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CABLE COMPETITION—INCREASING PRICE; INCREASING VALUE?

HEARING

BEFORE THE

SUBCOMMITTEE ON ANTITRUST, COMPETITION POLICY AND CONSUMER RIGHTS

OF THE

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CABLE COMPETITION—INCREASING PRICE; INCREASING VALUE?

WEDNESDAY, FEBRUARY 11, 2004

United States Senate,
Subcommittee on Antitrust, Competition Policy and Consumer Rights, of the Committee on the Judiciary,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:47 a.m., in room SD–226, Dirksen Senate Office Building, Hon. Mike DeWine, Chairman of the Subcommittee, presiding.

Present: Senators DeWine, Hatch, Kohl, Leahy, and Feingold.

OPENING STATEMENT OF HON. MIKE DEWINE, A U.S. SENATOR FROM THE STATE OF OHIO

Chairman DeWine. Good morning. I apologize for being late this morning.

As you can tell from the title of our hearing—"Cable Competition—Rising Prices; Increasing Value?"—any evaluation of cable television seems to require at least two different points of view. In fact, in some ways the truth about cable has always been really hard to pin down. The industry has swung from regulation to deregulation and various stages in between, and consumers and the Congress seem to have a long-term love/hate relationship with the cable industry.

For this Subcommittee, it has been 3 years since our last cable oversight hearing. The industry continues to be a source of competition in some markets and a source of frustration in others. On the one hand, the cable industry has made an enormous investment over the last decade of between $75 to $85 billion to upgrade cable facilities.

Those upgrades have increased the quality and availability of video, Internet and telephone services offered by the cable companies and increased the competitive pressures on telephone and satellite companies to improve their competitive offerings, all to the benefit, of course, of consumers.

Unfortunately, there is a downside, as well, a downside that is all too obvious to all of us. Cable prices have risen dramatically over the last decade—53 percent, which is more than twice the rate of inflation. That trend has accelerated recently, with cable prices going up 5 percent from June 2002 to June 2003, compared to a general inflation rate of 2 percent. These increases, of course, are of great concern to the Subcommittee and need to be examined. We need to understand, for example, why prices are routinely increased, despite the market presence of satellite providers and the so-called cable overbuilders.

We are likely to hear testimony today from several witnesses about the market share of satellite providers, which account today for about 22 percent of national pay TV subscribers, a level of market penetration that would normally indicate serious competition.

Why isn't satellite competition limiting cable price increases? Well, it is possible that the 22 percent figure is somewhat misleading because it appears that competition between satellite and cable is not spread evenly throughout the country. Specifically, the satellite companies often have a disproportionate number of customers in rural areas or other areas that cable doesn't effectively serve.

On the other hand, satellite has technological limitations that often restrict its ability to serve customers in crowded urban markets. So there are a number of markets, large and small, where cable and satellite do not compete with each other, which may limit impact they have on each other's pricing.

Even worse, satellite companies may have bigger market share in the smallest markets and smaller market share in the larger markets, making them a much weaker competitor and further decreasing their ability to restrain prices. This is an important factual issue and one the Subcommittee will, in fact, pursue.

Accordingly, today Senator Kohl and I will send a letter to the GAO asking them to examine market share of the incumbent cable providers versus the market share of satellite providers in geographic areas of different size and demographic make-up. The letter also asks the GAO to examine if the market share of satellite is affected by whether or not the local cable system is fully upgraded. We are also willing to expand the study, if necessary, and look forward to working with our witnesses for any recommendations they may have to more fully explore this issue.

However, pending completion of that study, and even assuming that the satellite providers don't really compete in certain large and small markets, they still represent over 20 million customers across a wide range of markets, and that should be enough to allow them to more effectively blunt the rise of cable price increases.

But that just doesn't seem to be happening. Why not? Is it just another example of oligopoly pricing, or are we actually seeing greater competition in the form of better customer service and enhanced viewing options? Those are important issues to evaluate today.

We also will examine another form of competition that has been somewhat disappointing, and that is the competition provided by cable overbuilders. Several years ago, these companies were investing a lot of money to put fiber in the ground and create brand new cable facilities that would provide a range of services to customers—video, voice, and high-speed data.

Last year, Senator Kohl and I commissioned a GAO report to examine how much impact these companies were having in a range of case study markets, and the report showed basically what one would expect, that for the most part increasing competition led to decreased prices and improved offerings.

However, the report also noted that the overbuilders as a group are ailing. Many of the companies are having recent financial difficulties and have been unable to expand to new markets, or even to fully market their services within their current regions. Why exactly are the overbuilders struggling? Is it the result of predatory conduct by the incumbent cable companies or just good, solid competition from cable and satellite providers? Is the overbuilder business model viable? We will explore these issues, as well as others, today.

To the extent that anticompetitive behavior is an element in the overbuilder struggles, the Subcommittee is considering at least one possible remedy—specifically, a modification of the program access rules that require vertically-integrated MVPDs to make content available to competitors on reasonable terms and conditions.

These rules have long included the so-called terrestrial loophole, which exempts programming delivered via wire, and there has been some concern that this loophole impacts the ability of competitors to compete. Senator Kohl and I are currently planning to offer legislation to close the loophole and look forward to discussing that idea here today.

Another idea to improve competition is to strengthen the uniform pricing rules. Broadly speaking, existing regulations require the incumbent to charge customers the same price throughout a market unless they face effective competition in that market. If they do face effective competition, they are then allowed to vary pricing as they see fit customer to customer. This allows incumbents to make very targeted responses to competitive efforts into that market.

Some of our witnesses here today believe that we should further limit the ability of incumbents to respond with customer-by-customer offers. Others believe that such responses are the essence of competition. This is an important issue that the Subcommittee plans to examine, and we will no doubt hear a spirited debate from our witnesses today.

Let me now turn to my colleague, the Ranking Member of the Subcommittee, my good friend Senator Kohl.

STATEMENT OF HON. HERB KOHL, A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator KOHL. Mr. Chairman, thank you for holding this hearing today. In the cable arena, there are certain simple truths. First, consumers pay more and more every year. Indeed, increases in consumers' cable bills are now about as predictable as the change of seasons. Second, cable companies make more and more money from these increased prices. And today we can add a third: Where real competition exists to cable, prices are lower, and often dramatically so.

At our Subcommittee's April 2001 hearing, we reported that cable prices had increased nearly three times the rate of inflation since the passage of the 1996 Telecom Act. Today, the just released FCC video competition report finds that little has changed since 2001. In the year ending June 2003, cable rates rose more than 5 percent, about two-and-a-half times the rate of inflation. During the last 10 years, cable prices rose about 53 percent, far in excess of the overall inflation rate.

While the prices consumers paid continued to escalate, so did the cable companies' earnings. The FCC report found that the cable industry's cash flow has increased more than 25 percent since 2001. So prices and profits go up dramatically in the absence of competition.

The GAO report that we commissioned provides today's news. It found that the cable industry reacts to competition with lower prices and better services. In virtually all communities where more than one cable company competes for customers, video prices are lower by 15 to 41 percent.

Therefore, our conclusion seems to be rather simple. Real competition benefits consumers and it keeps prices down. Our challenge is how to make competition a reality. Despite what the cable companies assert, satellite is not a complete substitute for cable in most markets, particularly in urban areas where many residents are not able to receive satellite. The key to video competition is the presence of cable overbuilders, companies that have built new cable systems to compete with the incumbent operators.

Unfortunately, these new cable companies face a range of obstacles which seriously harm their ability to survive. We have heard many disturbing stories of allegedly anticompetitive and predatory conduct by the cable incumbents, such as below-cost pricing designed to drive their new rivals out of business. Additionally, ties between programmers and the cable incumbents often make it difficult for competitors to obtain access to the very programming that consumers demand.

It is essential that these new challengers be given the breathing room to survive so that consumers can reap the benefits of true competition. Therefore, we will propose the following measures: first, ensuring that competitors have access to all essential programming owned by the cable incumbents by closing loopholes in the program access laws. Second, we urge that the Justice Department investigate allegations of predatory behavior by incumbents and take action to stop conduct which violates antitrust laws; and, third, a GAO study to determine whether satellite TV is truly an alternative to cable.

In closing, we should commend the cable industry for the billions of dollars it has invested to upgrade the quality of service in many areas. The cable industry is unquestionably bringing much needed competition to local telephone companies. Yet, we must not lose sight of the fundamental problem that brings us here today, which is that American consumers suffer with cable price increases and a lack of competitive choices. We hope that today's hearing will be helpful in determining how we can ensure that competition truly flourishes in this very important industry.

Thank you, Mr. Chairman.

Chairman DEWINE. Senator Kohl, thank you very much.

Let me turn to the Chairman of the Judiciary Committee, Senator Hatch.

STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM THE STATE OF UTAH

Chairman HATCH. Well, thank you, Mr. Chairman.

First, I would like to thank Senator DeWine and Senator Kohl for the work they do as Chairman and ranking Democrat member of this Subcommittee, and I commend them for holding this very, very important hearing.

As the title suggests, today's hearing will focus in part on whether the strongly increasing cable prices paid by consumers across the Nation actually reflect an increased value in cable television services. I would like to turn that around and, before I address the issue of price, comment briefly on the value, or more accurately the values reflected in television programming today.

I am sincerely troubled by some of the programming that is being aired on both broadcast and cable television, and I am not alone in this country in this criticism. Beyond Janet Jackson's and Justin Timberlake's deeply inappropriate display during the Super Bowl halftime show, I feel that certain recent programming has tended to reflect the least admirable qualities present in our Nation, and sometimes crosses the line into denigrating the values that I and many of my constituents in Utah, as well as millions of Americans, hold dear. At the Grammys, Justin Timberlake apologized, and I respect him for that and commend him for that.

Now, some of you may question what this has to do with cable competition and the antitrust laws. A partial answer may be that the enormous consolidation that has occurred in the cable and media markets, as well as the substantial vertical integration between these markets, appears to have resulted in the increasing harmonization of programming across the country.

I am sure that some of these concerns will receive attention in connection with Comcast's $66 billion bid to acquire Disney that was announced this morning. These issues also arose recently when many here in the Senate decried the loss of localism in media markets during the debate over media ownership rules.

It is not my intent to rekindle the media ownership debate or to pre-judge the proposed Comcast acquisition, but I would say that many of my constituents feel that the programming they and their families view these days on television seems to be targeted at an audience that has a distinctly higher tolerance for profanity and sexually-suggestive behavior than they do.

Although the most recent controversy involves broadcast television, some of the most offensive and indecent material comes from such large cable stations as FX and MTV. So I would like to take this opportunity to encourage all media operators, broadcast and cable, to clean up their content.

Having voiced these concerns, I want to emphasize that I do not mean to necessarily equate big with bad. I believe that much of the recent consolidation in media and entertainment markets has the potential to benefit consumers in the long run. However, as I have frequently stated, it is essential that consumer choice be preserved. In this case, that should include the ability to choose not to be exposed to objectionable material.

Turning to the narrower issue of competition in the market for subscription television, I am pleased to note that recent reports by the Federal Communications Commission and the General Accounting Office indicate that greater competition between cable television and direct broadcast satellite, or DBS services, that has emerged in the last several years has, on the whole, resulted in increased access and improved services for consumers. It is less clear, at least to me, whether current levels of competition adequately discipline price increases.

Over the past 10 years, inflation, as measured by the Consumer Price Index, as Senator Kohl has mentioned, has gone up about 25 percent, while by some measures cable prices have increased more than 50 percent during the same time period. I think Senator Kohl mentioned 53 percent. While this disproportionate increase in cable prices is partially explained by increases in programming costs, and in particular the skyrocketing price of some sports content, I am concerned that higher costs may begin to significantly limit the ability of consumers to afford subscription television service.

Interestingly, the recent GAO study indicates that facilities-based competitors, often referred to as overbuilders, may be successful in providing price competition in markets where they compete with incumbent cable service providers. I think this is something that deserves our ongoing attention, and I commend Senators DeWine and Kohl for their work on this issue.

I look forward to hearing more from the witnesses on this panel today about these issues and about any emerging issues arising as a result of quickly evolving technology and the changing competitive landscape in the communications sector. In particular, I hope that the witnesses will address the increased competitive significance of bundled service offerings that combine subscription television, local telephone and high-speed Internet services into a single package. Also, I hope that we will touch on the advent of Voice over Internet Protocol technology and how it is expected to be deployed to provide local telephone service.

Once again, I thank all of the witnesses for being here today, welcome them to the Subcommittee, and again commend our two leaders on this Subcommittee, Senators DeWine and Kohl, for their work and for their holding a hearing on these important issues. I am very grateful to them for doing so.

Thank you, Mr. Chairman.

Chairman DEWINE. Chairman Hatch, thank you very much.

Senator Leahy.

STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM THE STATE OF VERMONT

Senator LEAHY. Thank you very much, Mr. Chairman. As I have said before, the partnership that you and Senator Kohl have in running this Subcommittee benefits all of us in the Senate. It certainly benefits the Judiciary Committee and it benefits the Senate, and I believe the hard work both of you have done benefits the country.

I might say in just referencing something my good friend from Utah, Senator Hatch, has said, there is another part of that thing that offended me even more, the halftime. I think list most Americans, I totally missed the Janet Jackson thing because it happened so quickly. However, I was bombarded for several days afterwards, with the press making sure that I could be appropriately offended by what happened by repeating and repeating and repeating it.

But I will tell there was one thing that went on at some length that I haven't heard anybody talk about. Do you know what the most offensive thing to me was about that halftime show? Kid Rock prancing around with the American flag, with a hole cut in it making it a pancho, and he goes around like that desecrating our flag and then taking it off and throwing it out, I assume onto the ground.

Now, if people want to get offended by something, all Americans ought to get offended by that. That didn't need repeats over and over again so we could be properly offended. That went on at such length that I was actually standing up hollering at my TV set.

Chairman HATCH. Senator, I am happy to hear that because—

Senator LEAHY. I was so annoyed that, in fact, my wife finally said at one point, okay, Patrick, turn it off, turn it off.

Frankly, I didn't even notice. I was eating some popcorn and it happened it so fast. But, boy, that flag just ripped me. Sorry about that. I just wanted to get that off my chest.

Chairman HATCH. Senator, I am glad you got that off your chest. I presume now you are going to support the anti-desecration flag amendment.

Senator LEAHY. I don't think we need that, if the American public would stand up.

Chairman HATCH. Oh, I see.

Senator LEAHY. I will tell you right now, in my State we don't stand for that kind of thing. We don't need a law to tell us to protect the flag in Vermont. Vermonters are patriots. We don't stand for that, we don't stand for that.

Anyway, this hearing is extremely appropriate. There were three reports recently released by the Federal Communications Commission and the General Accounting Office. They tell us what we all know to be true: Greater competition among cable and satellite providers results in better prices, more options and improved service for consumers.

When Congress passed the Telecommunications Act of 1996, I was one of five Senators who voted against it. I expressed reservations at the time that the competition predicted by many would fail to materialize. All those who said vote for this because we have competition and prices will come down—I said it is probably not going to happen. Unfortunately, it turned out I was right.

The October 2003 GAO report notes that cable rates in this country have gone way ahead of inflation. In the last 10 years, to give you some idea, the Consumer Price Index has gone up about 25 percent and cable rates have gone up 53 percent; in other words, more than double what the Consumer Price Index has been.

In my own State of Vermont, I have heard complaints from a number of constituents who are very upset at substantial increases in their cable subscription fees. After all, when they see them go up twice the rate of inflation, of course, they are going to be upset, and rightly so. And as is the case in all but 2 percent of the television markets across the U.S., there is no wire-based competitor available to Vermonters who wish to change their service.

Now, I know we are going to hear testimony today attributing the increase in subscription costs largely to the increases in programming costs incurred by content providers. But at least in markets there is only one wire-based cable provider, why do we not see any downward market pressure on content providers acting to keep programming prices low? And if there is no meaningful downward pressure exerted on the cable market, what is going to stop prices from skyrocketing?

When sports programming licensing fees increase 59 percent in a 3-year period, as they did between 1999 and 2002, what would lead us to assume that this upward spiral is going to cease? I mean, at some point somebody is going to put in legislation to require cable companies to build for program, so if people don't want to buy the sports programming and that has a certain cost and they won't take it, then their costs will be lower.

They may decide they don't need ten channels with preachers telling them that if they will just send money to that one preacher, of course, they will be saved, the assumption being that if they send it to the other nine, they won't, and so on. Some people might say we don't want to pay for that.

I do understand that some of the increased price of cable reflects increased quality, more and better programming. I am told this by my staff and I am eager to see if that is so. But what will this do for the bottom line of consumers making these tough budgeting choices?

Subscription video services have become a vital component of America's information infrastructure. Cable accounts for the majority of that market across the country. According to the FCC, 67 percent of households today subscribe to cable television services. Many others subscribe to satellite DBS services.

In Vermont, those numbers are different. We have the highest penetration per-capita of satellite of any State in the United States, and correspondingly fewer cable subscribers. But we do lack much, if any, wire-based competition to Adelphia. That is the cable company serving those Vermonters.

I can give you one example. They wire our capital city of Montpelier and a couple of the adjoining towns. In my own town, which borders and wraps around more than half of Montpelier, there is no cable. There is no cable because the one monopoly basically for Vermont decides they don't want to bother, so it is not there. Many satellite subscribers in Vermont have no cable alternative, and vice versa.

So what I am saying is when prices spiral out of control for services Vermonters have come to depend on and there are no real options existing in terms of alternative providers, they are really hurting. And I suspect this is probably similar in many, many other rural areas of America, probably affecting most rural areas of America.

There are a variety of factors that conspire to raise cable rates borne by consumers. As they rise, fewer people are going to be able to afford access. It is my goal, and it should be the goal of the Senate to provide access to high-quality programming to as many Americans as possible.

Data from the FCC and GAO show us the best way to keep prices low and to improve the quality and quantity of programming offerings, of course, is to increase competition. We all know that. While there is a discrepancy in the exact amount of the reduction, all three reports show that competition reduces cable rates and when there is no competition, cable rates go up. The GAO study found that there is a 15-percent reduction in the cost of cable services when there are two wire-based cable competitors.

Finally, I know that my colleagues on the Antitrust Subcommittee do not intend to specifically address media consolidation, but it is an issue that impossible to avoid whenever we talk about providing choices to consumers at a fair price. Indeed, the GAO report points to this as an area of concern. If nothing else, the data show that ever-tightening bonds between corporate control of content and of distribution are having an anticompetitive effect on what consumers can see on their screens, and also how much they are going to pay for it.

Many of the technological issues, I would say to Senator Kohl, Senator DeWine, Senator Hatch and Senator Feingold—we have worked on this—these issues are never put to rest because the change is so rapid in this area. But I think providing access to the latest and best information at a fair price to consumers is an issue we can look forward to. And we have to do that if we want all parts of our country to be competitive, whether it is high-speed lines, whether it is working at home or getting information at a price Americans can afford.

Thank you very much.

Chairman DEWINE. Senator Leahy, thank you very much.

Senator Feingold.

STATEMENT OF HON. RUSSELL D. FEINGOLD, A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator FEINGOLD. Thank you, Mr. Chairman. I want to thank you and Senator Kohl for convening this hearing on the continuing increase in cable rates. It is a very important consumer issue and one on which Congress and the American people deserve some answers.

I am alarmed by the soaring cable rates that consumers in Wisconsin and across the country have had to endure. For a number of years, I have been hearing from my constituents about the rising cost of basic cable and the many other services that are often bundled together for the consumer, like high-speed Internet connections, wireless phone service and digital television.

For all of the promises of more services for less money since 1988, average cable rates have increased each year. Between the enactment of the Telecommunications Act of 1996, which I also voted against, like Senator Leahy, and today, rates have jumped by over 40 percent, almost three times the rate of inflation.

In my home State of Wisconsin, the problem is exacerbated in rural communities where there is no meaningful competitor to the local cable operator. Over the years, I have been actively engaged in efforts to foster true competition in the cable industry, and I hope today's hearing will help spur Congress to act responsibly.

I am concerned that as more and more services are bundled together and companies claim to offer special prices for these bundled services that we lose sight of the fact that already high prices actually keep getting higher. About two-thirds of the households in this country rely on cable for their television programming, and more and more households receive their Internet services from a cable company as well.

We now rely on cable for entertainment and information. More and more, cable has become part of the monthly budget for the average consumer. And instead of the cost going down because so many people now use the service, the costs actually just keep rising.

What I hear time and time again is not that we need hundreds of channels or more bells and whistles for our televisions, but rather that we need prices that families can afford. I believe that we have a responsibility to ensure that there is meaningful competition across the technological spectrum.

Without competition, cable companies have no incentive to keep rates low and consumers have nowhere else to turn for the products they provide. As the GAO study confirms, when there is a meaningful competition in a community, like a broadband or a satellite service provider, then cable rates will decrease. I believe Congress therefore has a responsibility to ensure that there is true competition in the marketplace.

Again, according to the GAO report, cable companies charge 15 to 41 percent less for the exact same programming in areas where they face competition. If applied across the country, the savings for the American consumer would equal more than $4 billion. So I was a little bit surprised to read in a recent Business Week interview with Rupert Murdoch, the new owner of DirecTV, that when he was asked if he intended to undercut cable's prices, he said that he wasn't, quote, "going to get into a price war with anyone," unquote.

If Rupert Murdoch isn't willing to compete, then we need to make sure our rules will allow someone else to offer the American people a better price.

I am looking forward to hearing about how Congress can protect new entrants into the marketplace. As we watch the providers of cable and satellite continue their vertical integration of the industry by controlling the distribution and production of content, I wonder if an independent operator trying to reach homes across America today like Ted Turner once did would have the same opportunity. Or have we gone so far in allowing the vertical integration between those who create the content and those who distribute content that new entrepreneurs can never enter the marketplace with any realistic chance of survival?

Mr. Chairman, I again thank you and the Ranking Member for holding this hearing.

Chairman DEWINE. Senator Feingold, thank you very much.

Before we get to our very patient panel today, let me just mention the hostile takeover offer that has been made by Comcast for Disney, which has already been mentioned here today. Obviously, this is a very important deal, if indeed it happens, and it is something that this Committee will, in fact, be looking at, just as we looked at the DirecTV-NewsCorp deal as well.

It is my pleasure to introduce our panel today, a very distinguished panel. Mr. Michael Willner is the CEO and President of Insight Communications Company, a company that he co-founded in 1985. Insight is the ninth largest cable operator in the country, serving customers throughout the Midwest, including my home State of Ohio.

Mr. Rodger Johnson is the president and CEO of Knology. He has been with Knology since 1999, before which he served as the CEO at Communications Central.

Robert Sachs is the president and CEO of the National Cable and Telecommunications Association. He has worked for over 25 years within the cable television industry. He has testified before the Subcommittee in the past and we certainly welcome him back.

Ms. Coralie Wilson is the president of the National Association of Telecommunications Officers and Advisors Board of Directors. She has worked extensively in the cable area serving Ohio as the Executive Director of the Miami Valley Cable Council, in Kettering, and as an adviser in the Dayton City Manager's office working with cable administration.

Mr. Scott Cleland is the founder and CEO of Precursor Group, and also serves as the Chairman of the Investorside Research Association. He has testified before the Subcommittee on prior occasions, and we also welcome him back as well.

Dr. Cooper is the Director of Research at the Consumer Federation of America. He works on telecommunications, media and economic policy. He is also the author of *Media Ownership and Democracy in the Digital Age*. He has testified before the Subcommittee in the past, and we welcome him back as well.

We will start from my left to my right, and we will start with Mr. Willner. Thank you very much. We are going to follow the five-minute rule and that will allow us to have plenty of time for questions. I think you all know how the system works up here. You get the one-minute warning.

Mr. Willner.

STATEMENT OF MICHAEL WILLNER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, INSIGHT COMMUNICATIONS

Mr. WILLNER. Mr. Chairman, thank you. I would like to point out that with a name that starts with "w," I think this is the first time that I get to go first. So thank you very much.

Mr. Chairman and Senator Kohl, my name is Michael Willner, and thank you for inviting me to testify today about the state of competition in the multi-channel video market. I am the President and CEO of Insight Communications, a cable company that serves about 1.4 million customers in Illinois, Indiana, Kentucky and Ohio. We also serve as employers of 3,200 people, virtually all of whom live in the communities that we serve.

I would like to make three basic points this morning: one, that the multi-channel video market is fully competitive; two, that cable has invested heavily—as we heard earlier, $85 billion since 1996—to upgrade its facilities and bring new services to market; and, three, that cable offers American consumers that excellent value and our prices are a reflection of what it costs to deliver top-quality product to consumers.

Competition is alive and well not only in Columbus, Ohio, Mr. Chairman, where, as you know, we do have a wireline overbuild, but as far as we are concerned in every community in America. It is real and it keeps me awake at night.

