and related to the first point, if non-carriage results from market failure or market power, it should be shown that the net effect of the proposed remedy would likely benefit consumers.

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[16] Economists typically employ a measure of consumer welfare based on the concept of "consumers' surplus." See Henderson and Quandt, Microeconomic Theory (third ed.), 1980, pp. 49-52.

III. Empirical Evidence on Cable Systems' Carriage Decisions

Information on cable systems' carriage decisions is available from three sources: (1) the FCC's 1988 Cable System Broadcast Carriage Survey Report ("Carriage Report"); (2) the 1990 GAO/FCC Follow-Up National Survey of Cable Television Rates and Services ("Follow-Up Survey"); and (3) the staff of the FTC's 1986 analysis of the carriage decisions of private cable systems (i.e., "SMATVs").

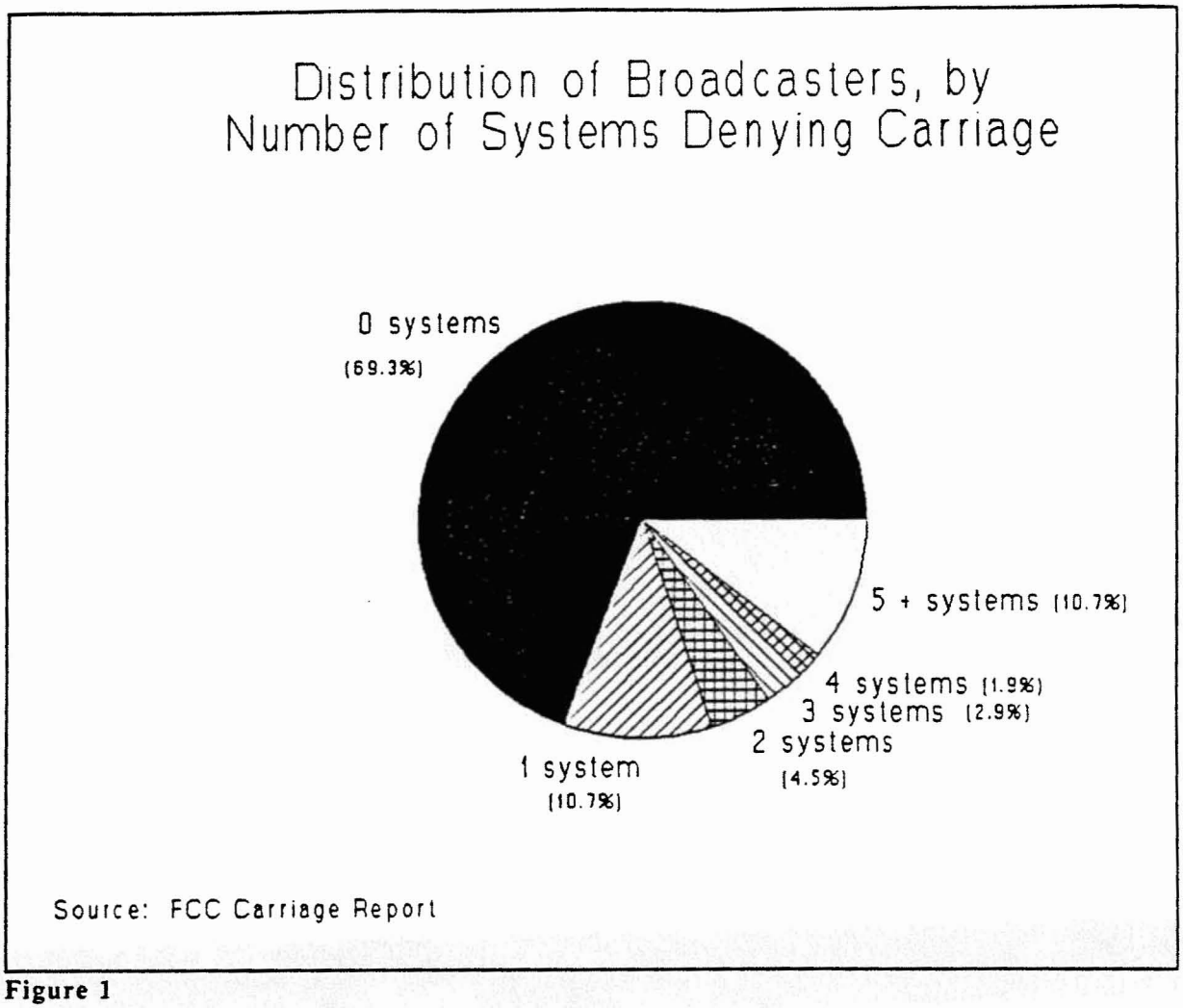

Figure 1

The Carriage Report is the most comprehensive source of information on cable systems' carriage choices in the post-must-carry period. The FCC surveyed a large number of cable systems (4,303) and broadcasters (912) to determine, among other things, the incidence of signal non-carriage among stations that would have been entitled to must-carry status under the old (pre-1985) standard. Most of the responding broadcasters (about 70 percent) reported that they had not been denied carriage by any cable system. Of the 280 broadcasters reporting at least one instance