Every customer we serve has at least three choices of video service providers, and some have four. The fact is that our most significant competitive pressure today does indeed come from satellite. For instance, just last summer when satellite began local-into-local broadcasts in the Louisville, Kentucky market, we saw the most intense competitive attack against us that we have ever experienced.

So why did DBS become our primary competition instead of wireline overbuilders? Because their infrastructure is far more cost-efficient than having to construct a duplicative wireline network in every community. Indeed, since DBS launched in 1993, cable's market share has dropped from 95 percent to under 75 percent today. Last year, DBS subscribership jumped from 19.4 million to 21.1 million, a painful 8.8-percent increase, while cable subscribership remained flat.

The GAO has noted that DBS has emerged as the principal and formidable competitor to cable. That is absolutely true. In short, even though competition did not develop the way we anticipated, competition is alive and kicking in the multi-channel video business.

Because of competition, cable operators embarked on a massive rebuild of our cable systems a few years ago. Yes, we were encouraged by the Telecommunications Act of 1996 and the subsequent deregulation it brought. But make no mistake about it, competition caused cable operators to raise $85 billion of risk capital to rebuild those systems. That is more than $1,200 per cable subscriber, and we did it without any government assistance. This, in turn, spurred a response from our competitors to roll out advanced services like digital subscriber lines and high-definition television.

Since I met with you, Mr. Chairman, 18 months ago, Insight has aggressively expanded and launched new and advanced services. We now provide interactive digital video services to over 400,000 customers, which includes video-on-demand, interactive services, and more recently, digital video recorders and high-definition television. We also deliver high-speed access to the Internet to over 230,000 customers, and we are a very aggressive competitor in facilities-based telephone service. Today, we serve 55,000 circuit-switched voice telephony customers in four markets, including in Columbus, Ohio.

As we look to the future, we soon will launch an Internet-based Voice-over-IP service in many of the markets where we do not have telephony right now, and we will have a blended service in the ones we currently serve. By any measure, from my point of view, we are indeed fulfilling the promise of the 1996 Telecommunications Act to provide a facilities-based competitor in every market.

So why do cable prices rise with all this competition in place? The answer is simple. Our prices are a function of our costs. Let me mention a few. I already talked about the $85 billion of invested capital, but did you know that the total wages paid by cable operators to employees—employees who live and work in the communities that we serve—rose 15 percent a year, five times the rate of inflation? That increase reflects the operating reality that competition brings—vastly improved customer service, expansion of operating hours, and the higher-tech nature of our business today.

And then there are the programming costs, our single highest external cost. Between 1997 and 2003, expenditures by basic cable networks on program acquisition and development increased 121 percent, from $4.7 billion to $10.4 billion, an average of 20 percent a year. The result of that investment is that cable viewership has indeed exploded.

Eight years ago, many of us expected wireline overbuilds to be the main competitor to cable operators. Instead, DBS succeeded in that role. Both the GAO and the FCC have confirmed the existence of a highly competitive multi-channel video market. The current environment has been extraordinarily successful in creating an opportunity where consumers enjoy ever-increasing choices of providers, programming and services. New regulations would simply deter additional investments while depriving customers of exciting, new-generation services.

I would like to thank you again for the opportunity to testify today and I will be pleased to answer any questions you have.

[The prepared statement of Mr. Willner appears as a submission for the record.]

Chairman DeWine. Thank you very much.

Mr. Johnson.

STATEMENT OF RODGER JOHNSON, PRESIDENT AND CHIEF EXECUTIVE OFFICER, KNOLOGY, INC., ON BEHALF OF THE BROADBAND SERVICE PROVIDERS ASSOCIATION

Mr. Johnson. Good morning. I want to express my appreciation to Senators Kohl and DeWine for sponsoring the GAO study that has just been released. I would also like to thank you for the opportunity to participate in this hearing and provide additional testimony regarding competition in the cable television market.

I am pleased to represent both Knology, a competitive overbuilder, in the terminology that you have used, and the Broadband Service Providers Association, the BSPA, which is a trade association that represents the companies that the GAO referred to as wire-based competitors to incumbent cable operators in its most recently released study.

Consumers are reaping the benefit of a $6 billion capital investment by BSPs in new, competitive networks. This new GAO report again documents that customers in communities served by broadband service providers, or BSPs, realized from 15-percent to 41-percent lower cable television rates than consumers in communities where there is no wire-based competition.

BSPs have shown that they not only provide consumers with demonstrable benefits on pricing and services, but they are proving the economic strength of their business model. This is attested to by Knology's successful completion of its initial public offering in the month of December. This is the first IPO in the telecom media sector in over 3 years.

These BSP systems are models for the type of competition envisioned by Congress in passing the Telecommunications Act of 1996. The key issue for policymakers today, however, is whether the legislation and its implementation as it currently exists supports the development of competition for cable services.

Knology and the BSPA are primarily concerned with three issues that, if not addressed, could slow the deployment of competitive broadband networks in communities around the country.

First, regulators must not mistake competition between cable and satellite with wire-based, head-to-head competition between incumbent cable operators and broadband service providers. In our experience, despite the fact that satellite has a 22-percent national share, a fully upgraded cable provider often maintains a market share of 90 percent or greater in local markets when it is only competing against a satellite provider. We do not believe that a market with 90 percent or more of subscribers concentrated with one provider should be deemed fully competitive.

We want to thank you for your support to publicly document the state of competition in local markets through an additional GAO study. We further would hope that this market analysis becomes part of the FCC's next annual assessment of competition.

The second key issue to the success of the deployment of competitive broadband networks is ensuring continued access to the content necessary to compete. Specifically, the protections of the 1992 Cable Act were limited to satellite-delivered programming. This has come to be known as the terrestrial loophole.

Incumbent cable providers have evaded application of the program access protections in the Cable Act by migrating critical programming services to terrestrial-based distribution. As a result of this terrestrial loophole in the Cable Act, BSPs and other competitors are often denied access to vital regional sports and news programming controlled by incumbent operators that consumers demand.

We fully endorse the need to close the terrestrial loophole. The FCC has repeatedly and conclusively acknowledged the critical nature of this issue. The Commission has concluded, however, that existing legislation does not provide it with the authority to promulgate rules prohibiting exclusive arrangements involving terrestrially-delivered programming. We agree. It is now time for Congress to step in and close the terrestrial loophole and address the expanding issues of fair access to content created by new technologies and distribution platforms.

Third, the BSP industry is threatened by other types of anticompetitive actions by incumbent operators, such as targeted predatory pricing campaigns and other conduct designed to prevent entrants from getting a foot-hold in a particular market.

Predatory pricing strategies are frequently accompanied by significantly higher prices in surrounding markets that do not yet have the benefit of facilities-based competition. Communities in the surrounding areas are, in effect, subsidizing the economic costs of the predatory pricing behavior of the incumbent cable provider. The FCC has recognized public harm inherent in predatory pricing, and has also disagreed that targeted discounts reflect merely healthy competition.

In closing, broadband service providers have shown that in markets they serve consumers enjoy the benefits of lower prices for broadband services. In order to continue to expand the availability of competitive broadband services, broadband service providers need policymakers to recognize that the market for cable television is not fully competitive and care must be taken to prevent incumbents from erecting artificial entry barriers and engaging in predatory pricing behavior. Moreover, access to content is a threshold issue that needs to be addressed in the upcoming session.

I again want to thank you for this opportunity to be with you this morning and look forward to your questions.

[The prepared statement of Mr. Johnson appears as a submission for the record.]

Chairman DEWINE. Mr. Johnson, thank you very much.

Mr. Sachs.

STATEMENT OF ROBERT SACHS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL CABLE AND TELECOMMUNICATIONS ASSOCIATION

Mr. SACHS. Mr. Chairman, Senator Kohl, Chairman Hatch and Senator Leahy, my name is Robert Sachs and I am President and CEO of the National Cable and Telecommunications Association. Thank you very much for this opportunity to testify.

In assessing the competitive effect of wireline overbuilders on incumbent cable operators, it is appropriate at the outset to establish the context. There are more than 9,000 cable systems serving 33,000 communities in the United States. And as the FCC has found, virtually all those systems face vigorous competition from two well-established national DBS providers.

While fierce competition from DBS is ubiquitous, competition between wireline video providers is scarce and often precarious. Only about 400 communities nationwide have two competing franchised wireline providers. So the real story of effective competition to cable is about satellite competition.

The GAO study released yesterday is based on a tiny percentage of those rare communities where there is a fourth video provider, in addition to the incumbent cable operator plus two national satellite providers. GAO examined six overbuild communities and compared them with six other communities that had a single cable operator and two satellite providers.

The half dozen overbuilds GAO looked at exemplify many of the difficulties faced by overbuilders. According to GAO, and not surprisingly, all six are currently experiencing some level of financial problems. In particular, the overbuilders told GAO that, quote, "their difficulty in obtaining access to necessary capital is threatening their ability to construct their networks and market their services," end quote.

The major reason for overbuilders' problems was that they simply underestimated the extent to which the marketplace they chose to enter was already fiercely competitive. Simply put, too much capital was needed to attract too few potential customers.

Overbuilders assumed that they could easily and profitably capture customers from incumbent providers with lower prices. But vigorous competition from DBS had already ensured that cable operators were providing the services that best met consumer demand at competitive prices. So overbuilders were caught in an economic bind. To entice customers away from cable and DBS, they had to charge lower prices than the incumbents, but those lower prices proved insufficient to cover costs and investment risk, and were economically unsustainable.

To supplement GAO's case study, which, as mentioned, examined six overbuild communities, NCTA retained Kagan World Media, a leading cable industry analyst, to review all of the 433 communities with identifiable overbuild systems. Kagan found that most of them do, in fact, display anomalies that explain why their prices and the prices of competing cable companies in those communities may, at least temporarily, be lower than prices in other communities.

As analyzed more fully for NCTA by economist Steven Wildman, those anomalous characteristics confirm that overbuilders frequently enter the market with prices that are artificially low. Incumbent cable operators may have no choice but to reduce their prices to such levels. But as Professor Wildman concludes, these lower prices are either not economically sustainable by the overbuilders or are sustainable only because of artificial cost advantages.

Indeed, 83, or nearly 20 percent of the overbuilds identified by Kagan, either have failed and are no longer operational or are not yet operating to any meaningful extent. Kagan also found that overbuilders might face significantly less extensive and costly franchise requirements than those imposed on incumbent operators. Kagan identified 96 such overbuild communities.

Additionally, some overbuilders' prices may be artificially low because the overbuilder is a not-for-profit entity with access to below-market capital. Kagan identified 31 municipally-owned overbuilds and 10 overbuilds owned by cooperatives.

The bottom line is that overbuilds are the result of anomalous circumstances in nearly all cases. Whether or not overbuilders ever develop sustainable businesses, their artificially low prices in a tiny number of communities cannot and should not serve as a benchmark to evaluate competitive cable prices in 33,000 franchise cable communities. As GAO states, and I quote, "Our approach in this report—a case study analysis—is not generalizable to the universe of cable systems."

Mr. Chairman, 21 million DBS customers offer ample evidence that there is vigorous competition to cable. Cable customers and all consumers have been the beneficiaries of such competition. Effective competition does exist, just in a different form than some had envisioned, and overbuild competition tells only a very small part of a much larger competitive story.

Thank you very much. I would appreciate it if my full remarks, along with Professor Wildman's study and the Kagan analysis, would be included in the record. Thank you.

Chairman DEWINE. They will certainly be made part of the record.

[The prepared statement of Mr. Sachs appears as a submission for the record.]

Chairman DEWINE. Let me just note for the record that with regard to the six BSP markets chosen by the GAO to conduct their study, those six markets represent more than 20 percent of all the overbuilder markets throughout the country. In addition, all six overbuilders chosen have been in existence for more than 1 year.

So I believe the study itself provides useful insights into the broader national market for cable services.

We do have a vote. As you may have noticed, some of the other members have left. We are going to go vote. The first member who will come back, whether it is Senator Kohl or myself, will then resume the hearing. So you can take a break for a moment. Whether it is Senator Kohl or myself—if Senator Kohl gets back first, he will then resume the hearing and we will start with Ms. Wilson, with her testimony. Thank you.

[The Subcommittee stood in recess from 11:38 a.m. to 11:53 a.m.]

Senator KOHL [PRESIDING.] We will resume right now and I believe, Ms. Wilson, your testimony is being requested.

STATEMENT OF CORALIE WILSON, PRESIDENT, NATIONAL ASSOCIATION OF TELECOMMUNICATIONS OFFICERS AND ADVISORS

Ms. WILSON. Chairman Kohl and members of this Subcommittee, I am Coralie Wilson, president of the board of directors of the National Association of Telecommunications Officers and Advisors. NATOA is a national organization that represents the cable and telecommunications interests of local governments across the United States. We are grateful for the opportunity to share our views and suggestions on the important issues before you today.

The FCC has repeatedly found that head-to-head competition between terrestrial facilities-based providers of video programming results in significantly lower rates, more channels and better service for consumers. The General Accounting Office recently estimated that the rate differential is approximately 15 percent and more nationwide.

Local governments therefore have a strong interest in promoting robust cable competition. In the late 1990's, competition actually began to emerge in many communities across the United States. Often, however, incumbents sought to thwart local governments from awarding competitive franchises and we began to see incumbents engaging in a variety of anticompetitive practices.

By 2002, the number of overbuilds declined dramatically. Although the economy was clearly a factor, the feedback that NATOA was receiving from its members suggested that the anticompetitive activities of incumbents were also contributing to this phenomenon. As a result, NATOA commissioned a study of the kinds of anticompetitive practices that were occurring and the steps that may be necessary to deal with this problem.

In March 2003, the Baller Herbst Law Group submitted its extensive report, a copy of which is attached, with privileged attorney-client material removed. As you will see, it contained dozens of examples of anticompetitive behavior. The report cautioned that, given the nature of the data collection process, some of the information presented might not be completely accurate or current, and that it has not been subjected to detailed analysis.

In presenting the report to you, we underscore its reservations and add a further qualification that the facts and cases cited are now nearly a year old. The report concluded, however, that the sheer volume of the information available indicated that anticompetitive practices by incumbent cable operators warranted further investigation.

Recent FCC decisions and orders have reflected increasing concern about anticompetitive practices by the major incumbent cable operators, but the agency believes that it lacks statutory authority to do anything about this problem. To this end, we believe that two statutory changes—you have already mentioned some of them—while not the entire solution, would be very helpful.

First, several major incumbent cable operators are practicing targeted rate discrimination through what they call win-back programs. A common and critical feature is that the incumbent does not offer its own subscribers the same special deals that it offers to subscribers who have transferred or are threatening to transfer their business to an overbuilder.

It was precisely for this reason that Congress enacted in 1992 a uniform rate requirement in Section 623(d) of the Communications Act. As Congress stated, the purpose of Section 623(d) was in part to prevent cable operators from dropping the rates in one portion of a franchise area to undercut a competitor temporarily.

In the Telecommunications Act of 1996, believing that true competition in the cable industry was imminent, Congress subjected the uniform rate requirement to an important qualification. It would no longer be applicable if there was effective competition in the relevant market. Because meaningful competition has not yet evolved and this loophole is being used to further frustrate competition, it should be closed, and Congress should therefore delete the effective competition exception from the uniform rate provision of the Act.

Second, Section 628 of the Communications Act prohibits vertically-integrated cable operators and programming vendors from entering into or renewing exclusive contracts under most circumstances. Unfortunately, the FCC has repeatedly found that these provisions apply only to video programming delivered by satellite and not to programming delivered terrestrially through fiber optic cable. As the FCC has itself recognized, this construction of the law adversely affects the ability of overbuilders to obtain programming, especially regional sports programming, and it gives incumbents the incentive to shift programming delivery from satellite to terrestrial.

NATOA recommends that Congress eliminate the terrestrial delivery loophole. Furthermore, given the efforts of major cable incumbents to tie up content of all kinds in exclusive contracts, Congress may also want to extend the ban on exclusive contracts to include all content.

We appreciate this opportunity to testify and would be glad to answer any questions or provide any further information that the Subcommittee or its staff may desire. Thank you.

[The prepared statement of Ms. Wilson appears as a submission for the record.]

Senator KOHL. Thank you, Ms. Wilson.

Mr. Cleland.

STATEMENT OF SCOTT CLELAND, CHIEF EXECUTIVE OFFICER, PRECURSOR GROUP

Mr. CLELAND. Thank you, Senator. I have the perspective of investors. We do research for institutional investors and so I have very much a market orientation type of point of view. I want to kind of make three points here briefly in my oral remarks.

One is that this is an artificial market created by the Government that has actually created many competitive benefits for consumers. Second, I will make a point that the pay T.V. market that we see today is going to change dramatically going forward. It will be very different going forward. It will be more of a bundled service marketplace. And then, third, I will make some comments about overbuilders, where they are possible and where they are not.

Actually, starting now back to my first point about this being an artificial market, this marketplace wouldn't exist if the Government hadn't licensed two DBS providers—they actually licensed four; only two ended up being viable—and creating the program access. So I am a little surprised that, as critical people are of the marketplace, 20 million Americans enjoy a choice. I am one of them. We are no longer captive to a cable provider. There is competition out there; there is vibrant competition. Twenty million Americans can attest to that.

There has also been $86 billion invested into a high-speed network. Cable now has the best high-speed network by far in the country that is enabling millions of Americans to get high-speed. They were forced through competition to improve their customer service. You have much better customer service now than you ever had because when they didn't take care of their customers, their customers left. I actually was one of them.

They now have created a digital network, and that allows them to do video-on-demand. Those are new products and new services to keep people and to provide value to them. They are also going to be able to offer cable telephony, and that is my segue to my second point about how Voice over IP, VoIP, is a game-changer.

I mean, the marketplace of the last 10 years has been pay TV, cable versus DBS. Well, what VoIP does is it allows the cable companies to be a direct competitor to the Bells, and so the marketplace has changed. It is not going to be pay TV to pay TV in the next 10 years. It is going to be service bundle to service bundle.

You don't need to look any farther than to watch what did the four Bells do very rapidly in 2003. They all made alliances with DBS in preparation for this. In 2004, we expect that VoIP will really ramp up. That is where the game is. So once again, competition and technology are vibrant here. The marketplace is changing, is responding, and I believe that many consumers are going to enjoy some price benefits if they avail themselves of the different competitive bundled choices going forward.

Now, is this going to be a perfect competitive market? No. I mean, it costs a ton of money in order to be in this business, and so people shouldn't think that there can be 5, 6, 7, 8, 9 competitors. It is not going to happen here. I know my clients and investors look at it and say, boy, three, maybe four.

Now, to my third point, when they look to overbuilders, overbuilders for a wire is all driven by density. You can create an overbuilder that could work, but it would to be in the really dense apartments markets of New York or Chicago, where you are really selective, where you can really get a real good bang for your buck when you overbuild.

But as other people have said, investors are not looking to invest in overbuilders. During the bubble, they got a lot of capital, and the reason they got a lot of capital is the same reason that CLECs, the telephone overbuilders, got a lot of money. At the end of the bubble, investors in the marketplace had more money than they knew what to do with. They were trying to put money to work wherever they could. So a lot of these overbuilder or CLEC models got funded during a period where money was near free. Money is cheap now, but it is not anywhere near free, and so there is very little interest from Wall Street or the investment community to invest a lot of money into overbuilding.

With that, I see my yellow light. I will quickly summarize. Thank you, Senator.

[The prepared statement of Mr. Cleland appears as a submission for the record.]

Senator KOHL. Thank you, Mr. Cleland.

Mr. Cooper.

STATEMENT OF MARK N. COOPER, DIRECTOR OF RESEARCH, CONSUMER FEDERATION OF AMERICA

Mr. COOPER. Thank you, Senator Kohl. Several Senators vented on the Super Bowl as a cultural event and I have to take an opportunity as well. The moveon.com ad that CBS refused to run had higher production values and a more thoughtful message than all the commercial crap that they put on the air. This is censorship that is just as much a threat to the values of our country as the moral and patriotic issues that Senators Hatch and Leahy properly raised. I think this needs to be thought about as well because the choice of who gets to speak goes back to the media ownership and concentration issue we mentioned earlier.

But having vented, let me move on to the more mundane question of price. In its first report on competition in the video market back in 1994, the FCC found that head-to-head competition between cable companies lowered prices by 16 percent. Last year, the GAO found that head-to-head competition between cable companies—that is, intramodal competition between two guys using the same technology—lowered prices by 15 percent. Several times in the decade, the same result was obtained. So over the course of a decade, while satellite was taking its 20 million customers, nothing diminished the ability of cable head-to-head competition to lower price.

Satellite doesn't lower price, for the reasons you have heard. It is not really head-to-head in lots of markets. It is an upscale niche, high-quality, high-content package that really doesn't address what we call the lunch bucket cable crowd. The econometric analyses of the FCC and the GAO have repeatedly found that satellite does not discipline cable prices. The simply, common-sense observation over the decade is correct.

So if only head-to-head competition matters, intramodal competition, then that is what we have to look to for the standard. And the excuses we heard about don't count these, don't count those, don't count the other ones, do not diminish the fact that over the past 8 years, since the passage of the Telecom Act, if that 15 or 20 percent is right, that sums to $30 billion of abuse of the American consumer by the cable operators.

In addition, what the cable operators did not mention about why it is so difficult—the one answer they did not look for about how difficult it is for overbuilders is the anticompetitive tactics that they use against overbuilders—the withholding of programming, the exclusives, the playing around in the regulatory process of the approvals. They don't sit idly by while the overbuilders try to get approvals. So they have created their own market power.

The other key lever that the cable operators use against consumers is to bundle all of their programming into larger and larger packages. They give consumers virtually no choice. Actually, you get three choices—nothing, almost nothing and almost everything. The "almost everything"—the expanded tier gets bigger and bigger. Lately, they have added the digital tier and, of course, they have moved popular programming into that tier, which causes people to pay more money to get the same set of shows.

So what the cable operators never give the consumer is real choice, the option to choose which shows they would want to watch. They have got to buy that whole bundle in order to see any. Ironically, if you gave consumers a la carte choice, you would not only give them the ability to protect their pocketbooks, but you would solve Senator Hatch's problem as well because they would be able to defend and protect their moral values. They would not choose to pay for, and therefore not have in their homes, the shows that offend their moral values. That sort of consumer sovereignty is critical to advancing the welfare of the public with this industry, both for its cultural values and for its pocketbook.

Congress created this problem by deregulating cable before there was competition, in the hope there would be competition. Overbuilders have been stymied, telephone companies have not entered the market, and the track record on satellite is clear. It won't give us the consumer protection we need.

If you believe the cable operators' message that overbuilding is not economically viable, then you better re-regulate fast because there is nothing to prevent the ongoing abuse of the public in the intermodal competition that they wave before you today. And it is going to get worse because the cable bundle is the dominant bundle, so their market power will become greater and greater.

Thank you, Senator.

[The prepared statement of Mr. Cooper appears as a submission for the record.]

Senator KOHL. Thank you very much, Mr. Cooper.

My first question is for Mr. Sachs and Mr. Cooper. As noted now at several points in this hearing, year after year consumers have endured rising cable rates. Just two weeks ago, the FCC reported that cable rates had increased more than 53 percent over the last 10 years and by more than 5 percent in the last year, very much in excess of the rate of inflation.

We know that the cable industry blames much of the increase in prices on the cost of programming. GAO has noted that a substantial portion of these programming costs are recouped by cable operators by increasing advertising revenues.

So, Mr. Sachs, and then Mr. Cooper, don't these constant price increases really demonstrate the absence of competition in the cable marketplace?

Mr. SACHS. Respectfully, Senator Kohl, I disagree with that conclusion. As GAO noted in its October 2003 report, while cable programming represented the most significant increase in operating expense, there were significant increases as well in personnel, which is the second largest category. This is an industry that, as Mr. Willner pointed out, has invested $85 billion since passage of the 1996 Telecommunications Act in infrastructure to provide consumers with new services like high-speed broadband and high-definition television. But for the cable industry's investment, we would not have the broadband deployment that we see today.

To put cable prices in context, if you look at the CPI-U numbers from the Bureau of Labor Statistics, which I believe was 55 percent from the period December 1993 through June 2003, education costs in this country went up 62 percent, college tuition and fees 60 percent, financial services 56 percent, cable television 55, admissions 55.

Let me focus on admissions, and I will submit an entire list for the record. Admissions includes ticket costs for movies, concerts, theater and sporting events. Cable in its purest form is an entertainment medium, and we have seen across entertainment alternatives that prices increase more rapidly than inflation because the inputs for creating programs increase—especially the inputs for sports salaries.

Do we think that consumers are getting good value for their money? Absolutely. For $40 a month, the average cost of a cable bill for basic cable and expanded cable, it is impossible to take a family of four to a movie for a single evening in the course of a month, whereas cable is something that people can enjoy for the full month for $40 a month. Now, people elect to pay more for premium services, for new digital services, for high-speed Internet, and now for telephony in an increasing number of communities. But those are all options that consumers have.

Finally, I believe we have a fundamental disagreement with Dr. Cooper about satellite competition. The fact that we have seen 21 million American consumers elect to subscribe to a DBS competitor offers ample evidence that consumers do have choices and are making those choices.

Thank you.

Senator KOHL. Dr. Cooper.

Mr. COOPER. Senator Kohl, if you look at the operating income of the cable companies, which is the cash available for profits and other kinds of things, it essentially doubled since the passage of the Telecom Act on a per-subscriber basis.

If you look at the question of the costs—and we tried to do that in the paper we released on Monday—traditional video services—that is, basic and expanded basic—were not driving the cost of the upgrade. The upgrade was built to deliver digital services, and lo and behold digital tiers and high-speed Internet have now become the number two and number three income streams of the cable operators. The digital upgrade is paying for itself and that was the intent of developing that plan.

So if you back out the reasonable projection of the operating costs of traditional video services, the income has been growing almost double over that period. And that takes into account programming costs, all the non-operating costs. So you have got a throw-off of cash here available for other uses.

So with respect to satellite, the 21 million, you have to back out a significant number of satellite subscribers who don't reside in places where they have cable, and that is where satellite started. But the simple fact of the matter is the GAO looked at it and they could barely find the merest price effect of satellite. So satellite basically appeals to a different market than does the basic lunch bucket cable opportunity that we have.

The market share at the point of sale in every American market roughly today is about an 80-percent market share. That is a number that under traditional antitrust practice clearly rises to a level at which monopoly abuse can be alleged. If a company has less than 60, the courts won't listen to it. Once you get to 65 or 70, you can allege monopoly abuse.

Let me make one simple point. In the recent Microsoft case, Microsoft asserted the same thing, that you could find about 20 percent of the people who didn't use a Microsoft operating system. Therefore, they concluded since people have choices, ignore my market share. Of course, on a 7–0 vote of the D.C. Circuit, they rejected that defense against the fundamental question of whether market power exists.

Thank you.

Senator KOHL. Mr. Cleland.

Mr. CLELAND. Yes. With all due respect to Mark, I have to kick in here because it is a little bit of a retrograde kind of regulatory view on cable. Ten years ago, in 1992, all of those statements were dead-on, but over the last 12 years the world has changed dramatically.

Twenty-one million Americans have chosen DBS. The cable industry has gotten some sense into it and started treating its consumers well so they wouldn't leave. It spent $86 billion or so to completely reinvest so that it could compete. It is now able to offer telephony, so it is competing against the local monopoly. It competes against Blockbuster with video-on-demand.

So competition is so much more than price. There are the benefits of competition, which means choice, innovation, new products, new services. So I am a little bit stunned to think that all is horrible in this market. It is never going to be perfect. It is never going to be perfectly competitive because it is an artificial market, but the strides that have occurred because of originally the 1992 Cable Act and then the 1996 Telecom Act and the program access rules have made dramatic gains for consumers.

Mr. COOPER. Scott, let's give consumers choice a la carte. That is real choice. That let's me vote with my pocketbook both for moral values and price values. Give me choice.

Mr. CLELAND. I don't believe that every product in the country is always served—

Mr. COOPER. But give me choice here. Instead of a $40 bundle, give me a series of choices, real choice so I can tell you what I really want to pay for. A study recently done—we mentioned it in our document—looked at ESPN, which is the most expensive one, and 80 percent of the people said they would not pay the price that ESPN is charging. Give me real choice, not three choices. Give me real choice, and that will discipline the heck out of this industry.

Senator KOHL. Ms. Wilson.

Ms. WILSON. First, I have to say I am not speaking as an attorney, a financial analyst, or an economist. But I am speaking as a regulator on the front lines in a normal community.

It seems to me that one of the first tests of effective competition, not competition alone, but effective competition is the impact on rates. So while I can acknowledge that DBS apparently does provide some competition, if the rates are not affected, if customer service isn't markedly better, then I would say that there is not effective competition, and certainly not the kind of competition that is going to impact what is most on the minds of a lot of my residents these days, which is price.

Every time the rate goes up, I get phone calls from a lot of people on fixed incomes, many of whom frankly do not have an option of direct broadcast satellite because of their financial circumstances, their living circumstances or their technical aptitude. So satellite is simply not an option for them.

As has been pointed out, they get a lot of services on expanded basic that they really don't want. They wouldn't buy them if they weren't forced to take them. So I think there are a number of issues here, but from my perspective and the perspective of the people who are cable customers, I will tell you that they do not believe that there is effective competition in the marketplace when they only have a choice between cable and DBS.

Senator KOHL. One other question before I turn it back to Senator DeWine. This is for Mr. Sachs and Mr. Willner. For years, we have heard allegations from competitors of predatory conduct engaged in by cable incumbents against new competitors. These allegations include stories of cable incumbents, when faced with a new competitor entering their market, offering subscribers extraordinary discounts off their normal prices, prices which appear to be below the cost of acquiring the programming. These discounts demonstrably are not being offered in neighboring communities where the incumbent does not face competition. So they clearly are a competitive action intended to drive out cable competitors.

Now, Mr. Willner and Mr. Sachs, are you denying these allegations? Are you saying they never occur or are you saying this is the normal course of business? I will ask you, Mr. Willner, first because you have some experience with this.

Mr. WILLNER. I do, and I thank you for that. Senator, we do have two communities where we have wireline overbuilds. And as I said in my oral statement, we think about competition in every market that we serve. We do have win-back programs. We have win-back programs against wireline competitors, we have win-back programs against satellite competitors.

When DISH Network comes out with an offer, we respond to that offer. When DirecTV comes out with an offer, we respond to that offer. When we come out with an offer, they respond. And it is the same thing with the wireline overbuilders; there is no difference between having two competitors rather than three.

I can use the example in Columbus, Ohio, where only 70 percent of our system is, in fact, overbuilt by a wireline competitor. In the areas where we have comparable service, the rates are exactly the same, whether they have an overbuild competitor or not in that market. The reason for that is because, quite to the contrary of what Dr. Cooper said, the satellite industry has, in fact, changed dramatically over the last few years. They are, in fact, winning the lunch bucket crew over to their services with their America's top 50 and top 100, and now it is top 120, with deeply discounted rates. And I will tell you that those competitive forces are in place in every community that we serve, not just where there is an overbuild.

Senator KOHL. Mr. Sachs.

Mr. SACHS. Senator Kohl, if competitors have a grievance of this nature, they do have the ability to take that complaint to the FCC, where it can be adjudicated. I am aware that just recently there was a case presented to the Commission which, after investigating all the facts, found that the win-back program was not inappropriate and was not in violation of the uniform pricing rules.

Cable operators everyday are competing against satellite providers who are offering very deep discounts, 3 months free service, three rooms installed for free, and introductory rates that may be one-half or a third of the normal rate for an extended period of time. That is not being offered to all existing customers. It is being offered in an effort to win customers from the cable operators.

So without the benefit of the specific allegations and the specific facts in a case, it is really difficult to respond generally. But what I would say is that it is a fiercely competitive environment out there. I am unaware of cases where cable pricing practices have been found to be predatory.

Ms. Wilson referred to a study that they are submitting today. We will obviously take a look at that study, but as I understand it, it consists of allegations and facts that were current as of a year ago. So it is difficult to respond more specifically without specific case examples.

Senator KOHL. Mr. Johnson, what has been your experience?

Mr. JOHNSON. Quite the contrary to what these gentlemen would say. We actually see markets—and we are the traditional overbuilder—where promotions are offered at costs that are less than the cost of programming that extend for in excess of a 12-month period. That is not a short-term promotion and it is significant for us as entrants into the marketplace, the degree of difficulty competing with price points that are that low. As a matter of fact, we have evidence in certain of our markets where people can buy expanded basic cable service for as long as $5 a month—very, very, very low.

I think if you look at the record, the statistics speak for themselves. The pricing advantage is in markets where there are overbuilders. I mean, that is where the discount actually occurs.

One of the statements was made earlier in the testimony about overbuilders coming in and pricing their product at a lower price, an arbitrarily lower price that was not a sustainable price. In fact, the reason that many of the overbuilders or broadband service providers have been able to price at that level is because they delivered earlier in the marketplace a full bundle of all three service offerings—telephone, video services and high-speed Internet services.

It stands to reason that when you are generating three revenue streams off a single pipe into a residence, you can discount all three services because it is germane. You have got the same infrastructure in place. You have got one technician to take care of all three products. So that is where the big benefit of another wireline competitor evolves.

Ms. WILSON. Senator Kohl, we have given to the Subcommittee staff an example of what we believe to be predatory pricing. It certainly looks like predatory pricing to us. It is an offer that MediaCom made to subscribers in Laurens, Iowa—Free Family, which is their concept for expanded basic or digital cable, for 2 months, and half price for the next 10 months and free installation.

The normal price for this service, family cable, is $23.25 per month. Now, if you do the math, as we have done, the effective price of this promotion takes the monthly rate down to $9.69 per month for that year. That is certainly less than what we believe the company is paying for programming. We estimate that their programming costs alone for these particular channels are a little over $14 per month. So that is not taking into consideration any of their ongoing operating costs, debt service, any of that kind of thing.

Again, I know that there are legal ways of looking at these kinds of things, but the fact of the matter is this was an offer that was only offered in Laurens, Iowa. It was not offered in surrounding communities. We also gave to the staff a transcript of a city council meeting with a representative from MediaCom when they asked why they were not getting the $9.69 rate or the special offer.

They suggested—and I think it may be true—that if you have got a larger company, a nationwide company with a lot of systems, they can afford to do these kinds of things that a smaller overbuilder will not be able to do. They can afford to offer these kinds of low rates for a year at a time and a competitive broadband or wireline overbuilder is not going to be able to sustain that.

Senator KOHL. Dr. Cooper.

Mr. COOPER. Senator Kohl, let me offer another example of predatory pricing used in an anticompetitive practice against satellite. If you call Comcast today and say I want cable modem service only, they will say you have to pay them $60 a month. If you say you will also take basic cable with the bundle, the price goes down to $45. In other words, there is a negative price on basic service of $15. Now, I understand that economists will argue about what the floor is under a predatory price, but a minus 15 is pretty tough to justify.

When they rolled that price difference out, people started calling and they said, this is nuts, I have satellite, I don't want basic cable and they are just ripping me off; they are trying to force me to take basic cable so that I can get that $15 discount off of my cable modem service. It was intended as a satellite killer. We have asked the Federal Trade Commission to look into it.

When Mr. Sachs says, well, we haven't been found guilty in a court, that may be one of the reason why the overbuilders can't get going because you have got to do a 10-year antitrust action before the markets will start to put up the money and believe you have a fair competitive landscape.

Senator KOHL. Mr. Cleland.

Mr. CLELAND. It seems like people are trying to have it both ways. In this instance, consumers are getting a lower price. Now, I do believe you can have predatory pricing for some of these overbuilders in one city. There may be a problem there with predatory practices because you are maybe using pricing in order to try and put that company out of business.

But don't cry for DirecTV or DISH about predatory DBS pricing. They are 10 million subscribers. They can hold their own. They are doing just fine in the stock market. And if anybody wants to offer me one of those so-called predatory prices to go after DirecTV, I would be delighted to get it. That is the price competition and the price decrease that you want, so I am kind of lost here.

Mr. COOPER. You may actually suffer from the short-term problem that Wall Street has inflicted us all with because predatory pricing is, in fact, a long-term strategy.

Ms. WILSON. If I may, I might also add that Mr. Sachs referred to an FCC ruling recently on a case before it. The fact is that the FCC did not find that the win-back pricing was okay under the uniform pricing rule. They didn't rule on the underlying conduct. They said they couldn't deal with those issues.

Again, that is why we are recommending that there be a statutory change that allows the FCC to, in fact, deal with predatory pricing. The reality is that, again, if a broadband provider cannot sustain or cannot survive predatory pricing for a year at a time, they are not going to be able to afford to go to court and bring an antitrust action against a cable company and bear that financial burden. It takes too much time and it takes too much money.

Senator KOHL. One more comment and then we will turn it back to Senator DeWine.

Mr. Johnson, do you want to say something?

Mr. JOHNSON. Sure. Mr. Cleland just made a comment that there may in a single market be the opportunity for predatory pricing. I think that is what we are finding out in the competitive marketplace. I just pulled some pricing structures and I am going to use Montgomery, Alabama, as one of our marketplaces that we operate where there is a competitive overbuilder.

At the end of last year, we priced $27.95 for our bundled product. That was the equivalent price point for cable. If I look at surrounding markets, Dothan, Alabama, $32.95: Selma, Alabama, $36; Birmingham, $39.54, and up. What that is saying is in the market where there is competition, there is viable price benefit to the subscriber, but it doesn't translate to those other markets that are, in fact, subsidizing the opportunity to deliver discounted pricing by the incumbent in those markets.

Senator KOHL. Mr. Willner, you wanted to say something.

Mr. WILLNER. Well, I would like to just point out that we have 1.4 million subscribers. Each of the DBS companies has somewhere close to 10 or 11 million. They are larger than every cable company, except for two. You know, when we go in and open up newspapers with full-page ads about free installation, free service for 3 months, and service for three TVs in the house, we know that they are pricing below their cost and we have to respond to that.

Now, I don't know if that is really predatory pricing or not, but a lot of times, for a lot of cable companies, they are competing against much bigger satellite companies. This whole debate as to whether or not there is predatory pricing or true competition doesn't make a lot of sense to me in the everyday marketplace, where we are responding to these types of marketing tactics all the time.

Senator KOHL. I thank you, and I will turn it back to Mr. DeWine with the expression of appreciation that no one has commented on the cost of sports programming having gone up so much.

Mr. WILLNER. Would you like me to?

Senator KOHL. You are very kind.

Chairman DEWINE. I was going to ask about that.

Mr. JOHNSON. I think we can be unified in our position there.

Chairman DEWINE. Mr. Sachs, you haven't said anything about this. Do you want to respond to any of this?

Mr. SACHS. Sure, I would be happy to. On the subject of overbuilds, my home is in Boston, which is one of the communities in the paired studies used by GAO, and I think it is a good one to use as an example here. This is a market which RCN entered in 1997. RCN is the largest alternative broadband provider, the largest overbuilder. Today, they have approximately 450,000 customers. They entered that market in 1997 with an expanded basic package which was below $20. The price today is about twice that.

In the GAO study, there was one very large overbuild that was noted. I believe that was probably Boston, where the prices with a comparative city were actually higher in the city with the overbuild than the city without the overbuild.

The point I want to make here is that cable franchises are awarded for 15 years with successive renewal periods of another 10 years, typically. You have to take a long-term view of prices to see whether they are sustainable.

RCN came into Boston with a lot of bravado six or 7 years ago. Three years ago, their stock was trading at $72 a share. At the end of December, it closed at $0.68 a share. The point of our testimony is that, yes, you can find examples where prices are lower, where there is overbuild competition. But you really have to look over a long continuum of time and ask yourselves "is this sustainable competition?" In some places it may be, but generally it has not been.

But that does not diminish the fact that cable customers can choose from two satellite providers. In 1992, Congress said that if there is an alternative taken by more than 15 percent of the people in a community, there is deemed to be effective competition. Today, in 40 States, satellite competition exceeds 15 percent.

Chairman DEWINE. Let me just say that Ms. Wilson mentioned in her testimony that she was submitting a report which was drafted by outside consultants which described alleged anticompetitive behavior by incumbent cable companies. She also noted that the information had not yet been subjected to a detailed analysis, nor had those mentioned in the report had a chance to respond to the allegations.

Accordingly, the Subcommittee is going to accept that report with those reservations noted for the record. In addition, the hearing record will remain open long enough for any interested parties to examine the report and respond. We will enter those responses in the record. So if anyone would like to do that, they will certainly have the opportunity to do that.

Mr. Johnson, let me direct this question to you, and also to Ms. Wilson. According to the cable industry, you and your fellow overbuilders are right on the verge of going out of business. Let me ask you, what is your financial state and is the overbuilder business model even a viable one today? If it is viable, why are you having so much trouble convincing the capital markets?

Mr. JOHNSON. Well, actually—and I appreciate that question—from an economic viability standpoint, we feel very comfortable with where we are. Knology completed a successful initial public offering in December of 2003. At the current time, our stock is trading at a level higher than the offering price. It is rated by at least three analysts that I am aware of right now as a "buy."

It is worth noting also that we accomplished the first media/telecom IPO in approximately 3 1/2 years. The company has also recently been presented with the opportunity to refinance its existing debt at very much more attractive rates than we have right now, if we choose to do so.

We operated in a positive free cash flow position in the third and fourth quarters of last year. What that means is fundamentally we have reached a stage of maturity—and everybody has talked about the heavy front-end capital investment, but we have reached a state of maturity where more cash is coming in than cash is going out, a very, very healthy position to be in.

I am also aware of other BSPs that have continued to raise capital. As a matter of fact, from Knology's standpoint, over these 3 years of very difficult economic times, we were able to raise over $300 million in equity to continue to get our business to the point where we are right now.

I am also aware that other BSPs have continued to raise capital and to expand their business. At least one other BSP that I have got public information on announced the successful completion of a private equity funding round in the past 90 days. And just as Knology announced a major acquisition, this firm also announced a major acquisition.

So when I hear some of the comments about economic viability, I think it is a little bit like whistling past the graveyard. We have been hearing this refrain. I have been around Knology 5 years. I heard that the day I arrived there. I think the incumbents have said that. They have tried to convince the financial markets, and they have also now tried to convince you. But quite frankly, we find that the companies that are well-managed companies are able to get capital.

Chairman DEWINE. Ms. Wilson.

Ms. WILSON. Well, I am not a broadband service provider, so I can't speak to their business model or their financial situation. But I do know that in 1992, or after 1992, with the program access rules in place, there was a substantial amount of overbuilder activity, and by the end of that decade we were really starting to see some serious efforts.

Where I live in Minnesota now, we saw two companies, Wide Open West and Everest, approaching us. And we had some concerns whether the market could support three wireline providers, as well as satellite, but we felt that it was not our responsibility to choose winners and losers. So, you know, come on in and do your best.

But in 1996, when that terrestrial loophole and the access to programming—I mean, early on we did see a lot of complaints that the overbuilders simply could not get access to programming. That stopped when Congress said you can't do that anymore. The terrestrial loophole, especially for regional sports programming, is a problem, and I think certainly the predatory pricing.

I think we have to be clear when we are talking about predatory pricing. We are not talking about temporarily lowering the price or special offers here and there. We are talking about a long-term concerted effort to price the product below cost for an extended period of time.

Chairman DEWINE. Very quickly, Mr. Sachs.

Mr. SACHS. Yes. Ms. Wilson referred to the so-called terrestrial loophole.

Chairman DEWINE. Well, that was my next question. I want to get into that. You can jump right in, but I also want to ask Mr. Johnson about that.

Mr. SACHS. If I could make one other brief comment?

Chairman DEWINE. Sure.

Mr. SACHS. I congratulate Mr. Johnson on his recent successful public offering. But one fact he omitted was that his company in 2002 filed for bankruptcy and emerged from bankruptcy only after having shed $250 million in debt and rearranged its balance sheet.

So I think if you are going to ask "is this economically viable?" The answer is yes, if you are able to rearrange your financing through bankruptcy, it may be. And if you are able to use the proceeds from a public offering to purchase assets of another overbuilder for a fraction of their original cost, the economics of the business look a lot better.

Ms. WILSON. Senator DeWine, may I just make a brief comment?

Chairman DEWINE. Briefly, Ms. Wilson, and then briefly, Mr. Johnson.

Ms. WILSON. I would say that if, in fact, we are not going to get effective competition—and by effective competition I mean competition that is going to affect rates—then the only option that we have is to go to a more regulatory environment in order to force that kind of rate behavior, that discipline on the rates.

I don't think any of us wants to do that. But, again, if you are going to get not just competition, but effective competition, you either have to get more entrants into the marketplace to bring that discipline to all of the participants or you have to take a regulatory approach.

Chairman DEWINE. Mr. Johnson.

Mr. JOHNSON. Senator DeWine, I would like to make two comments. First, I cannot not address the bankruptcy question that

Mr. Sachs talked about, and then I will comment on your terrestrial question to me.

First, relevant to the bankruptcy—

Chairman DEWINE. Let me ask it first, though, will you?

Mr. JOHNSON. Excuse me?

Chairman DEWINE. Let me ask the question first.

Mr. JOHNSON. Okay, I am sorry. Can I speak to the bankruptcy first?

Chairman DEWINE. Yes, sir.

Mr. JOHNSON. First, we saw an opportunity at the end of 2001 to restructure our debt on very, very favorable terms. Our business model was in great shape. We actually had no debt payments due for at least 18 months. We had the foresight, recognizing that the bond markets were very, very soft at that time, to be able to start buying our bonds back.

We went to our bond-holders and found 93 percent of our bond-holders who said this is a great time for you guys to do this; we support you entirely. We could not find 7 percent of those bond-holders, and rather than end up with a capital structure that had two diverse sets of bond-holders with two different sets of covenants and restrictions, we asked our lawyers was there a way to get a consolidated capital structure.

They suggested this pre-packaged bankruptcy that had the full support of 93 percent of our bond-holders that we could locate. We completed this administrative transaction. There were no service interruptions, no employee layoffs or lost customers, and all vendors continued to be paid in full. So it was not an escape from any debt obligations.

As a matter of fact, the Wharton Business School actually developed a business case and taught it this spring, highlighting Knology's restructuring as a premier example of the use of bankruptcy as an administrative tool to affect and improve capital structure.

Chairman DEWINE. We appreciate that explanation, Mr. Johnson.

Let me turn to the terrestrial loophole. Senator Kohl and I have stated we plan to draw up legislation addressing this loophole. In your experience, how often has the loophole been utilized to prevent an overbuilder from obtaining content, and how much of a factor is it in negotiations between the owners of content and other distributors?

Mr. JOHNSON. It is used in a number of the markets that the broadband service providers serve. As a matter of fact, in our extended comments that we filed for this session we have a listing of a number of cases in terms of regional sports programming and regional news programming.

In the market that we just recently acquired, in Clearwater and St. Petersburg, Florida, there is a local news programming station down there that is owned by the incumbent that is considered to be very, very viable. We would like to have access to that, which we don't have at this particular point in time. So we see it a good bit in the marketplace.

Chairman DEWINE. Very quickly, Mr. Willner.

Mr. WILLNER. I would just like to talk about the test of unintended consequences. That kind of a news channel, which is a money-losing proposition for an incumbent to create—and they are probably still not making any money—would never have been created in the first place if they had to, under a law or a regulation, sell it to their competitor. It is one of the tools that people use to compete in the marketplace.

Chairman DEWINE. Anybody else? Mr. Sachs.

Mr. SACHS. If I could add a word on that subject, when Congress created the program access rules in 1992, it expressly provided that if programming were being distributed terrestrially, it would not be covered by those rules. And as Mr. Willner just mentioned, that was to provide an incentive for companies to create new local and regional programming.

Since that time, we have seen in more than 30 markets cable operators invest to create 24-hour news channels like New York One or New England Cable News, and the public has benefitted from this. Virtually every nationally distributed network is available to cable overbuilders and satellite. Local programming is a small area where a company is able to differentiate its product from a competitor and create a service that is of benefit to that community. So, again, I agree with Mr. Willner about the law of unintended consequences.

Chairman DEWINE. Mr. Cleland, as you have testified, phone companies are now linking up with satellite providers to provide bundled services, specifically SBC with EchoStar, Qwest Communications with both EchoStar and DirecTV, Bell South with DirecTV, Verizon with DirecTV. Is this enough competition for the consumer, and will anyone else be able to provide bundled services or are consumers going to be faced with a duopoly?

Mr. CLELAND. Well, it is going to be more of two big providers offering the bundle. I know in my personal case I was upset with my cable company and I walked. I was one of the early DBS people. But right now, I couldn't get DSL from Verizon and so I got a cable modem and now I am entertaining going back to cable for the bundle savings that you get. So there is a benefit.

What it will create is a lot of different types of bundles and different prices. People have mentioned that DBS is competing at the low end. I imagine that the Bells and DBS will be much more aggressive at the low end, will offer much more aggressive pricing there. And I envision the cable companies are going to try and hold on to their high-value-add customers.

So I think that one of the aspects of bundled competition is probably going to result in a bifurcation of the market where they start to choose sides in where they are going to go. The reason for that is that the cable companies have a vastly superior pipe and offering. So they are going to be able to offer the high-value-added services that the high end wants, and they are going to be able to command the price for it. DBS and the Bells, in order to get the scale that they need and have the customers they need, are going to have to compete more on price.

Chairman DEWINE. Mr. Cooper, go ahead.

Mr. COOPER. Senator DeWine, Scott has just described a duopoly between two badly matched competitors. Two is not enough, four is not enough for real competition. But he has described the problem that satellite faces. They couldn't deliver a high-speed Internet and so they have signed deals with the cable operators, so it is not an integrated plan. So the economies of scope that the BSP gets they don't get. They are at a disadvantage. DSL is an inferior service. Even at the discounted rates, on a megabit basis it costs two to three times as much as cable services.