of non-carriage, most were denied carriage on three or fewer cable systems (see figure 1). In total, there were 1,533 instances of non-carriage reported by respondent broadcasters.[17] Almost half of these were reported by independent commercial stations, approximately one-fifth by noncommercial educational stations, and the remaining 30 percent were split among network affiliates and "other" (e.g., religious) stations.

The Carriage Report's survey of cable systems yields qualitatively similar results. Most cable systems (about 80 percent) reported that they did not deny carriage to any former must-carry station. Of those systems that did, about half denied carriage to only one station, and the overwhelming majority (close to 90 percent) denied carriage to three or fewer stations. About two-thirds of the dropped stations were non-network stations.

The 1990 GAO/FCC Follow-Up Survey is less comprehensive than the 1988 Carriage Report, but provides qualitatively similar information. The Follow-Up Survey asked respondent cable systems for information on the number of "local signals" available in the franchise area and the number of these signals that were carried by the system.[18] According to the Follow-Up Survey, the numbers of over-the-air signals available to the average cable subscriber

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[17] If a broadcaster reported that it had been dropped by two cable systems, this would count as two instances of non-carriage.

[18] "Local signals" were defined as signals that were (1) "significantly viewed" in the franchise area, or (2) "acceptable" in the area, as defined by the FCC.