So what we have here, then, is a future which looks like competition between two badly matched, partial competitors, one a high-end product, one a low-end product. And that is not going to get us effective competition that protects the consumer.

Mr. CLELAND. Could I follow up on that?

Chairman DEWINE. Sure, Mr. Cleland.

Mr. CLELAND. Many people talk about effective competition, which is a euphemism for more competition than they have now so that I have lower prices. Generally, to go in that direction, you are going to have to get more intrusive on a regulatory basis.

We see in the marketplace the Bells are hyper-regulated now. We regulate them more than we regulate toxic waste in this country, and their stock values and their business prospects reflect that. Cable has a lighter regulatory hand, and they then have the opportunity. Investors are willing to put their money at risk to invest in new products, invest in new technologies, invest in new plant, so that consumers can get the benefit of new services. So it isn't an either/or or a black-or-white.

By no means am I saying there is going to be perfect competition for everybody. But from my standpoint, which is admittedly an investor and market standpoint, you want to have a light touch in the Government. If you have a heavy hand, you are going to squash more than you would otherwise.

Chairman DEWINE. I want to thank you all very much. We have had a very vigorous conversation today. I think it has been very helpful. We had good opening statements, but I think, as usual, we get most of our information from exchanges from you all back and forth between you. And none of you are very shy or retiring, so that was very helpful.

This Subcommittee will continue to exercise oversight over this very interesting industry and we will continue to hold hearings in this area. So I thank you all very much.

[Whereupon, at 12:51 p.m., the Subcommittee was adjourned.]

[Additional material is being retained in the Committee's files.]

[Submissions for the record follow.]

SUBMISSIONS FOR THE RECORD

Testimony of Scott Cleland, CEO of the Precursor Group®
Hearing on:
Cable Competition – Increasing Price; Increasing Value?
Before the U.S. Senate Judiciary Antitrust Subcommittee, February 11th, 2004

Mr. Chairman, thank you for the honor of testifying before your Subcommittee and for the Subcommittee's interest in an independent analyst perspective on the state of cable competition.

I am Scott Cleland, a cable and telecom investment analyst.

- I am also **founder and CEO of Precursor®**, an independent research broker-dealer, which provides investment research to institutional investors covering the technology, telecom, and media sectors.
  - Precursor's business interests are aligned with investors' interests – actual and perceived.
  - We do no investment banking for companies; do not manage money or trade for proprietary gain; and our researchers may not trade individual stocks.
- In addition, I am **Chairman of the Investorside Research Association**, an association of over 60 independent research providers, which work for investors and do not have investment banking conflicts of interest.

Testimony Overview:

I believe the whole communications industry, including the cable sector, is going through a profound competitive change. **The pay-TV market of today will not be the pay-TV market of tomorrow.** Today's market is an "artificial" market with three dominant players (cable and the two Direct Broadcast Satellite (DBS) providers – News Corps/DirecTV and Echostar's DISH), who compete on many aspects, but rarely on price. However, digital convergence, and more specifically, the advent of deployment ready **Voice over Internet Protocol (VoIP) service are changing the competitive game of the industry**. VoIP, which allows cable to add voice to its current products of video and high-speed data, will quickly shift the market from traditional pay-TV vs. pay-TV competition to service-bundle vs. service-bundle competition. The much anticipated **bundle wars** among cable, telecom, and satellite are finally happening. All you have to do is look at the marketing alliances that rapidly formed in 2003 between the Baby Bells and DBS providers. Market success, especially for the most profitable, high-end customers, will depend on a provider's ability to offer a broader package of services in a cost-efficient, technologically-sophisticated manner. In this market dynamic, I believe cable, with its superior two-way broadband network, holds a big technological and business model advantage over the telecom and satellite partnerships.

My testimony has three main parts:

A. An Overview of the Current Market Dynamics: The Cable and Direct Broadcast Satellite (DBS) Oligopoly
B. How the Communications Market Is Changing: A Shift to Greater Bundle Competition
C. Why Cable Is Best Positioned to Compete in a Converged and Bundled Environment

A. An Overview of the Current Market Dynamics: The Cable and Direct Broadcast Satellite (DBS) Oligopoly

In order to understand current pay-TV competition, it is critical to realize that this is an "artificial" market. Pay-TV competition exists only because of government action. Cable's main competitor, DBS, is a government-created and licensed market that needed the landmark program access protections from predatory cable practices in order to become a viable industry. In fact, the government initially licensed spectrum for four DBS providers, but the market has only funded and supported two strong providers, DirecTV and Echostar. (A third provider, Cablevision's VOOM DBS service, is still a nascent offering and faces a high hurdle for success.)

As the two dominant players, cable and DBS have enjoyed oligopoly power. **Cable and DBS have chosen to compete on almost everything (marketing, features, and content), but rarely on price.** So, consumers have enjoyed many new services and improvements in customer service, but have rarely received significant price reductions. This is natural and economically rational in an oligopoly environment, especially in a market with such a large amount of fixed and capital costs.

I believe wide-scale entrance of a third facilities-based competitor, who could break this pay-TV oligopoly, is very unlikely given the high fixed costs of launching service, and the reality that cable and DBS are already very capable competitors.

- Cable overbuilders could be successful under certain market conditions, primarily in areas with *high customer density* or in *"new build" communities*. But, even with the presence of overbuilders, pay-TV prices are only slightly lower (~15%) than in other markets.[1] Overbuilders are profit driven. They only want to offer a discount that will entice a customer to switch providers while covering their fixed costs. Overbuilders are not altruists. Large entry costs limit an overbuilder's ability to cut prices. Overbuilders are also at a scale disadvantage to incumbent cable and DBS providers since they have smaller networks and dramatically fewer customers.

- The Baby Bells (Verizon, SBC, BellSouth, and Qwest), who are the most capable of deploying video on a large scale, have all but given up (at least for now) on providing video services over their own networks as Fiber-to-the-Home (FTTH) is currently too risky and expensive. The FCC's Triennial Review decision fell way short of expected deregulation. Moreover, Section 653 of the 1996 Telecom Act (Open Video Systems) requires that the Bells share two-thirds of their network bandwidth with competitors. These events lower the Bells' confidence in being able to achieve a good return on investment for FTTH.

B. How the Communications Market Is Changing: A Shift to Greater Bundle Competition

The current "artificial" pay-TV market is going through significant change. Digital convergence (and more specifically the advent of deployment ready Voice over the Internet Protocol (VoIP) service) is a **"game changer"** that is irreversibly altering the competitive balance of power in the entire communications sector in favor of cable. VoIP allows cable providers to leverage their broadband integrated networks and offer a more robust bundle of services that include video, data, and voice. This is causing a competitive shift in the market. Competition is now moving from simple pay-TV vs. pay-TV service (cable vs. DBS) to a battle over more comprehensive service bundles (video, data, and voice) offered by telecom providers, DBS, and cable. This is a pro-competitive development as prices will come down, but it will also sort out which network, bundle, and business model is better. My view is that it's cable, hands down.

[1] United States GAO. *"Telecommunications: Issues Related to Competition and Subscriber Rates in the Cable Television Industry."* GAO-04-8. October 2003.

The pay-TV market will change as convergence and VoIP are...

- **Realigning the market structure:** VoIP has forced alliances between DBS and the Baby Bells in an attempt to better compete with cable's superior integrated bundle of video, data, and voice. The Bells need DBS because they lack a video offering of their own. DBS needs the Bells because it can't compete by itself in voice and broadband due to the *inherent transmission latency* issues of satellite technology.

- **Accelerating competition for bundled services:** DBS and Bell alliances along with cable's ability to offer voice will increase the importance of the service bundle. Consumers are also getting more accustomed to receiving a bundle for their communication services. Local and long distance voice has almost become a single product as over 40% of consumer households subscribe to a voice bundle. It is just a matter of time before more consumers will demand bigger bundles that include video services. In this environment, success in the market will depend on the ability to offer multiple services – not just voice, not just data, and not just video.

C. Why Cable Is Best Positioned to Compete in a Converged and Bundled Environment

In this growing bundle war, cable holds an advantage over telecom providers and DBS for several reasons:

- **Cable Has the Best Network:** Cable has already spent the capital to upgrade its network to a superior two-way broadband service. Cable enjoys tremendously more two-way bandwidth (~750+ MHz of capacity to the Bells' 1 MHz of capacity) to offer more and better services. DBS broadband capacity is primarily limited to one-way.

- **VoIP Adds Incremental Value:** For cable, VoIP provides new revenue with only incremental new costs since voice is a low bandwidth application that rides over the high-speed data network, leveraging cable's existing infrastructure investments. In contrast, for the Bells, VoIP is a cheaper and better substitute for their existing voice service. Furthermore, as more VoIP equipment gets deployed, the Bells' traditional circuit switch network will have less use and value, but will still require large operating expenses.

- **Cable Has a Favorable Regulatory Environment:** Cable is not weighed down by regulation to unbundle its network to competitors, unlike the Bells. Cable is also trying to mitigate fears about limited access, recently taking the initiative to open its network to other VoIP providers.

In conclusion, the market's shift towards broader based competition for multiple services may provide some benefits to consumers. <u>Consumer will likely see more competition for their complete communication needs</u>. Digital convergence and bundling mean that consumers will be able to get more services from more providers. **Consumers may also get individual products at a lower average price as part of a bundle** since a key aspect of bundling is to provide a discount over the same services offered a la carte.

This market has been a huge competitive success for Congress, following the 1992 program access and local programming rule. Over twenty million customers have exercised their choice to leave cable. In fact, I have been one of them. However, because I could not get DSL high-speed Internet from Verizon, I had to get a cable modem. So, I'm greatly interested in the new competitive choice that I will have to save money with an overall bundle of services from one provider.

Thank you again Mr. Chairman for the honor and opportunity to testify before your Subcommittee on this important matter. I am available for questions, and you have my consent to include any of my comments in the official record.

Consumer Federation of America

Consumers Union
NONPROFIT PUBLISHER OF CONSUMER REPORTS

TESTIMONY OF MARK N. COOPER

ON

CABLE MARKET POWER IN MULTICHANNEL VIDEO PROGRAM DISTRIBUTION

Before the
Subcommittee on Antitrust,
Senate Judiciary Committee

February 11, 2004

Mr. Chairman and Members of the Committee,

My name is Dr. Mark N. Cooper. I am Director of Research at the Consumer Federation of America. I am speaking today on behalf of the Consumer Federation of America and Consumers Union. I have attached to my testimony a study on the continuing anti-consumer and anticompetitive practices of the cable industry that we released earlier this week. It provides a detailed and rigorous documentation that eight years after the passage of the Telecommunications Act of 1996, and twenty years after cable was first deregulated, cable operators still possess the power in the market to overcharge consumers, to hinder the entry of competitors and discriminate against programmers.

They possess this market power because satellite has never been able to discipline cable pricing. Head-to-head competition that results when a second cable company builds a competing network (called overbuilding) is extremely rare. At the same time, cable operators have been allowed to merge into huge national entities and trade systems to create regional clusters that dominate local markets. Cable operators have never entered each other's service areas or offered high-speed Internet access outside of their territories.

Cable operators use their market power to increase prices much faster than inflation, – almost three times faster than inflation in recent years. The cost imposed on consumers above what they would pay if cable markets were competitive and not concentrated is between $4.5 and $6 billion per year.

They use their market power to restrict consumer choice to a small number of ever larger, ever more expensive channel bundles. Consumers are forced to pay for channels that they would reject, if they were given a choice. They are forced to pay for dozens of channels in these bundles that almost no one watches.

Cable operators use this market power to discriminate against unaffiliated content and service providers. In the video market they favor their own programming. In the high-speed Internet market, they exclude Internet service providers.

Cable operators attempt to obscure the existence and abuse of market power with two arguments. First they claim that programming costs explain the massive increase in the price of basic and expanded basic service. Second, they claim that consumers are getting much greater value for their dollar so that quality adjusted prices have declined. Neither claim stands up to close scrutiny. My testimony briefly summarized the findings of that study.

EXERCISE OF MARKET POWER ON THE SUPPLY SIDE

Prices

Econometric studies by the General Accounting Office and the Federal Communications Commission show that where cable faces direct head-to-head over-builder competition the price of cable service is much lower.

- A recent GAO report found that in situations where cable faces competition over-builders, prices are 15% lower. Econometric analyses have consistently found this result of a decade. Unfortunately, less than two percent of cable customers enjoy the benefits of that competition.

- A recent GAO analysis found that a cable system owned by a large national operator has prices that are over 5 percent higher than if it is not. FCC econometric models show even larger effects.

- When the FCC models add in a specific variable for regional clustering, a dramatic trend in the industry, they find that clustering has an added effect of further raising price.

- The vast majority of cable subscribers are now served by one of a handful of huge-multiple system operators that have expanded their grip on the industry through mergers and clustering, who adds an additional 8 percent to the consumer's bill.

Market Structure

Cable's market power stems from a lack of effective competition. Even at the national level, the multichannel video market has become concentrated; the problem is much greater at the local level.

- In markets where 98 percent of Americans live, a single cable operator dominates multi-channel video distribution with a market share that exceeds 80 percent.

Moreover, the growth of huge national operators and using regional clusters undermines the ability of overbuilders to launch competition. Large operators and clustered systems have more muscle to thwart competition and impose price increases.

- They can distribute programming terrestrially and refuse to make it available to competing distribution systems. This is becoming increasingly important as vertically integrated companies dominate "must have" regional sports programming.
- They can extract exclusivity deals from independent programmers, thereby denying programming to competing distribution media.
- They have more leverage over local governments to obstruct the entry of overbuilders

Direct Broadcast Satellite does not have a significant or substantial ability to discipline cable pricing abuse. Satellite is a niche product that has had its greatest success in areas where cable was unavailable or among customers who wanted high quality digital services with large numbers of channels (before cable could offer such a package).

- Cable has surpasses satellite in the number of subscribers to digital video service.
- It is bundling high-speed Internet and basic cable service to further erode the ability of satellite to compete.

Discrimination in Access

Cable operators discriminate against unaffiliated service providers in both the video and the high-speed Internet product space. Cable operators are 64 percent more likely to carry the networks that they own, than the networks provided by others. Broadcasters have used their retransmission rights to also gain preferential carriage deals for their shows. As a result, independent programmers are placed at a severe disadvantage.

Cable operators dominate the residential market for advanced high-speed Internet access, with an 83 percent market share. By refusing to allow unaffiliated Internet Service Providers to compete for Internet access customers over the cable modem platform, cable operators have foreclosed a critical high-end market, which dramatically reduces competition for Internet service. Virtually no voluntary carriage agreements have been signed by cable operators.

Cash Flow

A close look at cable's financial operations shows that rising costs cannot explain the rising price of traditional video services.

- In the aggregate, price increases far exceed the increase in programming costs.

- An allocation of non-programming operating costs based on historical patterns shows that operating cash flow from traditional video services has increased by approximately 70 percent on a per subscriber basis since the passage of the Telecommunications Act.

Sale of advanced services, digital tiers and high speed Internet, which were the motivation behind the recent system upgrades, has skyrocketed. The upgrades are paying for themselves.

- High-speed Internet is now the second largest income stream and digital tiers are the third largest streams of income for the cable operators, bringing in a combined $10 billion per year.

The Shape of Market Power on the Demand Side

Cable operators claim that adding more channels to their bundles increases the value of he package. Unfortunately, consumers are not given a choice of which channels to purchase. They must take nothing, almost nothing (basic) or almost everything (expanded basic). With the addition of the digital tier, they have another option, but cable operators have been moving popular channels (like HBO) to the digital tier to drive consumer bills up even farther.

Because the cable operators restrict consumer choice to this small set of bundles, it is impossible to know how consumer welfare has changed and wrong to claim that every show adds equally to consumer value.

- The average consumer watches about 17 channels regularly, but the bundles have four times that number.

- The top twenty shows account for approximately three quarters of all viewing.

- Almost nobody watches the bottom 30 channels in the bundle. Only about one out of every 250 households where these shows are available watches them on any given day.

The economics literature has long recognized that bundling by firms possessing market power can be anti-consumer and anticompetitive. When different consumers have strong preferences for different channels, putting them into bundles forces each consumer to pay for many channels he or she does not want in order to get the channels he or she does want.

A detailed analysis of one of the most popular and expensive channels, ESPN, which has been a focal point of controversy, shows that approximately four-fifths of cable subscribers would not pay the price of ESPN if they were given a choice. By forcing consumers to pay for the show in a bundle, wealth is transferred from consumers to cable operators (and the programmer).

A recent analysis that claims that the BLS overstates price increase and that prices have fallen on a quality adjusted basis is riddled with analytic and measurement errors. The analysis double counts the quantity of programming and vastly overvalues the shift from viewing over the air to viewing cable. Watching an hour rerun of the same show on cable, instead of a broadcast station is assumed to increase consumer value by one hour, even though the exact same show is watched. Correcting these errors shows that the BLS cable price index yields, at best a lower limit on the quality adjusted price increases.

- In contrast to the 15 percent real decline that the NCTA analysis claims, the BLS shows a 27 percent increase. The actual quality adjusted price increase could be as high as 40 percent.

The embedded base of excess prices and the entrenched market power of the cable operators, reinforced against satellite and extending into the high-speed Internet, confront policy makers with a critical problem. After two decades of abuse, and eight years after the Telecom Act of 1996, it is clear that policymakers made a mistake in deregulating cable. It is time for policymakers to take steps to promote real competition and protect consumers from further abuse.

United States Senate
COMMITTEE ON THE JUDICIARY
WASHINGTON, DC 20510–6275

February 11, 2004

Mr. David Walker
Comptroller General
General Accounting Office
441 G Street, N.W.
Washington, DC 20548

Dear Mr. Walker:

We are writing to request a study on an issue related to competition within the subscription television, or Multi-channel Video Programming Distribution (MVPD), market. In particular, we would like to examine the extent to which direct broadcast satellite (DBS) competes with wire based cable television companies in different types of geographic markets.

In the last ten years, satellite video services have emerged as an important player in the overall MVPD market. According to the FCC's January 2004 Tenth Annual Report on video competition, as of June 2003 DBS represented a 21.6% share of the national MVPD market. However, little is known regarding how this DBS market share varies in different types of localities (i.e., urban, suburban and rural markets), and also whether the cable industry's upgrading of its systems to digital cable services have affected the rates at which consumers subscribe to DBS.

Incumbent cable companies contend that they face vigorous competition from DBS in all areas across the country, and that therefore the MVPD market is a fully competitive marketplace. Others contend that DBS is a less effective competitor in certain areas, such as high density urban areas where it may be difficult to receive DBS signals, or in areas in which cable incumbents have upgraded their systems to offer digital cable. This study will help provide needed empirical data to understand the competitiveness of DBS in the MVPD markets.

We therefore specifically request that the GAO study and compare the market share of DBS in the following types of markets –

1. Densely populated urban markets
2. Suburban markets
3. Rural markets
4. Markets where DBS has little or no wire based cable competition.
5. Markets where DBS competes primarily with analog only cable television systems
6. Markets where DBS competes primarily with digital cable television systems, and
7. Markets where DBS competes primarily with digital cable TV upgraded to provide Video-on-Demand and bundled services including broadband internet and voice.

In addressing these issues, we encourage GAO to contact whomever necessary to get a full understanding of the issues involved. We also encourage the GAO to pursue whatever related topics it determines are necessary to produce a comprehensive document.

Please contact Jeff Miller or Seth Bloom of Senator Kohl's staff at (202) 224-3406 or Pete Levitas of Senator DeWine's staff at (202) 224-9494, of the Subcommittee on Antitrust, Competition Policy, and Consumer Rights, to discuss this request and associated reporting requirements.

Thank you for your assistance in this inquiry.

Sincerely,

Mike DeWine

MIKE DeWINE
Chairman, Subcommittee on
Antitrust, Competition Policy and
Consumer Rights

Herb Kohl

HERB KOHL
Ranking Member, Subcommittee on
Antitrust, Competition Policy and
Consumer Rights

News From:

U.S. Senator
Russ Feingold

506 Hart Senate Office Building
Washington, D.C. 20510-4904
(202) 224-5323

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Contact: Trevor Miller
(202) 224-8657

Statement of U.S. Senator Russ Feingold
At the Senate Judiciary Committee Hearing on Cable Industry Competition

February 11, 2004

I want to thank Chairman DeWine and Senator Kohl for convening this hearing on the continuing increase in cable rates. I believe this is a very important consumer issue and one on which Congress and the American people deserve some answers.

I am alarmed by the soaring cable rates that consumers in Wisconsin and across the country have had to endure. For too many years, I have been hearing from my constituents about the rising cost of basic cable and the many other services that are bundled together for the consumer like high-speed Internet connections, wireless phone service and digital television.

For all of the promises of more services for less money, since 1988, average cable rates have increased each year. Between the enactment of the Telecommunications Act of 1996 and today, rates have jumped by over 40 percent, almost three times the rate of inflation. In my home state of Wisconsin, the problem is exacerbated in rural communities where there is no meaningful competitor to the local cable operator.

Over the years, I have been actively engaged in efforts to foster true competition in the cable industry, and I hope today's hearing will help spur Congress to act responsibly. I am concerned that as more and more services are bundled together and companies claim to offer new "special" prices for these bundled services that we lose sight of the fact that already high prices actually keep getting higher.

About two-thirds of the households in this country rely on cable for their television programming. And more and more households receive their Internet services from a cable company as well. We now rely on cable for entertainment and information. More

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Middleton, WI 53562
(608) 828-1200

517 E. Wisconsin Ave.
Milwaukee, WI 53202
(414) 276-7282

First Star Plaza
401 5th St., Room 410
Wausau, WI 54403
(715) 848-5660

425 State St., Room 232
La Crosse, WI 54603
(608) 782-5585

1640 Main Street
Green Bay, WI 54302
(920) 465-7508

and more, cable has become part of the monthly budget for the average consumer. And instead of the cost going down because so many people now use the service, the cost just keeps rising.

What I hear time and time again is not that we need hundreds of channels or more bells and whistles for our televisions but rather that we need prices that families can afford. I believe that we have a responsibility to ensure that there is meaningful competition across the technological spectrum.

Without competition, cable companies have no incentive to keep rates low, and consumers have nowhere else to turn for the products they provide. As the GAO study confirms, when there is meaningful competition in a community, like a broadband or satellite service provider, then cable rates will decrease. I believe Congress has a responsibility to ensure that there is true competition in the marketplace.

According to the GAO report, cable companies charge 15-41 percent less for the exact same programming in areas where they face competition. If applied across the country, the savings for the American consumer would equal more than $4 billion dollars.

So, I was more than a little surprised to read in a recent Business Week interview with Rupert Murdoch, the new owner of DirectTV, that when he was asked if he intended to undercut cable's prices, he said that he wasn't (quote) "going into a price war with anyone." If Rupert Murduch isn't willing to compete then we need make sure our rules will allow someone else to offer the American people a better price.

I am looking forward to hearing about how Congress can protect new entrants in the marketplace. As we watch the providers of cable and satellite continue their vertical integration of the industry by controlling the distribution and production of content I wonder if an independent operator trying to reach homes across America today, like Ted Turner once did, would have the same opportunity? Or have we gone so far in allowing the vertical integration between those who create the content and those who distribute the content that new entrepreneurs can never enter the marketplace with any realistic chance of survival?

Mr. Chairman, thank you again for holding this hearing. Let me ask a few questions of the witnesses.

# # #

News Release
JUDICIARY COMMITTEE
United States Senate • Senator Orrin Hatch, Chairman

February 11, 2004 Contact: Margarita Tapia, 202/224-5225

Statement of Senator Orrin G. Hatch
Before the United States Senate Committee on the Judiciary
Subcommittee on Antitrust, Competition Policy and Consumer Rights
Hearing on

"CABLE COMPETITION – INCREASING PRICE; INCREASING VALUE?"

First, I would like to thank Senator DeWine and Senator Kohl for the work that they do as the Chairman and Ranking Democratic Member of this subcommittee, and I commend them for holding this important hearing.

As its title suggests, today's hearing will focus in part on whether the strongly increasing cable prices paid by consumers across the nation actually reflect an increased value in cable television services. I would like to turn that around and, before I address the issue of price, comment briefly on the *value*, or more accurately, the *values* reflected in television programming today. I am sincerely troubled by some of the programming that is being aired on both broadcast and cable television. Beyond Janet Jackson and Justin Timberlake's deeply inappropriate display during the Super Bowl halftime show, I feel that certain recent programming has tended to reflect the least admirable qualities present in our nation, and sometimes crosses the line into denigrating the values that I and many of my constituents in Utah, as well as millions of Americans, hold dear.