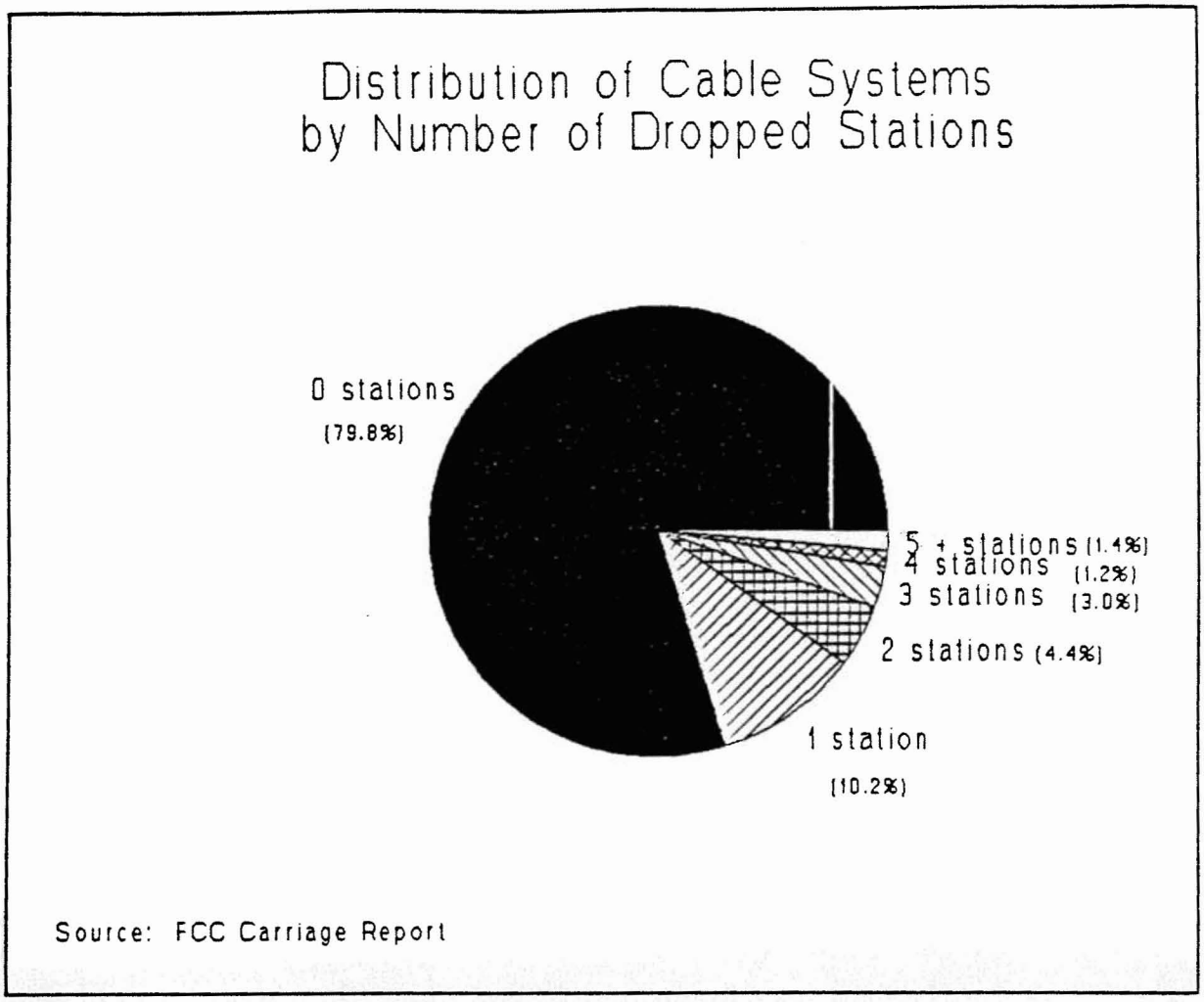

Figure 2

in 1986 and 1989 were 8.4 and 8.9, respectively.[19] The average number of local signals carried on the lowest-priced basic service tier in those years was 7.7 and 7.9, respectively. Thus, this survey evidence suggests that, even without being required to do so by regulation, cable systems would carry most of the local signals available to subscribers over-the-air.

The third piece of information relevant to cable systems' carriage decisions is contained in the 1986 Reply Comments of the

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[19] See Follow-Up Survey, Table V.3.

staff of the FTC in the previous must-carry rulemaking.[20] In this submission, the staff of the FTC analyzed the carriage choices of satellite master antenna television (SMATV) systems using data from the period 1981-85. SMATVs are private cable systems that do not cross public rights-of-way. Because SMATVs never were subject to must-carry rules, the staff regarded their carriage choices as indicative of how cable systems might behave in the absence of must-carry rules. All of the SMATVs in the sample analyzed carried the local signals of the three network affiliates. Holding constant the system's channel capacity, the proportion of local signals carried fell somewhat as the number of available local signals increased; however, a large proportion of these signals continued to be carried. For example, when three local signals were available, all were carried; when nine local stations were available, about two-thirds were carried. The proportion of local signals carried also fell with increases in the number of alternative programming sources, such as satellite channels; again, however, most local signals continued to be carried.[21] Thus, in 1981, when 35 satellite channels were available, eight of the nine local stations were carried; later, when 45 satellite channels became available, seven of the nine local stations were carried. Overall, this evidence suggests

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[20] Supra, note 15.

[21] The term "satellite channels" refers to channels that are made available to cable systems only by satellite (e.g., ESPN and CNN).

that even without regulation, market forces will lead cable systems to carry most local stations.

All three data sources show that some (although limited) non-carriage of local signals occurs. However, this does not imply necessarily that non-carriage results from market power or market failure requiring regulatory action. Instead, the particular non-carriage decisions observed could be the result of normal competitive market forces. This possibility becomes more apparent upon detailed examination of the data from the FCC Carriage Report.[22] These data suggest that most of the network affiliates that were denied carriage may have been relatively remote stations that substantially duplicated the programming of another network affiliate. Table 7 of the Carriage Report shows that in 379 out of 595 instances where a network affiliate was denied carriage, the distance between the station and the system headend was over 51 miles.[23] The mean distance was 59 miles.[24] In 417 of these cases, the dropped station was in a different

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[22] The raw survey data were provided by the FCC to the staff of the FTC.

[23] In contrast, most (78 percent) of the dropped commercial independent stations were less than 50 miles away; the mean distance was 38 miles. For public and "other" stations, the mean distances were 43 and 33 miles, respectively. The Carriage Report does not provide the transmitter-headend distance for those stations that were still carried, however, and thus does not itself show unequivocally that the retained stations were closer to the system than the dropped stations.

[24] Computed from survey response data provided to the FTC staff by the FCC.

"area of dominant influence" (ADI) from the cable system.[25] Moreover, despite dropping some network affiliates, these cable systems continued to offer their subscribers roughly the same number of network affiliates, about 4, as did those systems that did not drop any stations. The decision to drop a distantly-located network affiliate that may largely duplicate the programming of a more proximate affiliate that is retained could easily reflect a desire to replace one program service with an alternative to network programming that is more preferred by the system's customers.