Some of you may question what this has to do with cable competition and the antitrust laws. A partial answer may be that the enormous consolidation that has occurred in the cable and media markets, as well as the substantial vertical integration between these markets, appears to have resulted in increasing harmonization of programming across the country. I am sure that some of these concerns will receive attention in connection with Comcast's $66 billion bid to acquire Disney that was announced this morning. These issues also arose recently when many here in the Senate decried the loss of localism in media markets during the debate over media ownership rules. Now, it is not my intent to rekindle the media ownership debate or to pre-judge the proposed Comcast acquisition, but I would say that many of my constituents feel that the programming they and their families view these days on television seems to be targeted at an audience that has a distinctly higher tolerance for profanity and sexually-suggestive behavior than most of us. And although the most recent controversy involves broadcast television, some of the most offensive and indecent material comes from such large cable stations as FX and MTV. So, I would like to take this opportunity to encourage all media operators, broadcast and cable, to clean up their content.

Having voiced these concerns, I want to emphasize that I do not mean to necessarily equate *big* with *bad*. I believe that much of the recent consolidation in media and entertainment markets has the potential to benefit consumers in the long run. However, as I have frequently stated, it is essential that consumer choice be preserved. In this case, that should include the ability to choose not to be exposed to objectionable material.

Turning to the narrower issue of competition in the market for subscription television, I am pleased to note that recent reports by the Federal Communications Commission and the General Accounting Office indicate that the greater competition between cable television and Direct Broadcast Satellite (or DBS) services that has emerged in the last several years has, on the whole, resulted in increased access and improved service for consumers. It is less clear, at least to me, whether current levels of competition adequately discipline price increases. Over the past ten years, inflation – as measured by the Consumer Price Index – has gone up about 25 percent, while by some measures cable prices have increased more than 50 percent during the same time period. While this disproportionate increase in cable prices is partially explained by increases in programming costs – and, in particular, the skyrocketing price of some sports content – I am concerned that higher costs may begin to significantly limit the ability of consumers to afford subscription television service. Interestingly, the recent GAO study indicates that facilities-based competitors – often referred to as overbuilders – may be successful in providing price competition in markets where they compete with incumbent cable service providers. I think this is something that deserves our ongoing attention, and I commend Senators DeWine and Kohl for their work on this issue.

I look forward to hearing more from the panel of witnesses today about emerging issues arising as a result of quickly-evolving technology and changing competitive landscape in the communications sector. In particular, I hope that the witnesses will address the increased competitive significance of bundled service offerings that combine subscription television, local telephone, and high-speed Internet services into a single package. Also, I hope that we will touch on the advent of Voice-over-Internet-Protocol technology and how it is expected to be deployed to provide local telephone service.

Finally, I thank all of the witnesses for being here today, and again commend Senators DeWine and Kohl for holding a hearing on these important issues.

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Written Statement of Rodger Johnson
President and CEO of Knology, Inc.
and
Chairman, Broadband Service Providers Association

Submitted to:
U.S. Senate Judiciary Antitrust Sub-committee
February 11, 2004

Good morning. I want to express my appreciation to Senators Kohl and DeWine for sponsoring the GAO Study that has just been released. I also want to thank you for the opportunity to participate in this hearing and provide additional testimony regarding competition in the MVPD market. I am pleased to represent both Knology and the Broadband Service Providers Association (BSPA), a trade association that represents most of the companies that the GAO referred to as wire-based competitors to incumbent cable operators in its most recent study on cable rates and competition.[1] The facilities-based, last mile systems that Knology and my fellow BSPA members build today provide residential and small business customers with what we refer to as a "triple play" -- cable television, voice telephony, and high-speed Internet access to the Internet, all over a single, integrated broadband network.

Knology and other BSPs have been constructing competitive broadband networks and providing bundled video, voice and data services since the mid 1990s. To date, members of the BSPA have raised and invested over $6 billion in new, state-of-the art broadband networks providing competitive video, voice and data offerings to over one million customers around the country. Knology and its fellow BSPA members currently

[1] *See Telecommunications: Issues Related to Competition and Subscriber Rates in the Cable Television Industry* (General Accounting Office, Oct. 24, 2003)(the "GAO Report").

provide over two million units of service, known as revenue generating units or RGUs, to their one million customers.

Consumers are reaping the benefits of this capital investment in competitive networks. This new GAO Report again documents that customers in communities served by Broadband Service Providers, or BSPs, realize up to 15% lower cable television rates than consumers in communities where there are no wire-based competitors.

The BSPs have shown that they not only provide consumers with a demonstrable benefit on pricing and services, but they are proving the economic strength of their business model. When ranked against other cable providers, for example, Knology is number one in telephone penetration of basic cable subscribers and number one in high-speed data penetration of basic cable subscribers.[2] At the same time, Knology has a lower net debt to EBITDA ratio than some other incumbent cable providers such as Insight and Charter.

These BSP systems are models for the type of competition envisioned by Congress in passing the Telecommunications Act of 1996. They are one of the examples of networks that provide true facilities-based competition to residential customers for voice, video and high-speed data services. The key issue for policy makers today is whether the legislation and its implementation, as it currently exists, supports the development of competition for cable services.

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[2] *See Kagan Media Services 2003*

Knology and the BSPA are primarily concerned with three issues that, if not addressed, could slow the deployment of competitive broadband networks in communities around the country.

First, regulators must not mistake competition between cable and DBS with wire-based head-to-head competition between incumbent cable operators and BSPs. We are concerned with incumbent cable providers using DBS competition as an excuse to argue for elimination of competitive safeguards added by the 1992 Cable Act that help constrain incumbent conduct that would otherwise inhibit the rollout of competitive broadband networks. It can be misleading to talk about whether video competition exists locally by using national averages.

While it is true that Satellite now has about 22% of the total MVPD market, our experience is that the market share of DBS varies from over 90% to under 5% depending on the type of competition they face in specific markets. There are at least 4 different market structures worth evaluating:

1. Areas where Satellite has no cable competition
2. Areas where Satellite competes with Analog Only Cable
3. Areas where Satellite competes with Digital Cable
4. Areas where Satellite competes with Enhanced Digital Cable bundled with high-speed data, and voice.

We believe the data will show that in markets where an incumbent cable provider has fully upgraded its network to provide digital video and high-speed internet service, satellite penetration will fall well below the national average. In our experience, a fully upgraded cable provider often maintains a cable market share of 90% or greater when they are only competing against a satellite provider. We do not believe that a market with 90% or more of the market concentrated with one provider should be declared fully competitive. Such a finding would rob large numbers of consumers of the benefit of competitive video services.

We ask for your support to publicly document the state of competition in local markets through an additional GAO study. We are requesting a study of the state of competition in local markets with a variety of market conditions. We believe such a study would show why, even with the presence of a national satellite service, the cable television industry is not yet fully competitive, despite the industry's public rhetoric to the contrary. We would then request that this market analysis become part of the FCC's annual assessment of competition. Remember the GAO and the FCC studies only noted the consumer pricing advantage where BSP competition exists and not where only satellite competition exists.

The second key issue to the success of the deployment of competitive broadband networks is ensuring continued access to the content necessary to compete. Specifically, while the 1992 Cable Act recognized that assured access to programming networks is critical to competitive entry of competing distributors to incumbent cable operators, the protections of the 1992 Cable Act were limited to satellite-delivered programming. Programming delivered by land-based facilities does not enjoy the protection of the 1992 Cable Act. This has become to be known as the "terrestrial loophole."

Incumbent cable providers have evaded application of the program access protections in the Cable Act by migrating regional sports programming and other critical regional programming services to terrestrial-based distribution. As a result of this terrestrial loophole in the Cable Act, BSPs and other competitors are often denied access to vital regional sports and news programming that consumers demand because the access to the programming is controlled by incumbent cable operators. Incumbent cable providers use access to programming to limit the expansion of BSP service offerings. Examples of incumbent cable operators denying access to their programming to BSPs include:

- SportsNet in Philadelphia, PA.
- Regional sports in St. Cloud, MN.
- New England News in Boston, MA.
- Regional news in Concord, CA.
- Overflow sports programming in New York, NY.
- NESN HDTV (Bruins & Red Sox) in Boston, MA.
- SoapNet in Los Angeles, CA.
- SoapNet in Marshall, MN.
- RFD-TV in all MediaCom Communities.
- University of Missouri Sports in Kansas City, MO.

The FCC has repeatedly and conclusively acknowledged the critical nature of this issue, finding that continuing program access issues are real, abuse of vertical integration or market power is likely, and fair access to essential content is critical for the development of distribution competition. The Commission has concluded, however, that existing legislation does not provide it with the authority to promulgate rules prohibiting exclusive arrangements involving terrestrially-delivered programming. It is now time for Congress to step in and close the terrestrial loophole and address the expanding issues of fair access to content created by new technologies and distribution platforms.

Third, the BSP industry is threatened by other types of anti-competitive actions by incumbent operators, such as targeted predatory pricing campaigns and related predatory conduct designed to prevent entrants from getting a foothold in a particular market. In the face of BSP entry some incumbents are now pursuing targeted, discriminatory pricing strategies that have become more aggressive in the last 18 months, to the point where current offers in many cases are below any estimate of variable cost. For example, one Midwest incumbent has been so aggressive as to offer Expanded Basic Cable for $5.00 per month for a year. Data related to this and many other examples of pricing below $15.00 per month is also available. Predatory pricing strategies are frequently accompanied by substantial price increases in surrounding markets that do not yet have the benefit of facilities-based competition. The communities in these surrounding areas, in effect, subsidize the economic cost of the predatory pricing behavior of the incumbent cable provider. While the success of predatory pricing has been mixed for the incumbent cable providers, such behavior punishes consumers in the non-competitive areas and it can stop or slow the BSPs ability to attract capital for network expansion.

The FCC has recognized the public harm inherent in predatory pricing and similar anti-competitive conduct. In the context of the AT&T Broadband/Comcast merger, for example, the FCC found that the representations of AT&T Broadband and Comcast "leave open the substantial possibility" that AT&T Broadband and Comcast "may well have engaged in questionable marketing tactics and targeted discounts designed to eliminate MVPD competition and that these practices ultimately may harm consumers."[3] The Commission also disagreed that targeted discounts merely reflect healthy competition:

> In fact, although targeted pricing between and among established competitors of relatively equal market power may be procompetitive, targeted pricing discounts by an established incumbent with dominant market power may be used to eliminate nascent competitors and stifle competitive entry. . . . [T]argeted pricing may keep prices artificially high for consumers who do not have overbuilders operating in their areas because of the overbuilder's inability to compete against an incumbent who uses such strategies.[4]

The Commission went on to state that regulatory action may be warranted: "Mounting consumer frustration regarding secretive pricing practices and the threat that such practices pose to competition in this market suggest, however, that regulatory intervention may be required either at the local, state, or federal level."[5]

In one sense, targeted low cost discounts are a relatively low cost strategy to the incumbent because such discounts are only offered to customers that have access to competitive BSP service. In addition, these aggressive discounts are only offered to a very limited customer group and are subsidized by rates in areas where the incumbents do not face similar competition.

[3] *Applications for Consent to the Transfer of Control of Licenses from Comcast Corporation and AT&T Corp., Transferors, to AT&T Comcast Corporation, Transferee, Memorandum Opinion and Order*, 17 FCC Rcd 23246, 23292-93 (2002).

[4] *Id.* at 23292-93.

[5] *Id.* at 23293.

As a general matter, the Communications Act prohibits targeted discounting of cable services. For example, Section 623(b) states that "[a] cable operator shall have a rate structure, for the provision of cable service, that is uniform throughout the geographic area in which cable service is provided over its cable system." The Act goes on to state in Section 623(b)(1), however, that such a uniform rates structure is not required in geographic areas in which the cable operator faces "effective competition," as defined in Section 623(l)(1) of the Act.

Section 623 requires the Commission to find there to be effective competition in a market in which, among other possible independent justifications, a competitive MVPD offers service to at least 50 percent of the households in the franchise area and at least 15 percent of households in the area actually subscribe to any competitive MVPD.[6] Because satellite providers are considered to be MVPDs,[7] an effective competition showing usually merely requires that a total of 15 percent of households in a franchise area take satellite service.

In addition, a finding of effective competition can result when a cable provider with an ILEC affiliate enters any market. Knology has a subsidiary that is a rural ILEC providing telephone service to a small community on the Alabama/Georgia border. Cable incumbents have used this subsidiary to receive findings of "effective competition" from the FCC before Knology has an opportunity to market its services in any of its markets.

[6] *See* 47 U.S.C. § 543(l)(1)(B).

[7] 47 U.S.C. § 522(13).

The irony is that the current effective competition triggers, by themselves, do not sufficiently protect consumers and new entrants from discriminatory pricing practices of dominant incumbent cable operators, and allows incumbents to pursue targeting pricing strategies intended to thwart competition. The legal test for effective competition should be adjusted to promote the development of competition in the local market instead of hindering local competition.

In closing, Broadband Service Providers have shown that in markets they serve, consumers enjoy the benefits of lower prices for broadband services. In order to continue to expand the availability of competitive broadband services, broadband service providers need policymakers to recognize that the market for cable television is not fully competitive and care must be taken to prevent incumbents from erecting artificial entry barriers and engaging in predatory pricing behavior. Moreover, access to content is a threshold issue that needs to be addressed in the upcoming session. I want to again thank you for this opportunity to be with you this morning and look forward to your questions.

News from

HERB KOHL

United States Senator
Democrat of Wisconsin

330 Hart Senate Office Building • Washington, D.C. 20510 • (202) 224-5653

FOR IMMEDIATE RELEASE: February 11, 2004
Contact: Lynn Becker or Zach Goldberg Phone: (202) 224-5653

Statement of U.S. Senator Herb Kohl on Cable Competition

Mr. Chairman, thank you for holding this hearing today. In the cable arena there are certain simple truths. First, consumers pay more and more every year – indeed, increases in consumers' cable bills are now just about as predictable as the change of seasons. Second, cable companies make more and more money from those increased prices. And today we can add a third: where real competition exists to cable, prices are lower – often dramatically so.

At our subcommittee's April 2001 hearing, we reported that cable prices had increased nearly three times the rate of inflation since the passage of the 1996 Telecom Act. Today, the just released FCC Video Competition Report finds that little has changed since 2001. In the year ending June 2003 cable rates rose more than 5%, about two and a half times the rate of inflation. During the last ten years, cable prices rose about 53%, far in excess of the overall 25.5% inflation rate.

While the prices consumers paid continued to escalate, so did the cable companies' earnings. The FCC Report found that the cable industry's cash flow has increased more than 25% since 2001, and estimated the industry's profitability at 41% in 2003.

So, prices and profits go up dramatically in the absence of competition. The GAO report we commissioned provides today's news. It found that the cable industry reacts to competition with lower prices and better service. In virtually all communities where more than one cable company competes for customers, video prices are lower by 15 to 41%.

Therefore, our conclusion is simple. Real competition benefits consumers and keeps prices down. Our challenge is how to make competition a reality. Despite what the cable companies assert, satellite is not a complete substitute for cable in most markets, particularly in urban areas where many residents are unable to receive satellite. The key to video competition is the presence of cable "overbuilders," companies that have built new cable systems to compete with the incumbent operators.

Unfortunately, these new cable companies face a range of obstacles which seriously harm their ability to survive. We have heard many disturbing stories of allegedly anticompetitive and predatory conduct by the cable incumbents such as below cost pricing designed to drive their new rivals out of business. Additionally, ties between programmers and the cable incumbents often make it difficult for competitors to obtain access to the very programming consumers demand.

--More--

It is essential that these new challengers be given the breathing room to survive so that consumers can reap the benefits of true competition. Therefore, we will propose the following measures:

First, ensuring that competitors have access to all essential programming owned by the cable incumbents by closing loopholes in the program access laws;

Second, we urge that the Justice Department investigate allegations of predatory behavior by incumbents thoroughly, and take action to stop conduct which violates antitrust law. Further, we need to seriously consider legislation that requires cable companies to price uniformly in each market, to halt predatory behavior; and

Third, a GAO study to determine whether satellite TV is truly an alternative to cable.

In closing, we should commend the cable industry for the billions of dollars it has invested to upgrade the quality of service in many areas. And the cable industry is unquestionably bringing much needed competition to local telephone companies. Yet we must not lose sight of the fundamental problem that brings us here today -- American consumers have suffered for too long with unceasing cable price increases and a lack of competitive choices. Today's hearing will be essential to determining how we can ensure that competition flourishes in this industry.

# # #

U.S. SENATOR PATRICK LEAHY

CONTACT: David Carle, 202-224-3693 VERMONT

Statement of Senator Patrick Leahy
Hearing Before the Subcommittee on Antitrust, Business Rights, and Competition:
"Cable Competition – Increasing Price; Increasing Value?"
February 11, 2004

I want to thank both Senators DeWine and Kohl for holding this hearing today on an issue that is so important to the people of Vermont and indeed to consumers across the country. The timing of this hearing is also particularly appropriate. Three reports recently released by the Federal Communications Commission and the General Accounting Office reveal what we all intuitively know to be true – greater competition among cable and satellite providers results in better prices, more options, and improved service for consumers.

When Congress passed the Telecommunications Act of 1996, I was one of five Senators to vote against the bill. I expressed reservations at the time that the competition predicted by many would fail to materialize. My concerns were not ill-founded. The October 2003, GAO report notes that cable rates in this country have far outstripped the rate of inflation. In the last 10 years, the Consumer Price Index has risen by approximately 25.5 percent, while cable rates have gone up 53.1 percent. From my home state of Vermont, I have heard complaints from a number of constituents, rightly upset at substantial increases in their cable subscription fees. And, as is the case in all but 2 percent of the television markets across the U.S., there is no wire-based competitor available to Vermonters wishing to change services.

I know that we will hear testimony today attributing the increase in subscription costs largely to the increases in programming costs incurred by content providers. But, at least in markets where there is only one wire-based cable provider, why do we not see downward market pressure on content providers acting to keep programming prices low? And if there is no meaningful downward pressure exerted on the cable market, what will prevent cable prices from continuing to skyrocket? When sports programming licensing fees increase 59 percent in a three year period, as they did between 1999 and 2002, what would lead us to expect that this upward spiral will cease? I do understand that some of the increased price of cable reflects increased quality – more and better programming. But what will this do for the bottom line of consumers making tough budgeting choices?

Subscription video services have become a vital component of America's information infrastructure, and cable accounts for the majority of that market across the country. According to the FCC, 67 percent of households today subscribe to cable television services, and many others subscribe to satellite DBS services. In Vermont, those numbers are different – we have the highest penetration of satellite of any state in the country, and correspondingly fewer cable subscribers – but we do lack much, if any, wire-based competition to Adelphia, which is the cable company serving those Vermonters. Many satellite subscribers in Vermont have no cable alternative, and vice-versa – so it is of real concern when the prices spiral out of control for services Vermonters have come to depend on, and no real options exist in terms of alternative providers.

I am further concerned that as a variety of factors conspire to raise the cable rates borne by consumers, fewer people will be able to afford access. It is my goal, and should be the goal of this body, to provide access to high quality programming to as many Americans as possible. The data from the FCC and GAO sho
w us that the best way to keep prices low and to improve the quality and quantity of program offerings is to increase competition. While there is a discrepancy in the exact amount of this reduction, all three reports show competition reduces cable rates. The October 2003, GAO study finds that there is a 15 percent reduction in the cost of cable service when there are two wire-based cable competitors. While the impact on cost is less pronounced in the case of satellite providers, the GAO found that better service and programming options accompany this form of competition.

Finally, although I know that my colleagues on the Antitrust Subcommittee do not intend to specifically address media consolidation, it is an issue that is impossible to avoid whenever we talk about providing choices to consumers at a fair price. Indeed the GAO report points to this as an area of concern, although the exact effects are difficult to statistically quantify. If nothing else, the data show that ever-tightening bonds between corporate control of content and of distribution are having an anticompetitive effect on what consumers can see on their screens, and likely on how much they have to pay for it. This has been, and continues to be, an area of great concern to me, and one that I hope our witnesses will address.

Many of the technological issues dealt with by the Judiciary Committee, and the Senate as a whole, are never really put to rest. In the fast-paced world of technological change, providing access to the latest and best information at a fair price to consumers is one such issue, and I am sure this is not the last time we will meet to discuss these concerns. I appreciate all of the witnesses being here today, and I look forward to their testimony.

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RESPONSE OF
THE NATIONAL CABLE & TELECOMMUNICATIONS ASSOCIATION

TO

ALLEGATIONS CONTAINED IN NATOA'S MARCH 2003 REPORT
AS SUBMITTED FEBRUARY 11, 2004
DURING THE SUBCOMMITTEE HEARING ON
"CABLE COMPETITION – INCREASING PRICE; INCREASING VALUE?"

SUBCOMMITTEE ON ANTITRUST,
COMPETITION POLICY AND CONSUMER RIGHTS
COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE
WASHINGTON, D.C.

MARCH 11, 2004

INTRODUCTION

The National Cable & Telecommunications Association ("NCTA") submits this response to the "Report on Anticompetitive Practices by Incumbent Cable Operators," which the National Association of Telecommunications Officers and Advisers ("NATOA") submitted to the Senate Judiciary Subcommittee on Antitrust, Competition Policy and Consumer Rights with its testimony on February 11, 2004 ("NATOA Report").

As an introductory note by NATOA makes clear, the report was actually prepared a year ago and was presented to NATOA's Board of Directors in March 2003. The report purports to describe various actions by cable operators that supposedly have posed a "significant and growing threat to competition in the cable industry."

NATOA's introductory note specifically cautions that the examples cited in the report are based on media reports and allegations by local governments and "have not been further tested." NATOA therefore "encourage[s] readers to verify accuracy of any information which may have changed as a result of passage of time." Those warnings are well placed. Many of the allegations contained in the report are, in fact, stale, inaccurate or unverifiable.

Moreover, there are judicial and regulatory forums available to parties with legitimate complaints of anticompetitive conduct. There are no cases in which a judicial or regulatory body has confirmed the unfairness or unlawfulness of any of the conduct alleged in the report. In several cases, however, the allegations raised in the NATOA Report have subsequently been considered and <u>rejected</u>.

This is not surprising because the actions described in the report are generally not anticompetitive and harmful to consumers. Quite to the contrary, <u>offering lower prices or special</u>

promotions to attract or win back customers from competitors is not something that generally thwarts competition; it *is* competition, and consumers are the beneficiaries. Only in very limited circumstances are such tactics ever viewed as "predatory" and anticompetitive – and those circumstances do not exist in the examples of supposedly predatory conduct set forth in NATOA's report.

Some competitors of incumbent cable operators – who themselves often enter the marketplace with aggressively low prices and promotions – might have an easier time competing if the incumbents were barred from offering their own low prices and promotions. But protecting competitors *from* competition is the antithesis of promoting competition, and consumers are the ultimate victims of such protectionism.

PREDATORY PRICING

The NATOA Report is rife with allegations that cable multiple system operators (MSOs) have, in various instances, sought to compete with other wireline providers by offering prices that are below their nationwide average costs.[1] What this means, according to the report, is that (1) the MSOs must be losing money with such offers; (2) they must be subsidizing such below-cost offers with their profits from non-competitive markets; and (3) they must be offering such offers in order to drive their competitors out of business.

None of these conclusions are correct. As courts and antitrust experts have recognized, there is nothing inherently predatory in merely pricing below average costs. It is not necessarily a money-losing proposition for a company to sell goods or services at such prices. Only when a

[1] For example, NATOA claims that the city of Scottsboro, Alabama "showed that Charter's monthly rate of $24.95 to Scottsboro's subscribers was $0.87 less than its *nationwide average monthly operating expense* of $25.82 per subscriber." NATOA Report at 11 (emphasis added).

company sells goods or services at prices that are below average *variable* costs does a company lose money on each sale.[2]

It is not hard to understand why this is so. Companies have fixed costs and variable costs. The fixed costs – such as land, equipment, furniture, and factories – are incurred by the company regardless of how many purchases are made. The variable costs are the additional costs incurred with each additional purchase. If a company offers to sell a product or service for less than the variable costs associated with selling that product or service, it will lose money on each sale. It would be better off not selling the product at all.

But if a company offers to sell a product or service for more than the variable cost of selling that product or service, it will earn money on each sale. It may not make enough money to recoup all its fixed costs associated with the product or service – but those costs will be incurred whether or not it makes the additional sale. Therefore, the company will clearly be better off if a customer buys its product or service at a price that exceeds its average variable costs than if the customer does not buy its product at all and instead buys from a competitor.