In the case of public television stations, the signals that were denied carriage were closer to the cable system than in the case of commercial network affiliates (43 miles versus 59 miles). However, as in the case of commercial network affiliates, those systems that denied carriage to a public television station continued to offer their subscribers roughly the same number of public stations (about 2) as were offered by systems that did not drop any stations.

For independent commercial stations, program duplication is less of an issue,[26] so a system's decision to drop the station

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[25] A station's Arbitron ADI is geographic market measure that is based upon measured household viewing patterns.

[26] The issue does not disappear entirely, however. Some cable systems located between FCC designated television markets may have been obligated to carry independent stations from both markets. Such stations frequently feature some duplicate programming, inasmuch as program syndicators would have promoted the same programming, including sports and movie packages, in both markets.

may have a somewhat different motivation. Nevertheless, the motive also could be a desire to replace a relatively low-rated station with programming that viewers value more highly. Examining the rankings of the dropped signals in the last full year of must-carry (1984),[27] and using data from the cable survey, discloses that 191 of the 485 reported instances of non-carriage of independent commercial stations involved stations that did not attract a large enough audience to qualify for an Arbitron audience share rating.[28] Another 63 instances involved the lowest ranked station in the station's Arbitron ADI, and another 25 involved stations rated next-to-last. Only 20

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[27] The last year of must-carry was chosen to avoid the problems of inference associated with a post-must-carry year (i.e., did low ratings induce non-carriage, or were they caused by non-carriage?). Television station ratings were taken from Investing in Television: 5 Year Ratings Review (BIA Publications, Inc.).

[28] There appear to be a number of reporting errors in the Carriage Report survey. Some dropped stations were incorrectly classified as commercial independents when they were not; some dropped commercial independent stations were mistakenly included in other categories. The 485 reported instances of carriage denial break down as follows: 191 had no measurable audience share; 63 were ranked last; 25 were ranked next-to-last; 7 were below the median (but better than next-to-last); 13 were in the top half; 57 were incorrectly classified (i.e., were either network affiliates, educational, or "other"); 28 were home shopping networks; 83 came on-the-air after 1984; and 18 could not be identified (i.e., their call letters were not listed in the 1989 Television & Cable Factbook). When account is taken of commercial independents that were misclassified, the figures change to: 224 stations had no measurable audience share; 69 were ranked last; 26 were ranked next-to-last; and 85 came on-the-air after 1984. Other numbers are unchanged. The 85 stations that came on-the-air after 1984 break down as follows: 44 were unranked, and 41 were ranked last.

instances of non-carriage involved stations that were ranked better than next-to-last.

The Carriage Report's survey of independent commercial stations yields similar findings. Of the 73 independent stations that were denied carriage in 1988,[29] 50 were on-the-air in 1984; 23 commenced broadcasting afterwards. Of the former, 25 were unranked. Another 13 were the lowest or next-to-lowest station in their respective ADI's. Only 3 stations were in the upper half of the ratings distribution for their respective ADI's. For the 23 stations that came on-the-air after 1984, the 1988 rankings were: 8 unranked; 14 ranked last; and 1 ranked in the lower half (but better than last).

The figures from both surveys are consistent with the view that in many instances non-carriage of independent commercial stations may have been motivated by a desire to replace less popular stations. This does not mean that consumers' interests necessarily were served by these carriage denials. Determining whether these non-carriage decisions necessarily served consumers' interests is complicated by the fact that broadcast ratings are an imperfect measure of consumers' willingness-to-pay.[30] A station could have few viewers who nevertheless might be willing to pay a great deal to have its programming televised.

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[29] The Carriage Report (Table 1) states that 83 independent commercial stations were denied carriage. Ten of these, however, were actually home shopping networks.

[30] See Spence and Bruce Owen, "Television Programming, Monopolistic Competition, and Welfare," Quarterly Journal of Economics 91 (1977), 103-26.

In these circumstances, however, cable systems may respond better to consumer demands than would advertiser-supported broadcasters. Cable systems, unlike broadcasters, may have greater means to elicit information on the values consumers attach to different programs.[31] Consequently, a system's decision to drop a poorly-ranked station suggests that the station is both low-rated and low-valued; i.e., its cable viewers are unwilling to pay enough to cover the cable system's opportunity cost of carrying that station in place of some other. Under such circumstances, consumers' interests would not be well-served by requiring that these signals be carried.