In none of the examples reported by NATOA is there any suggestion or allegation that that a cable operator's prices are below its average *variable* costs.[3] Nor is it likely that any prices or promotional offers would be below average variable costs, since so many of the costs of

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[2] *See* P. Areeda & D. Turner, *Predatory Pricing and Related Practices Under Section 2 of The Sherman Act*, 88 Harv. L. Rev. 697, 718 (1975). *See also, e.g., United States v. AMR Corp.*, 335 F.3d 1109, 1115 (10th Cir. 2003) ("For predatory pricing cases, . . . the ideal measure of cost would be marginal cost because '[a]s long as a firm's prices exceed its marginal cost, each additional sale decreases losses or increases profits.' [*quoting Advo, Inc. v. Phila. Newspapers, Inc.*, 51 F.3d 1191, 1198 (3d Cir. 1995)] . . . . A commonly accepted proxy for marginal cost is Average Variable Cost ("AVC"), the average of those costs that vary with the level of output. *See, e.g., Stearns Airport Equip. Co. v. FMC Corp.*, 170 F.3d 518, 532 (5th Cir. 1999); *Advo*, 51 F.3d at 1198; *Arthur S. Langenderfer, Inc. v. S.E. Johnson Co.*, 729 F.2d 1050, 1056 (6th Cir. 1984); *Northeastern Tel. [Co. v. AT&T*, 651 F.2d 76, 88 (2d Cir. 1981)].")

[3] As Charter has pointed out to the FCC, the supposed "costs" in the Scottsboro claim included a wide array of fixed costs that are not properly included under applicable antitrust (or FCC) analysis. *See Annual Assessment of*

providing cable service are fixed costs. In particular, the cost of constructing and maintaining a cable plant that passes all the homes in a cable community is a very large fixed cost. And this cost is incurred whether or not any particular household purchases cable service.

To gain a new customer or to win back a former customer, a cable operator could lower its price far below its average *total* costs and still make money, as long as the price was higher than its *incremental* costs of serving that customer (such as the cost of installation, the additional programming costs, and the cost of billing the customer). It would make more sense to do so than to leave the customer unserved or served by a competitor.

This has nothing to do with subsidizing low prices in one area with monopoly profits from another area. And it has nothing to do with unfair efforts to put a competitor out of business. It would be a rational thing to do, even if the cable operator served no other areas and operated no other systems.

In any event, as courts and economists have recognized, even pricing that is below incremental costs would only be harmful to consumers if it enabled the supposed predator to eliminate competitors and then recapture its losses by raising prices to monopoly levels. Otherwise, the only effect on consumers would be a temporary drop in prices – which is hardly to their detriment.[4] But even if a cable operator could, by temporarily reducing prices to money-losing levels, drive out a wireline competitor, it could not acquire monopoly power unless it were

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the Status of Competition in the Market for the Delivery of Video Programming, Reply Comments of Charter Communications, Inc., CS Docket No. 01-129, (Sept. 5, 2001).

[4] *See, e.g., Brooke Group Ltd. V. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 224 (1993) ("The second prerequisite to holding a competitor liable under the antitrust laws for charging low prices is a demonstration that the competitor had a reasonable prospect, or, under Section 2 of the Sherman Act, a dangerous probability, of recouping its investment in below-cost prices. . . . 'For the investment to be rational, the [predator] must have a reasonable expectation of recovering, in the form of later monopoly profits, more than the losses suffered.' [*Matsushita Elec. Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 588-589 (1986).] Recoupment is the ultimate object of an unlawful predatory pricing scheme. Without it, predatory pricing produces *lower aggregate prices* in the market, and *consumer welfare is enhanced*.") (Emphasis added).

also able to eliminate its two substantial national DBS competitors.[5] This is not remotely possible, and nothing in the NATOA Report suggests otherwise.

DISCRIMINATORY PRICING

Having failed to establish any instances of anticompetitive predatory pricing, the NATOA Report suggests that "targeted rate discrimination" – by which they mean "win-back" rates and promotions that are only available to customers who have switched or threatened to switch to competing providers – "can be anticompetitive and contrary to the public interest even if the perpetrator does not charge below-cost rates or have a reasonable probability of its recouping losses after driving its competitor out of the market."[6]

The report does not explain how this can be the case. What the NATOA Report is complaining about is the sort of vigorous struggle for customers that goes on all the time in competitive markets. For example, when Southwest Airlines made Philadelphia a new hub and cut rates to as low as $29, analysts concluded that it would be "suicidal" for US Airways not to

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[5] Those DBS competitors are themselves competing fiercely for cable's customers. DBS offers free dishes, free installation, and discounted programming packages. *See* Chris Serres, *Time Warner Offers 'Video on Demand' Service in Raleigh, N.C., Area*, NEWS & OBSERVER, July 6, 2002. Dish retailers routinely offer $199 rebate vouchers. *See, e.g.*, http://www.commercemarketplace.com/home/rbelanger/onhold/Free_Promotions.html. In a previous marketing campaign specifically directed at Charter, EchoStar's DISH Network offered 115 channels for $9 per month, and an additional $100 off a DISH Network TV system starting at $199. *DISH Targets Charter in Promotion*, SkyREPORT, Oct. 8, 2001 at http://www.skyreport.com/viewskyreport.cfm?ReleaseID=687#Story1. (The $9 price was available to all new subscribers, while the $100 off promotion was specifically limited to Charter subscribers). In announcing this campaign, EchoStar CEO Charlie Ergen said: "If Charter doesn't want to lose customers who switch to DISH Network, then their reaction should be better service and better pricing for their customers. We believe consumers, not Charter's lawyers, should decide who has lower rates. We challenge Charter to lower their rates." *Id.* Recently, both DirecTV and DISH have begun offering free second receivers and free digital video recorders (DVRs). Their SEC filings report huge subscriber acquisition costs – exceeding $400 per customer – attributable to such giveaways and promotional rates. Echostar DBS Corp.-N/A, Form 10-Q, filed Nov. 13, 2003 for period ending Sept. 30, 2003, Part I, Item 2 at p. 29; Hughes Electronics Corporation, Form 10-Q, filed Nov. 7, 2003 for period ending Sept. 30, 2003, Part I, Item 2 at p. 37. *See also*, George Mannes, Hughes Electronics Posts Subscriber Gains, TheStreet.com, at http://www.thestreet.com/_yahoo/tech/georgemannes/10142719.html .

[6] NATOA Report at 14.

cut prices.[7] Major airlines create new discount airlines, such as United's "Ted" and Delta's "Song," that underprice their own "standard" fares in order to compete with existing low cost carriers, such as Southwest and America West.[8] Sears, Home Depot, or Lowe's offer to "meet or beat" competitors' advertised prices. Many grocery stores will honor competitors' coupons. Mattress stores trumpet that they meet or beat competitors' prices.[9]

As discussed above, where pricing is not below incremental costs or there is no probability of recouping losses through monopoly pricing, consumers can only benefit from these sorts of competitive promotions, whether they are available throughout a community or are targeted at particular customers who have decided to switch. This, in fact, is precisely what the Public Service Commission of West Virginia recently found with respect to one of the alleged instances of targeted discrimination cited in the NATOA Report.[10]

After an extensive two-year proceeding, the West Virginia PSC concluded that Charter Communications' offering of reduced or promotional rates to defined categories of customers (including, and sometimes limited to, an overbuilder's subscribers) in Parkersburg was a reasonable competitive response that benefited consumers. The PSC found that the Parkersburg market was "characterized by . . . intense rivalry and competition" among an incumbent cable operator, a wireline overbuilder, and two national satellite services.[11] And it determined that, far from having an anticompetitive effect, "the promotional offers in the Parkersburg/Wood County

7 Ben Mutzabaugh, *Philadelphia Fare Wars Intensify*, USATODAY.com *at* http://www.usatoday.com/travel/deals/fare/compare.htm (last accessed February 20, 2004). *See also*, Melanie Trottman, *Southwest Air Rivals US Air in Philadelphia*, WALL ST. J., Dec. 12, 2003 at A8.

8 Paula Scuchman and Susan Carey, *Trouble in Low-Fare Land*, WALL ST. J., Feb. 13, 2004 at W1.

9 Matthew Kauffman, *No Rest for the Weary*, THE HARTFORD COURANT, Jan. 15, 2004 at E1.

10 *Community Antenna Serv. v. Charter Communications*, VI, LLC, Case No.01-0646-CTV-C, slip opinion, (WV Pub. Serv. Comm'n Feb, 10, 2004); *petition for recon. filed*, Feb. 17, 2004.

11 *Id. at* 13.

area have created an environment of *more* competition and has resulted in *lower prices to consumers.*"[12]

As the PSC pointed out, both the incumbent cable operator and the overbuilder offered similar targeted promotions – and, as a result, the number of customers switching from the incumbent to the overbuilder was almost equal to the number moving from the overbuilder to the incumbent. In these circumstances, the Commission concluded that it was not its "role to dictate market strategy in these competitive situations, *particularly when the effect is benefiting the public.*"[13]

In the context of common carrier regulation, the Federal Communications Commission also held that Verizon's marketing approach of offering special concessions to potential wireless phone customers in order to keep them from choosing another provider should not be deemed unreasonably discriminatory. The United States Court of Appeals affirmed the FCC's determination, noting that such an approach was good for consumers:

> In considering whether Verizon justified its sales concession practices as reasonable, the Commission was "entitled to value the free market, the benefits of which are well-established." *MCI WorldCom v. FCC,* 209 F.3d 760, 766 (D.C.Cir.2000). Haggling is a normal feature of many competitive markets. It allows consumers to get the full benefit of competition by playing competitors against each other. Here Verizon has adopted the practice as a competitive marketing strategy. Consumers, including Orloff, can only benefit.[14]

The FCC also recently rejected the complaint of Wide Open West ("WOW"), cited in the NATOA Report, that it was anticompetitive and unfair – and at odds with the customer service

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[12] *Id.* (emphasis added).

[13] *Id.* at 13-14 (emphasis added). *See also Implementation of Cable Act Reform Provisions of the Telecommunications Act of 1996*, Report and Order, 14 FCC Rcd 5296 ¶ 107 (1999)(" To paraphrase the Supreme Court, it would be ironic indeed if the standards for predatory pricing liability were so low that predatory pricing complaints themselves became a tool for keeping prices high.").

[14] *Orloff v. FCC*, 352 F.3d 415, 421 (D.C. Cir. 1993).

provisions of the 1992 Cable Act – for Comcast not to "disclose in writing to all of its customers each and every offer made to any customer for any reason for any period of time."[15] The FCC correctly recognized that WOW, an overbuilder competing with Comcast in the Detroit, Michigan area, was, in effect, "seek[ing] to preclude all win-backs and other promotional activities."[16] It rejected WOW's contention that such a result was consistent with the statutory objectives of the Act.

NON-UNIFORM RATES

The NATOA Report also notes that when Congress enacted the Cable Consumer Protection and Competition Act of 1992, it included a requirement that cable operators charge uniform rates throughout a cable franchise area.[17] In 1992, DBS had not yet been launched and cable was perceived by many as having no significant competition from other multichannel video programming distributors. The uniform rate requirement had the effect of incubating the development of such competition from wireline overbuilders by protecting them from targeted price competition.

But the uniform rate requirement Act was enacted as part of the rate regulation provisions of the 1992 Act, and therefore, as the D.C. Circuit confirmed, applied only to systems that were subject to rate regulation – *i.e.*, systems that were not subject to effective competition.[18] This

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[15] *In re Complaint Against Comcast Corporation*, Memorandum Opinion and Order, EB-02-MD-033, FCC 03-333, released Jan. 8, 2004, ¶ 9.

[16] *Id.*

[17] *See* 47 U.S.C. § 543(d).

[18] *See Time Warner Entertainment Co., L.P. v. FCC*, 56 F.3d 151, 191 (D.C. Cir. 1995). As the Court noted, requiring systems subject to effective competition to charge uniform rates would "undermine[] a hallmark purpose of the 1992 Act: to allow market forces to determine the rates charged by cable systems that are subject to 'effective competition' as defined by Congress. In other words, where 'effective competition' exists, the consumer is left to the wiles of the marketplace." *Id.*

made good economic sense. The protectionism of the uniform rate requirement would clearly be unnecessary and detrimental to consumers in those markets where cable operators faced effective competition and could not, therefore, have any chance of recouping targeted discounts with monopoly pricing.

In the Telecommunications Act of 1996, Congress confirmed the D.C. Circuit's interpretation of the statute and explicitly created an exception to the uniform rate requirement where a cable operator is subject to effective competition – an exception which is wholly consistent with the established standards for predatory pricing. The NATOA Report concedes that this exception "may sound reasonable in theory."[19] Its principal complaint is only that the FCC's application of the statutory "effective competition" standard has been misapplied. In its view, the FCC has found cable operators to be subject to effective competition where no such competition really exists.

Today, when virtually all television households have a choice of at least three providers of multichannel service, including a cable operator and two national DBS services, this stale complaint rings hollow. As the General Accounting Office recently confirmed, those DBS services now provide "formidable" competition to cable operators virtually everywhere.[20] In these circumstances, there is no reason to protect overbuilders from price competition – and to deny consumers the price breaks associated with targeted competitive discounts and promotions. Yet the NATOA Report suggests that steps be taken to ensure such protectionism in perpetuity.

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[19] NATOA Report at 15.

[20] *See* General Accounting Office, Report to the Subcommittee on Antitrust, Competition Policy, and Consumer Rights, Committee on the Judiciary, United States Senate, "Wire-Based Competition Benefited Consumers in Selected Markets," Feb. 4, 2004, p. 26 ("GAO Report").

EXCLUSIVE ACCESS TO MULTIPLE DWELLING UNITS

The NATOA Report also suggests that exclusive contracts to serve multiple dwelling units (MDUs) are thwarting competition from overbuilders. The report concedes, however, that the FCC recently examined this question in an extensive rulemaking proceeding and was unable to conclude that the adverse effects of such exclusivity on competition outweighed the procompetitive effects.

The Commission undertook to examine the question of exclusive contracts because some overbuilders had been making precisely the same sort of general and unsubstantiated allegations that are set forth in the NATOA Report. But when offered the opportunity to document their case, the overbuilders came up empty. The FCC found that

> [t]he record does not indicate the extent to which exclusive contracts have been utilized, and, more importantly, does not demonstrate that such contracts have thwarted alternative providers' entrance into the MDU market, so as to warrant imposition of limits on such contracts.[21]

What does the NATOA Report offer to counter the results of the FCC's comprehensive inquiry? Nothing but one more unsubstantiated anecdote involving exclusive contracts between Time Warner and MDU owners in Charlotte and Raleigh, North Carolina, which the report suggests caused the demise of overbuilder Carolina Broadband. But Carolina Broadband's own representatives have elsewhere made clear that it was "a lack of investments in a slowing economy"[22] and "the current drought in bank financing for emerging telecommunications"[23] – and not exclusive contracts to serve MDUs – that were the cause of their problems.

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[21] First Order on Reconsideration and Second Report and Order, CS Docket No. 95-184, MM Docket No. 92-260, 18 FCC Rcd 1342, 1369 (2003).

[22] "Cable Company Delays Network," *Charlotte Observer*, June 26, 2001, p. 1A.

[23] "We're Here To Stay; Carolina Broadband Is Taking a Time Out for Financing Drought To Pass, But Our Services Will Be Worth Waiting For," *Charlotte Observer*, July 3, 2001, p. 12A.

Thus, according to the minutes from a meeting on June 25, 2001, Carolina Broadband's CEO told the Charlotte City Council that:

> [t]he most daunting roadblock by far has been the global economy and its effect on businesses like theirs in the capital market. Over the long term, they can compete with the incumbent provider *and work through difficulties in getting on poles and into apartment buildings*, and they can handle most any other challenges that may come their way. What they can't control is the economy. . . . Despite their best efforts over the past six months, the deteriorating economic climate, including the virtual shutdown of the capital markets to emerging carriers such as Carolina Broadband, has made securing the remainder of the debt portion exceedingly difficult at this time.[24]

This, of course, is consistent with what the General Accounting Office found in its recent study of overbuild competition. GAO reported that all the overbuilders that it studied "have had difficulties securing continued access to adequate financial resources that are needed to rapidly construct their networks and market their services. As a result, the BSPs we interviewed are currently experiencing varying states of financial problems due to a lack of capital."[25] These problems have nothing to do with exclusive MDU contracts – or access to programming, or predatory or discriminatory rates, or any of the other supposedly anticompetitive practices alleged in the NATOA Report. According to GAO, "BSPs told us that, to a large extent, these financial problems are the result of the economic problems that have affected the entire telecommunications sector."[26]

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[24] Minutes of lunch briefing of City Council of the City of Charlotte, North Carolina, June 25, 2001 (Minutes Book 116, p. 613) (emphasis added).

[25] GAO Report, *supra*, at 5-6.

[26] *Id.* at 27.

ACCESS TO PROGRAMMING

The NATOA Report includes a lengthy complaint that the program access provisions of the 1992 Cable Act, which limit the right of vertically integrated, satellite-delivered program networks and cable operators to enter into exclusive contracts, includes a "loophole" exempting terrestrially delivered program networks. As NCTA has previously pointed out,[27] it is wrong to characterize the terrestrial exemption as a "loophole." To the contrary, Congress struck a deliberate balance in 1992. It sought to ensure that cable's fledgling competitors would have sufficient access to popular programming, while preserving the procompetitive benefits of exclusivity in order to foster new program networks – especially local and regional programming networks.

The current law preserves incentives to engage in the significant financial risk-taking necessary to launch and promote local and regional program services. At the same time, overbuilders can choose from among hundreds of channels of available programming.

As discussed above, there are many reasons why overbuilders have had difficulty competing successfully in a vibrantly competitive video marketplace that now includes not only the incumbent cable operator but also two formidable national DBS providers. But nobody has presented any credible evidence that limited exclusivity for a few channels among the hundreds otherwise available has had the effect of thwarting an overbuilder's ability to compete. The NATOA Report adds no new evidence and sheds no new light on the matter.

[27] *See* Letter of Steven K. Berry, NCTA Senior Vice President, Government Relations to Pete Levitas, Majority Staff Director and Chief Counsel, Senate Judiciary Subcommittee on Antitrust, Competition Policy and Consumer Rights, March 4, 2004.

CONCLUSION

The NATOA Report is filled with allegations of conduct by cable operators that has supposedly thwarted competition in the video marketplace. But the report fails to show how the conduct that it alleges harms consumers. To the contrary, the activities that NATOA characterizes as anticompetitive – in particular, discounted prices, promotional win-back offers, and exclusive contracts – are the hallmarks of a vibrantly competitive marketplace that benefits consumers. Barring such practices might protect certain *competitors* – but it would only harm *competition* and *consumers*.

TESTIMONY OF ROBERT SACHS
PRESIDENT AND CHIEF EXECUTIVE OFFICER
NATIONAL CABLE & TELECOMMUNICATIONS ASSOCIATION

on

COMPETITION AND OVERBUILDS IN THE VIDEO MARKET

Before the

SUBCOMMITTEE ON ANTITRUST,
COMPETITION POLICY AND CONSUMER RIGHTS
COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE
WASHINGTON, D.C.

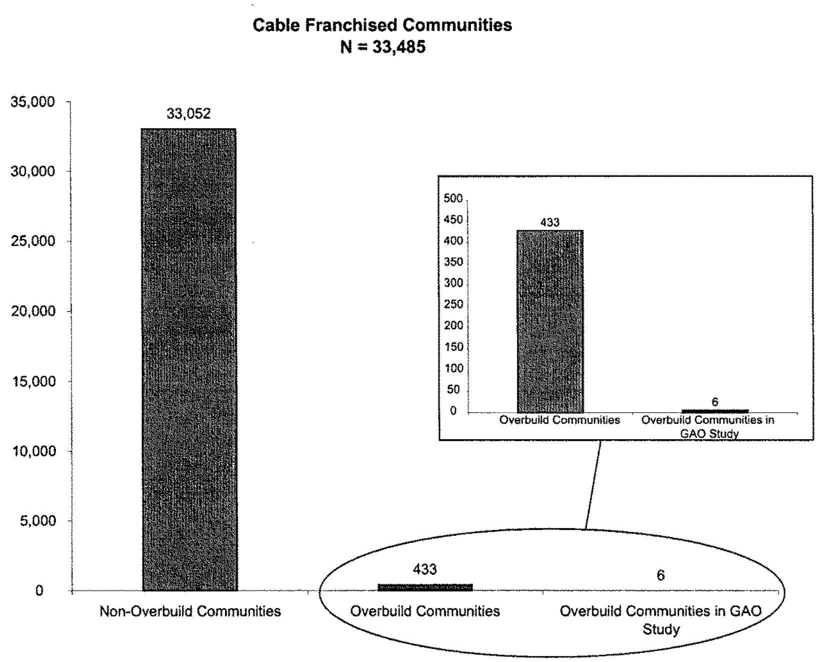
FEBRUARY 11, 2004

Mr. Chairman, Senator Kohl, and members of the committee, my name is Robert Sachs and I am President & CEO of the National Cable & Telecommunications Association. NCTA is the principal trade association of the cable television industry in the United States. It represents cable operators serving more than 90% of the nation's 73.4 million cable television households and more than 200 cable program networks, as well as equipment suppliers and providers of other services to the cable industry. Thank you for providing us with the opportunity to testify this morning.

Introduction

In assessing the subject of this hearing – namely, the competitive effect of wireline overbuilders on incumbent cable operators – it is appropriate at the outset to establish the context. There are more than 9,000 cable systems serving 33,000 communities in the United States. As is documented by the Federal Communications Commission's recent ten-year review of the status of competition in the video marketplace, virtually all those systems face vigorous competition from two well-established national Direct Broadcast Satellite (DBS) providers who together serve more than 21% of the multichannel video programming market. And, as the General Accounting Office has pointed out, this competition has resulted in an explosive growth of new video and non-video services, as well as slightly lower prices for cable subscribers.

While fierce competition from DBS is ubiquitous, competition between wireline cable operators is scarce – and often precarious. Only about 400 of the 33,485 cable communities nationwide have two competing franchised wireline providers. Many of these franchised overbuilders, however, have either never deployed and launched their services, launched and failed, or are in danger of bankruptcy.



GAO's most recent study of cable overbuilds is based on a tiny percentage of these rare communities. GAO examined only six overbuild communities, and compared them with six other communities that appeared to share certain characteristics with the overbuild communities but had only a single cable operator. The half dozen overbuilds exemplified many of the difficulties faced by overbuilders, and GAO identified the reasons for these problems.

A major reason was that overbuilders simply underestimated the extent to which the marketplace they chose to enter was already fiercely competitive. Overbuilders may have assumed that they could easily and profitably capture customers from incumbent providers with lower prices. But sustainable competition from DBS, which enjoys nationwide economies of scale, had already ensured that cable operators were providing the services that best met consumer demand, at competitive prices. So, overbuilders were caught in an economic bind. To entice customers away from the incumbent, they might have to charge lower prices than the incumbent. But those lower prices were insufficient to cover their costs and investment risk and were economically unsustainable for more than an introductory period.

Moreover, the vast majority of overbuilders only came into existence in the last few years. As rare as overbuilds are now, they were even less prevalent during the first four decades of cable's existence. Cable television is an extremely capital-intensive business. To serve a community, cable operators typically must deploy facilities that pass and extend to all households in the community, whether or not particular households choose to purchase their service.

The viability of such an investment required that a substantial portion of the homes passed by the system did choose to purchase the system. Competing builders, such as in the well known example of Allentown, Pennsylvania, who constructed systems simultaneously in an area where off-air reception was poor, had the best chance of being viable. But for many years, the prospect that multiple cable operators could build such facilities and each capture a sufficient number of subscribers to support their investment was, in most cases, implausible. Therefore, few overbuilds were deployed.

But several developments in the last decade of the twentieth century encouraged new overbuild ventures. For example, the technological ability to provide voice, video and data services over shared broadband facilities – and the emergence of the Internet as a new source of data services for consumers – altered the economics of overbuilds.

Existing telephone companies, whose narrowband facilities were not particularly well suited to the provision of video and Internet broadband services, made significant investments in new stand-alone broadband facilities so that they could offer video (and cable modem) service along with the telephone and DSL Internet services provided over their existing facilities. Meanwhile, the Telecommunications Act of 1996 encouraged the emergence of new "competitive local exchange carriers." With new broadband facilities, these new companies saw opportunities to offer competing cable television service and cable Internet service along with telephone service.

In short, the bundling of video, Internet and telephone services over shared facilities was expected to make it possible to provide an economically viable competing wireline cable service. But just as they may have underestimated the competitive effects of DBS, overbuilders also faced more competition and less demand for their non-video services than they anticipated.

The boom in wireless telephony (and the increasing availability of telephone service from incumbent cable operators and other competitive local exchange carriers) reduced potential revenues from telephone service. Similarly, vigorous competition between cable operators' cable modem service and telephone companies' DSL reduced the ability of overbuilders to subsidize their video prices with revenues from high-speed Internet service. And in this competitive environment, overbuilders have had serious difficulty obtaining the capital they anticipated and need to deploy and build out their systems.

What all this suggests is that the prices and service offerings of overbuilders at any recent point in time can hardly be viewed as representative of a "competitive" standard that all cable operators would meet if only they faced effective competition. To the contrary, cable operators do face effective competition in all the services that they provide. It's the prices and services offered across the nation by cable operators that face strong competition from DBS, DSL and competing telephony providers that provide the best indication of a competitive marketplace at work. There is no basis for looking to the prices offered by an anomalous handful of unprofitable overbuild systems as an appropriate benchmark for video prices.