IV. Potential Benefits of Must-Carry

A. Preventing the Exercise of Market Power in Advertising Markets

Cable systems, like broadcast television stations, receive revenues from the sale of advertising time. If a cable system is not subject to sufficient competition from other cable systems, television broadcasters, or other advertising media, a system might be able to raise unilaterally the price of its advertising time to supracompetitive levels, as advertisers would have

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[31] Cable systems that are not subject to basic service rate regulation could place highly-valued stations on higher-priced service tiers. Viewership of these stations then would be limited to those who place a relatively high value on them. In the limiting case, an individual station's signal could be scrambled and sold on an "a la carte" basis. For a general discussion of these issues, see Minasian, "Television Pricing and the Theory of Public Goods," Journal of Law and Economics 81 (1964), 71-80.

insufficient alternative means to reach potential customers in the area served by the system. It has been suggested that non-carriage of local signals may be motivated by a desire to impair the ability of local broadcasters to compete in the market for advertising. If so, must-carry rules could be beneficial if they increase the audience size, and therefore the viability, of local broadcast stations competing with local cable systems in the market for advertising.

This theory of competitive harm posits that individual cable systems can profitably exercise or acquire market power in advertising markets through unilateral decisions to deny carriage. As explained below, however, there are a number of conditions that must hold if this theory is to explain carriage choices and provide a possible justification for reimposing must-carry rules. While it may be the case that cable systems possess market power in the delivery of certain video signals to the households in their franchise area,[32] it does not follow from this that each cable system necessarily possesses market power in the local advertising market in which it competes.

Note first that a cable system faces a trade-off when it denies carriage to a local station. If cable viewers prefer a dropped local station to the alternative programming carried in its place, then the cable system's audience and its advertising

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[32] Whether cable systems are constrained in the price they can charge for the delivery of local over-the-air signals is discussed at length in the FTC Staff Comment on the Effective Competition Standard, supra note 15.

price would be reduced by the carriage denial. On the one hand, carrying that local station would increase the cable system's audience and the price that it can charge subscribers and advertisers. But on the other hand, carrying that local station may also increase advertising competition if it increases the station's audience size, and this may tend to reduce advertising prices in the market as a whole, including the prices the cable system can charge. The decision to carry or drop would depend upon which effect predominated. An anticompetitive motive for carriage denial would be most plausible when a system's penetration rate is both high and relatively unresponsive to the system's carriage decisions.[33] Under such conditions, denial of carriage could cause the affected station to lose access to most of the households in the system's franchise area.[34]

Second, in order for carriage denial to reduce competition, advertising sold by cable systems must compete directly with advertising sold by local broadcasters and account for a large share of this market. If purchasers of cable advertising do not regard broadcast advertising as a close substitute, a cable system would not need to reduce broadcasters' access to cable subscribers in order to raise the price of cable advertising -- it could do so unilaterally.

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[33] A system's penetration rate is the ratio of subscribing households to total households passed. The average cable system has a penetration rate of 58 percent (See 1990 GAO/FCC Follow-Up Survey, p. 25).

[34] As discussed below, however, cable subscribers might still have the means to receive non-carried stations.

A recent FCC working paper does suggest that cable advertising, both local spot and cable network, is becoming an increasingly close substitute for broadcast television advertising.[35] Cable advertising accounts only for a very small share of this market, however. In 1990, five years after the elimination of must-carry, cable advertising revenues accounted for only 6 percent of total video advertising revenues.[36] This small fraction suggests that even if denial of cable carriage to some stations could result in a monopolistic reduction in the quantity of advertising time, the principal beneficiaries of this reduction would be other broadcasters, which continue to produce most of the output in this market. Also, unless the local stations (especially those that continue to be carried) could be prevented from increasing their output of advertising time in response to the incentives created by cable's supracompetitive advertising price, expansion of output back to the competitive level would tend to occur.[37]

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[35] See Setzer and Levy, "Broadcast Television in a Multichannel Marketplace," FCC OPP Working Paper Series No. 26, June 1991, pp. 129-31.

[36] In 1990 total broadcast television advertising revenues were $26,616 million. By contrast, total cable advertising revenues were $1,789 million. Source: Setzer and Levy, supra note 35, Table 24.

[37] Given the large fraction of market output contributed by these producers, only a small percentage increase in their collective output would be necessary to restore the competitive price and output. See Landes and Posner, "Market Power in Antitrust Cases," Harvard Law Review 94 (1981), 937-83, esp. pp. 946-47.