Why Overbuild Prices Are Artificially or Uneconomically Low

With the foregoing in mind, it may still be useful to take a closer look at the small number of overbuild systems that have come into (and out of) existence in order to see why some recent studies – including GAO's most recent reports – have found that a snapshot of average prices of overbuilders tend to be lower than the prices charged by cable operators in areas without overbuilds. NCTA has done such an analysis.

Unlike GAO's most recent study, which looked at only six overbuild communities, we examined all of the 433 communities with identifiable overbuild systems for which information was obtainable. We confirmed that most of them did, in fact, display anomalous characteristics that explain why their prices (and the prices of competing cable operators in those communities) may, at least temporarily, be lower than prices in other communities. As analyzed more fully by Steven S. Wildman, Professor of

Telecommunication Studies at Michigan State University, in a white paper attached to this testimony, those anomalous characteristics show that lower rates do not indicate that those overbuild markets are more "competitive" than other markets. To the contrary, as Professor Wildman concludes, "[a] close look at overbuilders and the communities they serve shows that it would be imprudent to use prices in these communities as benchmarks for evaluating prices in other cable communities."[1]

1. Overbuild prices are often unsustainable. First of all, the vast majority of overbuilds have only been in existence for a very short time. <u>388 of the 433 overbuilds did not exist before 1996 – and 92 of them did not exist before 2001</u>. This means that it's impossible to view a snapshot of prices at any given point in time as representative of the stable prices of long-term, established competitors. (Typically, cable franchises are awarded for 15 years and then are eligible for successive renewal periods of 10 years.) A "moment in time" snapshot does not show whether the reported prices were sustainable for even an initial franchise term. It does not show how many overbuilders failed to survive with such prices. Nor does it show whether such prices were merely temporary and soon rose to higher levels.

In fact, <u>83 of the overbuilds that we identified either have failed and are no longer operational or are not yet operating to any meaningful extent</u>. In a competitive market, companies are expected to charge prices sufficient to cover their costs and to earn a fair, risk-adjusted return on their investment over time. The prices of companies that have failed or are failing obviously cannot be viewed as benchmarks for what competitive systems should charge.

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[1] S. Wildman, "Assessing the Policy Implications of Overbuild Competition," February 9, 2004, at 27.

The overbuild landscape is populated with such failed or failing companies. Some, like Altrio, Everest Connections, TOTALink, and WINfirst briefly got started operating overbuild systems before they went bankrupt and/or stopped further construction. Other well-financed companies like Ameritech and GTE constructed and operated systems only to sell them for a small fraction of their original cost.

In addition, a large number of overbuilders never even built their systems and launched their services. For example:

- **American Broadband**

American Broadband announced that it would overbuild cable systems in major cities in Rhode Island as well as Baltimore, Buffalo, Jacksonville and other medium size markets on the East Coast. When it initially filed in January 2000 with the Rhode Island PSC, American Broadband told the PSC that it would cost \$170 million to build systems in 20 markets serving 80% of the state's households in the towns of Barrington, Bristol, Central Falls, Coventry, Cranston, Cumberland, East Greenwich, East Providence, Johnston, Lincoln, North Providence, North Smithfield, Pawtucket, Providence, Scituate, Smithfield, Warren, Warwick, West Warwick and Woonsocket.

American Broadband initially received a commitment for \$50 million in equity capital from Great Hill, and expected to receive another \$120 million in equity and debt for the Rhode Island project. Great Hill Partners and venture capital companies pulled back on their initial commitment. CIBC World Markets that in 2000 committed to provide the company up to \$150 million in senior debt financing opted not to make the loan. In addition, \$50 million in equity promised by Great Hill Partners, a Boston venture capital firm was placed on hold. Great Hill owned 83 percent of ABI.

Unable to attract other financing, American Broadband decided not to go into business in January 2001.

- **Carolina Broadband**

Carolina Broadband was formed in 2001 and targeted major markets in North and South Carolina including: Charlotte (pop. 540,828), Raleigh/Durham (pop. 276,093 and 187,035 respectively), Winston-Salem (pop. 185,776), Greenville/Spartanburg (pop. 56,002 and 39,673 respectively), and Columbia, SC (pop. 116,278).

In 2001, the company received $402 million from Charlotte's Carousel Capital and the venture capital arms of banks such as Bank of America Corp. and First Union Corp. Other investors included M/C Ventures, Spectrum, Chase, JH Whitney, Haborvest and Providence.
After raising $402 million in equity, Carolina Broadband was unable to obtain another $400 million in debt financing. The investors did not want to commit all of the money until the company received additional loans needed to fully fund its construction projects.

Carolina Broadband spent about $40 million before the company folded without significant construction.

- **DeCom**

  DeCom was a Midland Park, NJ-based firm headed by a veteran cable operator. In mid-2000, DeCom announced that it hoped to be OVS provider in Charlotte, NC (pop. 540,828). The company never moved forward with its plans to provide service.

- **Digital Access Corporation**

  Digital Access announced plans to overbuild cable systems in Indianapolis, IN (pop. 781,870), Kansas City, MO (pop. 441,545), Milwaukee, WI (pop. 596,974), and Nashville, TN (pop. 1,270,520) in 1999. The company's major investors included Bachow & Associates, CALPERS, Cornerstone Equity, First Union Capital, Goldman Sachs, M/C Venture Partners, Norwest Equity, Providence Equity, M/C Venture Partners, Navis Partners (formerly Fleet Equity Partners) and Spectrum Equity Investors. Digital Access was able to raise $450 million in equity but unsuccessfully sought $850 million in debt financing. Digital Access went out of business in early 2001 after trying for two years to obtain debt financing.

- **Digital Union**

  During mid-2000, Digital Union (affiliated with a Local Utility) announced that it was going to overbuild the incumbent cable system in Austin, TX (pop. 656,562). After a few months, Digital Union abandoned its plan to provide service.

- **LyncStar**

  LyncStar was a private company that planned to overbuild the cable system serving Little Rock, AR (pop. 183,133). The company never moved forward with its plans to compete in this market.

- **Quality Entertainment**

  Quality Entertainment was a private company with plans to provide service in Poteau, OK (pop. 7,939). The Company never proceeded with these plans.

What seems apparent is that the investment community has not been persuaded that the overbuild business model, which is built on capturing market share with low prices, is an economically sound and sustainable model. As Professor Wildman points out, "[t]he fact that only a tiny fraction of a percent of cable communities attract overbuilder entry in any given year in itself suggests that most knowledgeable potential investors see little prospects for profit in the overbuilder strategy."[2] And the recent failures of existing overbuilders confirms that this is the case. Thus, as Altrio stated two months ago when informing the City of Los Angeles of the company's decision to shut down the company, "the capital markets are not friendly to early stage telecommunication companies today. After six months of effort, we have been unable to raise the necessary capital to continue operations."[3]

Even some of the more established and recognizable overbuild companies have been on or over the brink of bankruptcy. For example, Knology, which has 127,500 subscribers, went through bankruptcy in 2002. On September 18, 2002, Knology filed for Chapter 11 bankruptcy protection with debts that exceeded $473 million. On November 7, 2002, Knology announced that the bankruptcy allowed it to exchange $444

[2] Wildman at 28.

million in bonds for $193.5 million in newer bonds and a 19.3% equity ownership in the company. In total, the bankruptcy reduced Knology's debt by $250 million.

Meanwhile, RCN, the largest and most established overbuilder, is reportedly in serious economic peril and "skating on thin ice."[4] Its stock has not bounced back even as the telecommunications sector has begun to recover. RCN's stock plummeted from a high of $72 per share in February 2000 to 68 cents per share as of December 31, 2003. On January 15, 2004, RCN missed a $10.3 million payment on senior debt. According to one trade publication report, RCN's cash supply is rapidly disappearing: "Its most recent available results show in Q3 it lost $110.5 mil[lion]. RCN in Oct. 2001 had $1 bil[lion] in cash. It now holds $289.5 mil[lion] in cash, and is burning through its once-formidable fund at a clip of about $70 mil[lion] per quarter."[5]

Moreover, just two weeks ago, regional power company Pepco Holdings Inc., RCN's partner in Washington, DC area overbuilder Starpower Communications LLC, announced that it was that it was "getting out of the telecommunications and cable TV business by selling its 50 percent stake in" the venture.[6]

As mentioned, even some of the large, established telephone companies that promised to compete with incumbent cable operators in their telephone service areas have ultimately backed away from those plans and have emphasized the marketing of DBS services instead.[7] As the FCC recently noted,

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3 Letter from David G. Rozzelle and Stephen R. Ross to Ms. Liza Lowery, Chief Information Officer, City of Los Angeles, Dec. 10, 2003.

4 "RCN Skating on Thin Ice," Broadband Technology, Jan. 21, 2004, p. 10.

5 Id.

6 "Pepco to Sell Starpower; Shedding Cable Stake Will Come at a Loss," Washington Post, Jan. 30, 2004, p. E1.

7 See "Bells Fight Cable War with Satellite-TV Deals," Wall Street Journal, February 9, 2004, p. B1.

> The 1996 Act amended Section 651 of the Communications Act in order to permit telephone companies to provide video services in their telephone service areas. . . .As a result the presence of LECs in the MVPD market grew. By 1998 the Commission indicated that "LECs are already or are becoming significant regional competitors." Ameritech (later acquired by SBC) was a significant overbuilder in the Midwest, BellSouth was an overbuilder and MMDS operator in the southeast, . . . and Bell Atlantic (now Verizon) and SBC were selling, marketing and installing DirectTV DBS video service. Additionally, LECs briefly owned and operated two joint programming and packaging ventures, but by 1998 both of these efforts were ended or scaled back, and today no longer exist.
>
> Today facilities-based cable franchise services provided by the large, former "baby bells" are much less prominent . . ., with only BellSouth and Qwest offering such services. Some LECs have come full circle, however, and are marketing DBS service as they did in 1998.[8]

There have also been many reported examples of overbuilders entering markets with very low prices but, before long, implementing substantial price increases. As Professor Wildman points out,

> It is not uncommon for firms entering a market to offer their products or services at prices too low to cover their costs over the long term. They do this to rapidly build their customer base to a level large enough to ensure profitability once prices return to sustainable levels. Incumbents often respond to such tactics with lower prices of their own. Because market prices frequently rebound to higher levels once entrants' initial price-cutting strategies have run their course, it is important that prices in markets with recent entry not be used as competitive benchmarks for prices in other markets.[9]

One example is RCN's system in Boston. Since entering the market there in 1997 RCN's price for the expanded basic tier has nearly doubled

2. Overbuilders often targeted communities where cable operators had not yet rebuilt their systems. While cable operators nationwide have been rapidly

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8 Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, Tenth Annual Report, MB Docket No. 03-172, ¶¶ 113-115 (released January 28, 2004).

9 Wildman at 11.

rebuilding and upgrading their facilities to provide more channels and advanced broadband services, at least 107 of the overbuilders targeted communities where the incumbent operator had not yet rebuilt its system. In those markets, overbuilders might have expected to be able to lure customers away from the incumbent to a more advanced system with artificially low prices and advanced services that the incumbent was not (yet) able to offer. But it does not follow that either the rates or the overbuild itself would be sustainable after the incumbent rebuilt its system. And, as the FCC's recently released Tenth Annual Report on video competition shows, communities with non-rebuilt systems are quickly disappearing. Just between 2001 and 2002, the percentage of systems with at least 750 MHz leapt from approximately 64% to approximately 73%,[10] and the percentage continues to grow.[11] This is, in other words, a strategy available only in a rapidly dwindling number of communities and only for a very limited period of time.

3. Many overbuild systems were purchased at a substantial discount from failing companies. In many cases, overbuilders faced costs significantly lower than those of incumbent cable operators for artificial reasons that had nothing to do with competitive efficiency. For example, in 77 communities – almost 20% of the cases – the systems were purchased from failed or failing overbuild companies at pennies on the dollar.

These cases include the sale of systems and assets owned by the bankrupt Western Integrated Networks ("WIN"). While WIN had announced plans for building all-fiber networks in many southwestern and western cities, it only built and began operating a system in Sacramento. WIN sold its Sacramento assets to SureWest

[10] *Id.*, ¶ 25, Table 3.

[11] Id., ¶ 25 n.58.

Communications for less than 15% of what it had invested in the system – and a much smaller percentage of what the assets were worth at the time of sale. WIN's assets in Sacramento were worth $200 million; they were sold to SureWest for $12 million. Similarly, in December 2001, SBC sold the assets of the stand-alone cable systems that Ameritech had built in the 1990's. WideOpenWest acquired those mid-western systems at fire-sale prices far below the costs of building them. Likewise, in December 2003, Verizon Media Ventures Inc., a subsidiary of Verizon Communications Inc., sold off its cable television systems in Pinellas County, Florida and Cerritos, California to Knology for a price dramatically below the value of the assets. When companies purchase systems for much less than what it cost to build them, they, of course, can charge prices that reflect this discount. But there is no reason to view such prices as in any way indicative of what an economically efficient incumbent or new cable operator facing marketplace competition would or should charge. They are, in effect, subsidized by the initial overbuilder who mistakenly invested in a system that should never have been built in the first place, given the real costs of construction and operation.

4. Franchising authorities often impose fewer requirements on overbuilders. Many overbuilders faced significantly less extensive and costly franchise requirements than those imposed on incumbent cable operators. Although NCTA has not been able to review all the franchises in overbuild communities, we have identified 96 communities in which the overbuilder does not have the same requirements as the incumbent. It may be possible for local governments to create a price differential between overbuild and non-overbuild communities simply by creating a cost differential between overbuilders and incumbent cable systems. But where this is the case, there is no reason to suppose that the lower prices in overbuild communities are any more "competitive" than the prices of incumbents in non-overbuild communities.

5. Overbuilders often target high-density areas. We found 103 instances in which the overbuilder was not required to build out and serve the entire franchise area. In Montgomery County, Maryland, for instance, Starpower was not required to extend service to lower density areas of the county despite the fact that the incumbent's franchise requires universal service. Not surprisingly, given this green light to cream skim, we found 175 instances where the overbuilder targeted high density areas to provide service. By picking and choosing areas that are less costly to serve on a per-household basis because density is greater overall, overbuilders can charge rates that are lower than if they, like virtually all incumbent cable operators, were required to serve all areas of a community.

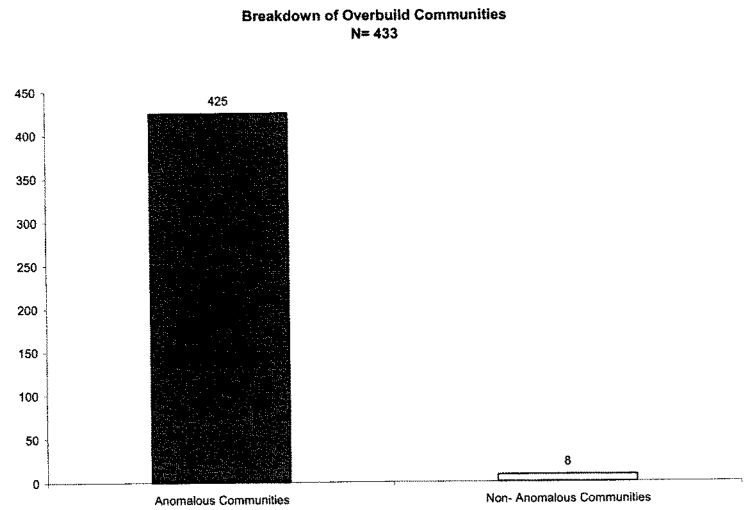
6. Some overbuilders operate on a not-for-profit basis. In some cases, overbuilders' prices may be artificially low because the overbuilder is a not-for-profit entity that has no need even to project, much less recover, a profit. For example, we identified 31 municipally-owned overbuilders and ten overbuilders owned by cooperatives.

7. Many overbuilders are owned by utilities or telecommunications companies. In 20 cases, the overbuilder is owned by a utility. And in 91 cases, the overbuilder is affiliated with a local telecommunications company. These operations present unique cost advantages of shared facilities for similar, plant-intensive businesses. They also present cross-marketing advantages that accompany such utility ownership.

And the rates of such overbuilders may be artificially low to the extent that they can be cross-subsidized by the ratepayers of the regulated utility service.

8. Most overbuilders bundle video services with other services. Finally, a large number of overbuilders entered the market offering bundled video, Internet and telephone services. More than ¾ of them – 310 – offer high-speed Internet service. And 179 offer all three services. When multiple services are offered over the same shared facilities, prices for the service offerings will be based on projected demand for all the bundled services. The shared cost of common plant may make the attributable costs for video lower, assuming that buy rates for the Internet and telephone services are sufficient to contribute to support of the system's costs. But if overbuilders' projections regarding their telecommunications and Internet offerings were unduly optimistic (as may well have been the case during the recent years when most overbuilds were initiated), then the prices for their video programming services may have been lower than necessary to cover costs – i.e., lower than economically competitive levels.

As the foregoing discussion shows, there are a number of clearly identifiable circumstances in which the prices of overbuild systems may be artificially and uneconomically low – and these circumstances apply in a large number of overbuild communities. The chart below illustrates how the vast majority of observations in the Overbuild sample involve anomalous situations.



* Anomalous Communities: Includes Failed/Failing, Purchased assets below value, targeted non-rebuilds, targeted high density, unique ownership issues (telco, utility, co-op, municipal), different franchise or buildout requirements, or offers bundled services.

In fact, according to Professor Wildman, "it is striking how few communities remain in the comparison sample [of overbuild communities] when all identifiable sources of potential bias are eliminated."[12]

GAO's Survey of Six Overbuilders Is Not a Useful Indicator of Competitive Rates

Even if there were no such multiple explanations for the price differentials between overbuild and non-overbuild communities, it would still be necessary to take any price comparisons in GAO's most recent study with a large grain of salt. That study only examined six overbuild communities – only about 1.5% of all overbuild communities, and a very small fraction of one percent of all cable communities – and compared their

[12] Wildman at 19 (emphasis in original).

prices with the prices of six superficially similar cable systems in non-overbuild communities. It's hard to see how the differentials between the overbuild and non-overbuild systems in such a minuscule number of cases could possibly be deemed to have any statistical significance.

In any event, not surprisingly, the six overbuilders in GAO's study – like most of the overbuilders nationwide – appear to share one or more of the identifiable characteristics, described above, that are likely to result in artificially and anomalously low prices.

For example, Everest Connections is, first of all, owned by an energy utility company (Aquila, Inc.). In addition, it is a company facing serious economic difficulties. Everest, which was formed in 2000, initially planned overbuilds in Amarillo, Lubbock and several smaller Texas communities. It also was granted franchises in the Kansas City and Minneapolis-St. Paul regions and had applied for more than a dozen franchises in the Grand Rapids, Michigan area. But it has never expanded beyond its two systems in Lenexa and Mission, Kansas.

During the first half of 2003, Everest's energy company parent restructured Everest and terminated 160 of its employees. It recently told the FCC that it had stopped funding Everest because of the company's poor long-term prospects. And Everest has told the Federal Communications Commission that it will "soon cease all construction in Kansas City due to lack of funding."

Grande, the overbuilder in Waco, Texas, offers bundled video, Internet and telephony services. It acquired its system from a financially impaired company, ClearSource, two years ago. Although the sale price was not reported, it is reasonable to assume that the assets were purchased at a substantial discount, reducing Grande's costs – and potentially supporting prices – substantially below what would have been sustainable if the company had to cover the true costs of the system.

Seren Innovations is another utility-owned and funded overbuilder. It was founded in April 1996 as a subsidiary of Northern States Power Co. and is now owned by Xcel Energy, Inc., which was formed by the merger of NSP and New Century Energy of Colorado.

PrairieWave is an investment company formed in 2002, which is affiliated with local telephone companies. It was formed to purchase the assets and operations of McLeodUSA Incorporated, a financially impaired operator of incumbent telephone systems in South Dakota and competitive telephone, cable and Internet services in South Dakota, southwestern Minnesota, and northwestern Iowa. Again, it is likely that the cable systems were acquired at a substantial discount to their initial cost.

The two remaining overbuild companies in the GAO study are Knology and RCN – both of which have already been described above in the discussion of companies that have gone through bankruptcy (Knology) or are in economic distress (RCN). Both systems offer bundled video, Internet and telephony services. And RCN, as noted above, has been around long enough to demonstrate – with rate increase after rate increase – that the low rates charged by overbuilders when they enter a market are far from sustainable.

Conclusion

The bottom line is that overbuilders are the results of anomalous circumstances in nearly all cases and often exist, if at all, in financial distress or as the aftermath of financial distress – unless they are tied to a utility or not-for-profit cooperative. In the rare circumstances where they exist, incumbent cable operators cannot afford to ignore such wireline competition. But they already face vigorous competition from DBS in virtually every community that they serve. And the services they offer and the prices they charge are already dictated and driven by such competition – whether or not they face an additional wireline competitor.

Overbuilders may enter the market with prices that are lower than these competitive prices. And incumbent cable operators may have no choice but to reduce their prices to such levels. But, as we have shown, these lower prices are either not economically sustainable by the overbuilders or are sustainable only because of anomalous artificial cost advantages and subsidies that are not available to incumbent operators. Whether or not overbuilders ever figure out a sustainable business model, their current model cannot serve as a benchmark for assessing the prices and conduct of cable operators in today's highly competitive video marketplace.

Assessing the Policy Implications of Overbuild Competition

Steven S. Wildman
Michigan State University
February 9, 2004

I. Introduction

Unlike the situation prior to the emergence of the national direct broadcast satellite (DBS) television services in the mid-1990's, it is indisputable that cable operators face direct competition in the provision of their primary service, multichannel television. Today the local cable operator competes directly with two highly successful DBS services who, nationwide, have captured approximately 22 percent of all multichannel television service customers.[1] Most operators also now offer a high speed Internet service for which they face competition from the incumbent local telephone company and frequently a number of other suppliers of high speed data services as well. And a small but growing fraction of cable operators offer voice telephony in competition with at least one, and increasingly, several telephone companies. The question now is whether this multifaceted competition, and especially the competition between the cable and DBS providers of multichannel video services, is intense enough to provide consumers with the benefits of lower prices and better services policymakers expect competition to provide.

[1] Federal Communications Commission, Annual Assessment of the Status of Video Competition in the Market for the Delivery of Video Programming, Tenth Annual Report, MB Docket No. 03-172, Released January 28, 2004, Appendix B, Table B-1.

In a tiny fraction (less than two percent) of the communities they serve, incumbent cable operators also compete with newer wireline providers of multichannel video service, commonly known as "overbuilders." Although it is not always the case, a few empirical studies have suggested that on average prices are lower in markets with overbuild competition than in markets where the incumbent is the only wireline provider of multichannel video service.[2] These studies have not systematically controlled for short run factors, such as low introductory prices charged by recent entrants and the presence of competitors who are not viable long-term, that might drive prices below their competitive equilibrium levels. Nevertheless, their findings have been offered as evidence that prices charged by cable operators in non-overbuild communities are too high.

Unfortunately, the world is more complex than this simple argument would imply and the evidence offered is not, by itself, sufficient to support the claim that is made. While the claim that lower prices in overbuilt communities are an indicator that prices in other cable communities are too high might be true, it may also be false. Because there are situations in which market prices may fall below the efficient market standard

[2] The most recent published study is an article by J. A. Karikari, S. M. Brown and A. D. Abramowitz, "Subscriptions for direct broadcast satellite and cable television in the US: an empirical analysis," *Information Economics and Policy*, vol. 15 (2003), pp. 1-15. Karikari, Brown and Abramowitz estimate that overbuild competition produces an approximately 10 percent reduction in cable prices. Their coefficient estimate is similar in magnitude to that found in an empirical study using earlier data by Dertouzos and Wildman, but the price effect in the Dertouzos and Wildman study was not statistically distinguishable from zero by commonly applied criteria for statistical significance. See, J. N. Dertouzos and S. S. Wildman, "Regulatory Standards: The Effect of Broadcast Signals on Cable Television," in R. Noll and M. Price, eds., *A Communications Cornucopia*, Brookings Institution, 1998. In its October 2003 Report, "Issues Related to Competition and Subscriber Rates in the Cable Television Industry," the GAO reports finding that overbuild competition reduced cable TV rates by about 15 percent.

associated with a competitive equilibrium, policymakers must take care to determine that the lower prices are in fact the efficient competitive prices and that the market structures generating those prices are sustainable in the long term. While consumers may benefit if supracompetitive prices are lowered, they may also be hurt by deteriorating quality and the exit of service providers if companies are forced to set prices below their competitive levels.