The anticompetitive motive for carriage denial is most plausible when the cable system's franchise area is large relative to the total area served by the affected broadcast station. A system that serves only a small fragment of the station's total potential audience has a very limited ability to harm that station through unilateral actions. A decision not to carry a station would be unlikely to contribute significantly to the station's failure; other anticompetitive effects also would be minimal.

To illustrate, consider a cable system with 10,000[38] subscribers located within a metropolitan area (i.e., ADI) of 1,000,000 households.[39] Although this system may have unilateral market power that it can exercise against the households in its franchise area (e.g., by raising the price of cable service), it is not clear that it could profitably undertake a unilateral anticompetitive strategy against a broadcast television station. This system's carriage choice will have only a minor effect on that station's viewership (which is drawn from the entire metro and surrounding areas), and thus on

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[38] According to the Carriage Report, the average number of subscribers on systems that dropped at least one must-carry signal was slightly more than 10,000.

[39] To use a real-world example, consider the Washington, D.C. "area-of-dominant influence" (ADI). According to the 1989 Television & Cable Factbook, there are 22 cable systems serving this ADI, which contains about 1.6 million television households. When account is taken of multisystem ownership, the number of independent systems is 14. The Herfindahl-Hirschmann index (HHI) for these systems (based on the each system's share of total cable subscribers) is 1,438. An HHI computed for total television households would obviously be much smaller.

the station's advertising revenues and profits. Moreover, the attendant anticompetitive "gains" to the cable system, whatever their magnitude, would be shared in part with all of the other local cable systems and broadcasters serving other parts of the broadcast area, while the costs (in terms of reduced consumer and advertiser demand for the system) would be borne solely by the system denying carriage.

Accordingly, when (as will often be the case) a metropolitan area is subdivided into multiple independent cable franchise areas, a significant anticompetitive effect from carriage denial may require express coordination among these cable systems.[40] Otherwise, each system would find it most profitable to carry popular local stations, thus avoiding any loss of subscription and direct advertising revenue, and to "free ride," at least to some extent, on the higher advertising prices that result from the other systems' actions. Of course, if each system were to follow this individual strategy, the joint strategy of reducing advertising time via carriage denials would fail. This coordination problem would fail to arise only if the cable system's franchise area covered a large portion of the affected station's reception area.

Finally, carriage denials could be anticompetitive only if subscribers had no other low-cost way to continue to receive non-

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[40] Such conduct would be a per se violation of Section 1 of the Sherman Act, 15 U.S.C. § 1. Northern Pacific Ry. Co. v. United States, 356 U.S. 1, 5 (1958); Fashion Originators' Guild of America v. FTC, 312 U.S. 457, 468 (1941).

carried signals. If subscribers can receive the non-carried signals satisfactorily over the air, they could, in theory, thwart any anticompetitive denial of carriage on cable systems. Consumers with cable service may be able to receive non-carried broadcast signals in several ways. Some televisions and VCRs have built in capacity to receive two inputs simultaneously, allowing easy access to both cable system signals and signals received through a traditional antenna. Many households with a television served by cable have other televisions that are not connected to cable, and thus continue to receive broadcast signals on them. A basic way to receive non-carried signals on a set connected to a cable system is an "A/B" switch connected to an antenna.[41] The switch itself is inexpensive and easy to install. Using an A/B switch could be more difficult and costly for cable subscribers who have dismantled, or who have never had, an exterior or separate antenna.

Few surveyed cable households reported ever having used an A/B switch,[42] suggesting that consumers tend to find that its costs exceed its benefits. But that result may be due not to high costs, but to low benefits from receiving broadcast signals

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[41] An A/B switch operates much like the AM/FM switch on a car radio. When the switch is in one position, the television set receives broadcast signals; in the other position, the set receives cable signals.

[42] See Comments of the National Association of Broadcasters In the Matter of Reexamination of the Effective Competition Standard for the Regulation of Cable Television Basic Service Rates and for the Carriage of Television Broadcast Signals by Cable Television Systems, MM Docket Nos. 90-4 and 84-1296, September 25, 1991 ("NAB Comments"), pp. 32-34.

in addition to cable signals. Factors contributing to low benefits would include the continued high rate at which local stations are carried on cable, the infrequency with which some non-carried stations are viewed, and the duplicative nature of other non-carried stations. If cable systems attempted to behave anticompetitively, by decreasing the rates at which they carried local stations, in order to exercise market power, installing or using an A/B switch might enable their subscribers to have continued, low cost access to local broadcast stations, even if A/B switch utilization is currently very low.

The empirical evidence presented in § III on cable carriage choices provides little support for this anticompetitive theory. First, most systems did not deny carriage to any of their former must-carry stations, indicating either that cable market power in advertising markets is absent, or that the likely decrease in audience size and profits from carriage denial is large relative to any anticompetitive gains in advertising revenue.[43]

Second, when carriage denial did occur, it often involved stations that either did not sell advertising or that accounted for only a trivial share of the total television advertising market. The Carriage Report's surveys of cable systems and broadcasters show that a large percentage (between 36 and 39 percent) of the instances of carriage denial involved either

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[43] The FCC may wish to conduct a more detailed study of cable carriage choices to fully determine if there were any systematic differences between systems that dropped stations and those that did not.

public television stations or other noncommercial (e.g., religious) stations.

Third, the cable system survey showed that about 30 percent of all carriage denials involved network affiliates that appeared to be located a substantial distance from the cable system. About 70 percent of these network affiliate carriage denials involved stations that served an ADI different from that served by the cable system. Dropping distantly-located stations seems inconsistent with the advertising monopoly hypothesis; a desire to restrict the quantity of advertising time in a cable system's own market would lead it to deny carriage to a local station, not a remote one (e.g., Washington-area systems would presumably wish to drop Washington-area affiliates, rather than those from the Baltimore-area).[44]

Fourth, the remaining carriage denials (30 percent) involved commercial independent stations that tended to have very low audience shares even when they were entitled to must-carry status. Again, this behavior is inconsistent with the advertising monopoly hypothesis. Denying carriage to stations

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[44] We also note that recent regulatory changes would now discourage the carriage of these signals. Under the network nonduplication rules that became effective in 1990 (47 C.F.R. §§ 76.92 - 76.97), less distant network affiliates can, in most cases, demand that a cable system "black out" all network programming on a more distant affiliate of the same network (e.g., the Washington-area NBC affiliate could demand that Washington-area cable systems black out the network programming component of the Baltimore-area NBC affiliate's telecast). In such circumstances, a cable system would likely carry only the less distant network affiliate.

that viewers seldom watch is not a promising anticompetitive strategy for reducing advertising output.

B. Eliminating Other Distortions in Cable Systems' Carriage Choices

An alternative rationale for regulating cable systems' carriage choices might be based on the premise that each system has market power in the distribution of programming. Generally speaking, a system with market power might be expected to alter the quantity and quality of the programming it offers relative to what would be offered if it behaved competitively. Economic theory demonstrates that a monopolist's level of quality can differ from that arising under competition.[45] But theory does not say whether quality will exceed or fall short of the competitive quality. This means that even when the exercise of market power by cable systems changes programming choices, the direction of the change is indeterminate. Some cable systems with market power might carry fewer local stations than their subscribers would receive under competition, but others might carry more. Where customers would prefer that the system carry more local stations, it does not follow that they would prefer the system to carry all of the local stations, or that carrying all of them would increase consumers' surplus. Thus,

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[45] See Leffler, "Ambiguous Changes in Quality," American Economic Review 72 (1982), 956-67, and Besanko, Donnenfeld, and White, "The Multiproduct Firm, Quality Choice, and Regulation," Journal of Industrial Economics 36 (1988), 411-29.

reimposition of a rule requiring carriage of all local stations could ultimately harm rather than help consumers.

V. The Costs of a Must-Carry Rule

The empirical findings cited earlier imply that a must-carry rule would not affect the majority of cable systems, because they carry all local stations voluntarily. But that does not mean a must-carry rule would be costless. Adoption of the rule could generate two types of costs, whose magnitudes are admittedly difficult to estimate. Although these costs may be small, they nonetheless could exceed any benefits associated with must-carry.

First, for those systems where the requirement would increase the number of local stations carried, the rule could cause them to eliminate some currently-carried nonlocal stations or programming sources. If these systems cannot alter their channel capacity when the rule is adopted (e.g., because it is costly to alter capacity quickly), the number of nonlocal stations carried would be reduced to accommodate the greater number of must-carry stations. The empirical evidence presented earlier suggests that this could often represent a shift from a preferred to a less-preferred array of channels, which would reduce the welfare of consumers.

Over the longer run, affected systems could find it profitable to increase their channel capacities to avoid discontinuing certain program choices otherwise replaced by must-carry stations. The cost of this capacity expansion would likely

be reflected in higher cable rates to subscribers. Moreover, depending upon the costs of adding channel capacity, some program services that would have been offered absent the rule might be unprofitable to carry, even after affected systems adjust their channel capacities.[46]

A must-carry rule also could reduce somewhat programmers' incentives to make expenditures on programming. To retain carriage in an unregulated market, satellite programmers and broadcasters compete to demonstrate their program's attractiveness to viewers and their profitability to cable systems. These competitive forces spur existing programmers and entrants to expend resources developing programming that they hope will attract audiences. This competition has brought about substantial growth in the quantity and variety of cable programming over the last decade. As the FCC's 1990 Cable Report observed:

> There is no question that the number of programming services offered by cable systems has increased substantially since the passage of the Cable Act in

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[46] For example, suppose the following: the incremental cost of adding a thirteenth channel to a twelve-channel cable system is $100, while the cost of adding a fourteenth channel is $200; absent a must-carry rule, with thirteen channels available the system would offer four out of five local broadcast stations and nine satellite services. Suppose also that the lowest incremental revenue generated by any satellite service carried is $150. Now, if a must-carry rule requires the cable system to carry all five local broadcast stations, carrying all nine satellite services as well would require spending $200 to add the fourteenth channel. That would be a money-losing proposition, because the last satellite service generates only $150 in revenue. A profit-maximizing cable operator would not invest in the additional capacity necessary to carry that service.

> 1984. As we observed in the Notice of Inquiry, the number of existing or proposed cable services in 1984 was reportedly 67, while in 1989, the number of domestic existing and proposed pay TV and satellite cable services was reportedly 181.[47]

If certain carriage choices were to be mandated by regulation, rather than chosen voluntarily by market participants, these competitive incentives would be somewhat diminished. A must-carry rule guarantees local stations free cable carriage, whether or not their programming is sufficiently appealing to lead cable operators to select it voluntarily. Guaranteed cable access would attenuate the competitive pressure these stations face.[48] Moreover, the initial decline in the quantity of cable systems' discretionary channel capacity would reduce the number of potential outlets for new programming services. In effect, fewer cable outlets would be available for new programming, and the risk of introducing new programming presumably would increase. Absent higher returns (and ultimately higher costs to consumers) to compensate for this higher risk, there will be fewer such investments.

One could argue, given the abundance of programming services now available, that the effect of must-carry on competition among programmers would be minimal. It bears noting, however, that

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[47] Report in the Matter of Competition, Rate Deregulation and the Commission's Policies Relating to the Provision of Cable Television Service, MM Docket No. 89-600, July 31, 1990, ¶ 43.

[48] These stations would still face competitive pressure to attract audiences (and thus advertisers). The argument here is that these pressures would be diminished, not completely eliminated.

this expansion of programming services occurred concurrently with a substantial increase in cable channel availability.[49] It is doubtful that this growth of programming services would have occurred without the contemporaneous expansion of cable capacity. In the short-run, when the supply of program services is fixed, it might be difficult to discern any clear impact of must-carry on incentives to develop programming services. In the long-run, however, a deleterious effect is more likely. It would be undesirable to institute a regulatory policy that would diminish the incentive to develop programming that is attractive to viewers, unless the policy provided offsetting benefits. Such benefits from must-carry are not readily apparent.

VI. Conclusion

Under conventional economic criteria for measuring consumer welfare,[50] must-carry regulations could be justified only if: (1) non-carriage of local signals is shown to occur and potentially to raise sufficient concern to require a broad-based regulatory remedy; (2) non-carriage of local signals is the consequence of some market failure, such as the exercise of market power by the cable system; and (3) the net effect of the proposed remedy would likely benefit consumers.

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[49] According to the Follow-Up Survey, Table V.5, the average number of active cable channels increased by 33 percent between 1984 and 1989.

[50] See note 16, supra.

A review of available empirical evidence shows that most cable systems voluntarily carry all of their former must-carry stations. Additionally, most episodes of non-carriage have involved distantly-located (and duplicated) network signals and relatively low-rated commercial independent stations. Such actions are consistent with competitively-determined carriage decisions, and generally suggest that non-carriage decisions are not motivated by anticompetitive considerations, such as the acquisition of market power in advertising markets. If this inference is correct, requiring systems to carry all local broadcast signals could displace programming cable subscribers value more highly and could reduce incentives to develop cable programming. Under these circumstances, consumer interests would unlikely be served by reimposing must-carry obligations on cable television systems.