To convincingly demonstrate that lower prices in overbuild markets show that prices in non-overbuild markets are too high it would be necessary to provide: (1) evidence that cable prices charged in overbuild communities might reasonably be interpreted as competitive equilibrium prices, and (2) empirical support for the proposition that the prices (and numbers of competitors) observed in these markets would also be sustainable long-term in communities currently not served by overbuilders. Until evidence supporting the existence of both of these relationships is provided, the argument that lower prices in overbuild markets show that prices in other cable markets are too high must be considered empirically unsubstantiated. On the other hand, this argument would be empirically refuted by a demonstration that either of these relationships does not hold.

To this end, I have reviewed data on overbuild competitors and the communities they serve compiled from a NCTA-commissioned study by Kagan World Media[3] and data descriptive of cable communities and markets from trade data sources. My review of this evidence suggests that it is highly likely that prices in overbuild communities are below long-run competitive levels and that, unless recent and/or new technological

[3] Kagan World Media, "Survey of Incumbent Cable Operators in Overbuild Communities," January 2003. See Attachment A.

developments substantially change the economics of competition in multichannel video services, the overbuilders in these communities are not equilibrium features of the markets they serve. Furthermore, based on the US experience with overbuild competition to date, it would be dangerous to assume that overbuilders could profitably enter and offer services in the typical community in which a single cable company currently competes with the two satellite services.

The analysis that lead me to these conclusions is presented in the remainder of this report, which is organized as follows. Section II briefly describes the properties of a competitive equilibrium and identifies factors unrelated to differences in competitiveness that may lead to departures from a competitive equilibrium. Indicators of when such factors may be influencing overbuild markets are then discussed. Section III uses the framework presented in Section II to classify overbuilders and assess the long-term viability of overbuilders in current overbuild communities. The implications of this exercise for the interpretation of earlier studies comparing cable prices in communities with and without overbuild systems is then discussed. Section IV builds on the findings presented in Section III to examine the usefulness of the experience with overbuild services in the United States for assessing how close prices for cable services in communities without overbuilders come to their competitive equilibrium values. The findings of the study are summarized in Section V.

II. Competitive Prices and the Competitive Market Standard

A. Using the competitive market standard to judge market performance

The competitive price standard commonly employed in policy analyses is the long-run equilibrium price of the textbook model of a perfectly competitive market. In a perfectly competitive market in equilibrium, each buyer pays no more than the cost of the output purchased and sellers' revenues are just sufficient to cover their costs. Because price paid is a measure of value delivered to the buyer, this equation of cost with value at the margin indicates that the market is providing the maximum value possible with the resources at hand. The market output associated with this desirable state is the competitive equilibrium output or supply. Departures from equilibrium values for prices and outputs may rightly be interpreted as evidence that the societal resources employed to serve a market are not delivering the value they should. [4]

Policy intervention may be warranted *if departures from equilibrium are not naturally corrected by market forces*. Thus, for example, if output was held below its competitive equilibrium value for an extended period of time, the increase in price attendant on the reduction in supply would be a measure of how much the added value to consumers from increasing output might exceed the cost of doing so. Similarly, if supply exceeded its competitive equilibrium value, price would fall to less than the cost of delivering the market's product or service, and the excess of cost over price could be

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[4] For a straightforward presentation of the basic argument for the efficiency advantages of competitive equilibrium prices and quantities, see F. M. Scherer, Industrial Market Structure and Economic Performance, Second Edition, Rand McNally Publishing Company: Chicago, 1980, Chapter 2.

interpreted as a measure of how much more value the resources employed could contribute to society if used to create other goods and services.

Because observed prices may be above or below their competitive market values, the simple observation that the price for a product or service is lower in one market than in another is not sufficient to determine which, if either, is closest to the competitive equilibrium price. For this reason, policy-driven comparisons of prices in different markets must be sensitive to the implications of factors that may cause prices (and numbers of competitors) to depart from their equilibrium values. Analysts must also be sensitive to the possibility that differences in underlying demand and/or cost conditions may lead to differences among markets in equilibrium prices and numbers of competitors, which is considered in Section IV. The remainder of this section focuses on factors that may cause prices and numbers of competitors to differ from equilibrium values and how these might be incorporated in a study of competition in the supply of multichannel subscription television services.

Four types of factors other than deficiencies in the competitive process may cause prices and numbers of competitors to depart from their competitive equilibrium values. These are: (1) Errors in judgment by entrants, potential entrants and incumbents, which may include bets on new technologies, (2) Changes in market conditions, (3) Low, but unsustainable, introductory prices, and (4) Government policies. Each of these four types of factors should be considered in constructing a sample of communities with overbuilders, which I will call a comparison sample, to be compared with communities not served by overbuilders to assess the competitive performance of the latter.

B. Errors in judgment by entrants, potential entrants, and incumbents

The ideal of a competitive equilibrium that has become a touchstone of competition policy analysis is an analytical abstraction, the properties of which rest on a set of assumptions that are at best only approximated in real world markets. Critical among these assumptions is that market participants be completely informed about cost and demand conditions and about the strategies employed by their competitors. The reality, of course, is that market participants are never perfectly informed and are constantly scouring the market and the larger economic and political environment for bits of information that might help them better align their strategies with the true states of the markets they serve. Because they must work with incomplete information, the decision to commit resources to provide service in a market always entails some risk of loss as well as the possibility of gain. [5] This is true for firms already serving a market as well as for firms contemplating entry.

Entry in competitive markets is always an uncertain prospect because entrants must predict on the basis of incomplete information the reception their products will receive once they are introduced and the costs they will incur in supplying them. Potential entrants may err by both underestimating the profits they might earn if they enter and by overestimating their post-entry profits. Both types of mistakes will be corrected by the market in the long run, but the short term impacts will be quite different. The first type of mistake will be corrected either through the entry of other firms who more accurately assess their prospects, or as high prices and high profits earned by

[5] For a recent treatment of how uncertainty about demand conditions influences firms' entry strategies, see G. Pacheco-de-Ameida and P. Zemsky, "The Effect of Time-to-Build on Strategic Investment Under Uncertainty," RAND Journal of Economics, Vol. 34 (2003), pp. 166-182,

incumbents cause initially unenthusiastic potential entrants to change their minds. The short-term consequences of potential entrants' failures to take advantage of opportunities for profitable entry will thus be prices that exceed their competitive equilibrium values. It is important to note, however, that prices that exceed competitive equilibrium levels are not evidence that markets that are less than competitive if there is nothing to prevent the entry of new competitors to bring about the efficient competitive outcome in the long term.

The price-effects of entry spurred by overly-optimistic predictions of post-entry profits are just the opposite of those for overly pessimistic forecasts that delay entry in markets where entrants could prosper. When the number of firms in a market exceeds the number the market can realistically support, the competition to determine who remains in the market will often drive prices to levels that are too low to cover the costs of investments and ongoing operations in the long term. Visible signs of failed investments of this type would include business closures, reorganizations under the protection of bankruptcy, and the sale of assets at less than their original cost. However, not all failed investments will be publicly revealed because owners with sufficient resources may choose to keep open business that cover their operating costs even if they don't fully recover their sunk investments.

Just as entrants may misjudge market circumstances or their own capabilities and enter when it is inefficient to do so, so may incumbents invest in new services or capacity that fail to generate revenues commensurate with their costs. Depending on their magnitude, incumbent mistakes of this type may lead to the same financial consequences just described for failed entrants.

Incumbents may also make mistakes that encourage entry in situations in which it would not normally occur. For example, an incumbent cable operator, whether through inattentiveness, lack of capital, or a wrong bet on the direction and implications of technological change, may fail to upgrade its plant in a timely manner, leaving it unable to supply the quality, breadth and variety of services a more up-to-date operator could profitably provide. Because a market served by such an operator is in effect underserved, an opening may be created for profitable entry that would not have arisen had the incumbent been on its toes. The consequences of entry of this type are good for consumers, and, because the threat of entry by suppliers using more advanced technology gives incumbents an incentive to continually improve their services, beneficial to society at large.

Nevertheless, as long as entry in response to incumbent inefficiency remains the exception rather than the rule, it would be inappropriate to regard prices in markets where this occurs as reliable benchmarks for evaluating cable prices generally. The competitive equilibrium standard assumes a market served by efficient competitors and in the long run it must be expected that inefficient cable operators will exit the markets they currently serve. Evidence that entrants were responding to opportunities created by inefficient incumbents would include entry concentrated in markets where incumbents failed to keep up with the rest of the industry in upgrading their services and facilities.

C. Changes in market conditions

Equilibrium prices and the number of firms a competitive market can support may both change with changes in market demand and changes in the costs firms incur in supplying the market. Increased demand is typically associated with a larger number of firms in equilibrium while increases in costs tend to increase equilibrium prices and may reduce the number of viable competitors. Of course the opposite is true when demand and costs fall. Because entry and exit are both time consuming processes, new equilibria may lag considerably the changes that produced them and prices during the transition may differ considerably from their values in either the original or the new equilibrium.

New technologies are important agents of market change.[6] Advances in technology may lower costs or make possible delivery of combinations of services that were not feasible with earlier generations of technology. New firms can be expected to adopt these technologies from their inception, while incumbents may find it more prudent to adopt them more slowly over time as they replace or enhance existing facilities. Anticipated cost savings and the possibility of selling different mixes of services may stimulate entry in markets where entry otherwise would not have occurred. Optimism based on the allure of new technologies often turns out to be unfounded, however, and ventures built on them may fail, as we recently witnessed with the implosion of so may of the early dotcom businesses. But even when the investments supporting technology-driven entry are proved wise in hindsight, it is inappropriate to view post entry prices as

[6] For example, D. Clark shows how evolution in the local loop technology underlying Internet access may change the nature of competition to provide Internet access to consumers. D. Clark, "Implications of Local Loop Technology for Industry Structure," in S. E. Gillett and I. Vogelsang, eds., Competition, Regulation, and Convergence: Current Trends in Telecommunications Policy Research, Lawrence Erlbaum Associates, Publishers: Mahwah, NJ, 1999, pp. 283-296.

evidence of what competitive prices would have been pre-entry with the older technology. Instead, costs and prices are likely to depend on the technology employed. Furthermore, entrants employing new technologies should not be counted as permanent features of their markets until they have demonstrated the viability of their business plans.

D. Low, but unsustainable, introductory prices

It is not uncommon for firms entering a market to offer their products or services at prices too low to cover their costs over the long term. They do this to rapidly build their customer base to a level large enough to ensure profitability once prices return to sustainable levels. Incumbents often respond to such tactics with lower prices of their own. Because market prices frequently rebound to higher levels once entrants' initial price-cutting strategies have run their course, it is important that prices in markets with recent entry not be used as competitive benchmarks for prices in other markets.

E. Government policies.

Due to their powers of taxation and regulation, decisions made by governments at all levels may significantly affect the costs of doing business and the prices charged by firms serving local markets. As a result, differences in local government policies may lead to substantial differences in local prices and the numbers of firms serving local markets

Privately-owned cable operators must acquire franchises to provide service from local regulatory authorities, and franchises are typically awarded contingent on the operator meeting obligations specified by the local authority. Such obligations may substantially increase the cost to an operator of providing service in a local community. Variation in franchise obligations is one reason cable prices may differ among communities. Because franchise obligations influence costs, they also affect the prospects for entry by new cable providers. Results of the survey described in more detail later in this report suggest that in a number of communities franchise authorities have favored entrants with less onerous, and thus less costly, franchise obligations than those of the incumbent operators already serving these markets. While the cost advantages of more favorable regulatory treatment may be a powerful inducement to entry in some markets, and prices may fall when entry occurs, it clearly would be a mistake to attribute either entry or any subsequent reductions in prices to the workings of competitive forces when the entry occurs in response to a regulatory advantage.

In a number of overbuild communities, the competition to a privately-owned incumbent operator comes from a government-owned system. Because a cable system operated as a government service serves both political and economic goals, and especially because the economic constraint of earning a market-return on capital investments cannot be assumed to apply to government-owned enterprises, it would be inappropriate to use prices in markets with government-owned systems as benchmarks for competitive prices.

III. Overbuilder Viability and the Questionable Value of Price Comparisons

The discussion of Section II makes clear that a number of factors might cause the prices and numbers of competitors in a market to depart from their long-run competitive values. For this reason, if comparisons of overbuild markets to markets without overbuilders are employed to inform a policy analysis, it is important that the overbuild markets employed be ones for which the likelihood is small that prices and numbers of competitors differ substantially from the competitive equilibrium values for these markets. While it is not possible in practice to guarantee that prices and the number of competitors observed in any given market are at their long-run equilibrium values, it is possible with the framework developed in Section II to identify markets mostly likely to be tainted by factors known to be potential sources of bias and exclude them from any comparison samples.

This section reports the results of such an exercise using data for a sample of 433 communities with an overbuilder presence[7] (the overbuild data set), based on a study of overbuilders by Kagan World Media commissioned by NCTA,[8] which was supplemented with additional information from trade data sources compiled by NCTA. The analysis presented in this report is a secondary analysis of this data. The sample and the methodology employed in constructing it are described in Section III.A. A set of potential comparison samples constructed using the framework developed in Section II is described in Section III.B. The implications of this exercise in classification and comparison sample construction for policy interpretations of comparisons of prices in cable communities with and without overbuild services are discussed in Section III.C.

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[7] Some of the overbuild franchises awarded were not built out or never offered service. The data set includes these communities along with those built out that offered service as communities with an overbuilder presence.

[8] Kagan World Media, "Survey of Incumbent Cable Operators in Overbuild Communities," January 2003.

A. The overbuild data set

NCTA retained veteran cable industry analyst John Mansell of Kagan World Media to conduct and supervise the data collection regarding overbuilds from the incumbent cable operator in each overbuild market with the goal of identifying and gathering information on all of the wireline systems that compete with incumbent cable television systems in the United States. NCTA used Kagan World Media data from the *2003 Broadband Cable Financial Databook*[9] to identify 465 "Cable TV competitive franchises," which Kagan considers a near-comprehensive listing of existing overbuild franchises as of mid-2003 when the data in the *Databook* was compiled. The Kagan data lists the City and State and name of each Overbuilder. NCTA used a Nielsen Media Research database (FOCUS) to identify the incumbent cable system operators in each of these communities. NCTA then developed a survey instrument to collect information about the challenger in each market. Specifically, the survey included questions addressing the following overbuilder characteristics:

1. Name of current overbuilder.
2. The year in which overbuild commenced service.
3. Capacity of overbuilder (in MHz)
4. List of services offered by overbuilder .
5. Ownership Information. Is the overbuild owned by local government (town, city or county), a utility company (gas, electric), a local telephone company, a co-op, or privately owned.
6. Name of incumbent at the time of overbuild.
7. Similarity of build-out requirements.
8. Demographics of neighborhoods where overbuild currently offers service.
9. The population density of the markets targeted.

[9] Kagan World Media, 2003 Broadband Cable Financial Databook, pp.81-84.

10. Sales/acquisition information. Whether current owner is the original owner and sales price if not.
11. Similarity of franchising requirements to those of incumbent.

The survey of incumbent cable operators was conducted between October 21, 2003 and January 2, 2004. Each MSO (or individual system if not affiliated with the Top 10 MSOs) was provided an electronic copy of the questionnaire and a list of communities where their companies faced a wireline competitor according to the Kagan data. In some cases, the MSOs collected the data directly from their cable systems and forwarded their results on to John Mansell and in other cases the data was collected by Mansell at the system level. Since a few overbuilders have exited the business in recent years, public information about these companies was used to collect data for these observations. All data gathered from the questionnaires and public sources were tabulated electronically by Mansell to create the spreadsheet attached to this report.

In total, information on 433 communities was collected and compiled. Because survey respondents identified several overbuilders that had entered their communities in late 2003 or early 2004 after Kagan stopped collecting information for the *2003 Databook*, the final tally was 470 identified communities with an overbuilder presence. Survey respondents did not provide information for 39 of the 114 former Ameritech New Media franchises sold by SBC to WideOpenWest, which is two more than the difference between the 470 communities identified and the 433 in the sample for which information was collected. This suggests that two of the former Ameritech New Media franchises may have been missed in the Kagan census of cable communities, or, perhaps shut down since their sale to WideOpenWest.[10]

B. Constructing comparison samples

Of the 433 overbuild communities identified by the survey, 62 had overbuilders that had already failed,[11] six were identified as failing,[12] and 15 had not yet begun to build out their franchises or were not yet offering service at the time of the survey. Clearly failed and failing franchises do not belong in a comparison sample, and systems that are not operating provide no performance measures. Therefore all 83 communities with failed, failing and not built systems were eliminated from the comparison sample. These deletions reduced the sample to 350.

While not classified as failed or failing systems because they are still in business and offering service, an additional 76 communities were served by overbuilders who purchased their plant from previous owners at a small fraction of the original construction cost. (Systems serving 77 communities were sold for less than cost, but one of them also failed.) The fact that the original owners of these systems were forced to sell them for substantial discounts relative to their investments in them shows that that the markets they served did not generate revenues sufficient to both cover their operating costs and provide a fair return on upfront investments. There are numerous potential buyers capable of operating these systems. Therefore, the ability of the actual buyers to pick up

[10] All 114 of the former Ameritech New Media systems are assumed to still be providing service in their franchise communities in various calculations reported below.
[11] This includes operators who failed after offering services, which is the majority of this category, and operators who experienced financial failure before commencing service.
[12] These operators were either in the process of filing for bankruptcy or in negotiations with creditors.

them up at pennies on the dollar shows that they would not have been willing to pay the full costs of building these systems if that were the price of entry. Systems in these communities are properly classified as the types of investor mistakes that will be eliminated from competitive markets in the long run. Subtracting the 76 systems purchased for less than original construction costs leaves 274 systems in the comparison sample.

31 of the communities with overbuilders were served by municipally-owned systems, but one is one of the failed systems eliminated above. Because such systems are likely to be operated to address political as well as economic goals, and because access to public funding is likely to be reflected in both build and pricing decisions, these systems must also be eliminated from the comparison sample, leaving a total of 244.

244 is the absolute maximum number of overbuild communities that might retained in the comparison sample. Call this sample CS1. There are several reasons to believe that the number of communities served by overbuilders where two cable services might plausibly be viable in a competitive equilibrium is substantially smaller than the 244 communities in CS1. One reason is the 107 communities identified by survey participants where the overbuilder came in with new plant to compete against an incumbent who had fallen behind industry standards in upgrading its facilities. As explained in Section II, an inefficient incumbent may create an attractive opportunity for a more efficient entrant, but the competitive equilibrium used as a standard for policymaking is one in which efficient firms compete against each other. To ensure that the comparison sample is not tainted by the inclusion of communities whose overbuilders entered in response to incumbent incompetence, overbuild communities where the

incumbent operates outdated plant should be eliminated from the comparison sample as well.

Overbuilders in eight of the 107 overbuild communities with incumbents operating outdated systems were municipally owned, 52 were purchased at a fraction of construction cost, four had failed or failing systems, and one had a failed/failing system purchased at a fraction of its buildout cost. As all of these communities were already excluded from CS1, we are left with an additional 42 overbuild communities served by inefficient incumbents that probably should be subtracted from CS1 to ensure that inefficient incumbents do not bias the sample. Call the resulting sample CS2. CS2 has 202 cable communities.

A second reason to believe that that CS1 includes many communities where overbuild competition is not likely to be sustained in a competitive equilibrium is that the 76 communities served by overbuilders who purchased prior operators' assets for less than construction cost were identified through publicly-available documents. These are all the communities for which system cost and purchase price was found. An additional 39 communities served by systems operated by second or subsequent owners were identified by survey respondents. Given the numbers of failed and failing systems and the fact that systems for which information on construction cost and sales price was found were sold at less than cost, it seems likely that many, if not most, of the resold systems for which construction cost and purchase price were not available were also sold at a loss. At any rate, the strong possibility that they were sold for less than cost suggests that they should be eliminated from the comparison sample. In six of the communities served by these second (or subsequent) owner systems, the incumbent was operating outdated plant and thus was already eliminated from the comparison sample. If we subtract the remaining 33 communities from CS2 to completely eliminate the possibility that failed systems are included in the comparison sample, we are left with 169 communities. Call this sample CS3.

The possibility that local politics played a role in entry decisions must be also be considered in situations in which overbuilders' franchise authority-imposed conditions for operation differ from those required of the incumbent. This is a third reason to believe that CS1, as well as CS2 and CS3, includes communities in which overbuilders would not be viable in a true competitive equilibrium. While cost advantages based on regulatory favoritism may be a reason for entry, entry in such cases cannot be considered the outcome of a competitive process. Respondents to the survey identified a total of 96 communities for which the overbuilder did not have the same franchise requirements as the incumbent and 103 communities where the overbuilder was not required to serve the entire franchise area. To eliminate the possibility that the overbuilder's entry decision was based on favorable regulatory treatment, communities where the overbuilder and the incumbent have different franchise and build-out requirements should also be eliminated from the comparison sample. Subtracting these communities from CS1, CS2 and CS3 would produce the most restricted, but methodologically purest, comparison samples. Call these purer samples CS1P, CS2P and CS3P. CS1P has 131 communities, CS2P has 109 communities, and CS3P has 94 communities. It is striking how few communities remain in the comparison sample when all *identifiable* sources of potential bias are eliminated.

Table 1

Eliminating Sources of Bias from Comparison Samples

Complete Sample	CS1	CS2	CS3	CS1P	CS2P	CS3P
433	244	202	169	131	109	94

A fourth reason to believe that all the comparison samples just described, including the last three, include communities served by systems that are not long-term viable is that the vast majority of systems for which no financial information was available were assumed to be viable. That is, if some of the systems for which no financial data was available were failing, they would have been misclassified as viable. If overbuilders for which financial data is not available experience financial difficulties and failure at the same rate as those for which data is available, then most of these systems have been misclassified. In addition, the newness of many of the overbuilders in the sample also introduces a bias against a failed or failing classification because the process of failure has not yet had time to work itself out, which is a fifth reason to believe that the comparison samples include communities served by systems that in the long run will be proved nonviable.

C. The questionable relevance of overbuild price studies for cable policy

The question of whether overbuild competition lowers cable prices is relevant for policymaking only if the overbuilders in the overbuild communities examined are realizing market returns on their infrastructure investments. The results of the study of overbuilder viability reported in Section III.B show that it would be incautious to assume long-term viability for more than a small fraction of existing overbuilders. For the remaining systems, any effects they might have on prices in the markets they serve should be considered departures from equilibrium prices. Because studies of the price effects of overbuild competition reported to date did not control for viability with anything close to the rigor applied in the study reported in Section III.B, the odds are high that many, and perhaps most, of the overbuilders included in these studies were the products of failed investments. This being the case, it would be inappropriate to rely on the findings of these studies to assess the competitiveness of cable prices in communities without overbuilders.

IV. The Real Lessons from the US Experience with Overbuild Competition

The statistics on indicators of overbuilder viability presented in Section II.B provide strong reasons to suspect that most of the current crop of overbuild services likely are not viable participants in the markets they serve in the long term. The 365 communities currently served by privately-owned overbuilders constitute just 1.1% of the approximately 33,000 cable-served communities in the United States.[13] The fact that overbuilders are offering services in such a small fraction of US cable communities suggests that in general potential investors in such services view their prospects as poor. The trend of overbuilder entry over time tells the same story. Table 2 presents data on the number of communities in the entire Kagan sample entered by privately-owned overbuilders for two-year intervals from 1995 through the present.

[13] 365 is calculated as 433 communities in the sample minus a total of 77 that either never offered service or failed minus 30 operating municipally-owned systems plus 39 former Ameritech New Media franchises not in the sample but assumed to still be operating. This count includes a handful of co-operatives that may be non-profit.

Table 2

Overbuilder Entry Over Time

(built-out commercial systems)

Pre-1995	1995-1996	1997-1998	1999-2000	2001-2002	2003-2004	No Entry Date
33	46	66	77	70	17	42

The Cable Act of 1992[14] eliminated any statutory authority local franchise authorities may once have had to restrict franchise awards to incumbent providers and the Telecommunications Act of 1996[15] (Telecom Act) provided further encouragement to entry in local markets for communications services, including cable. The pace of overbuilder entry did increase beginning in 1997, but this also coincided with increased adoption of new technologies that would allow the provision of high speed data and telephone services over cable plant throughout the cable industry, so it is difficult to know to what extent the Telecom Act, as opposed to the lure of new technologies, influenced the pace of overbuilder entry.

Missing data on entry dates for some communities make it impossible to determine exactly how much entry occurred in each of the periods listed in Table 2, but we can determine reasonable upper bounds on the rate of entry. The 17 startups identified for 2003-2004 represent Kagan observations for a little more than the first half of 2003 plus a few additional entrants identified by survey respondents after that time. If

[14] 47 USC § 541 (a) (1).

[15] 47 USC §§ 251et seq.

we assume all 17 started up in the first half of 2003, this would reflect a two-year entry rate of 68, which is close to the pace of entry for the prior three two-year periods. Entry date is provided for 74 of the 75 former Ameritech New Media communities in the sample, and all were from 1996 to 2001. If we assign the remaining 39 Ameritech New Media franchises to the six years from 1977 through 2002, total private entry would have been 252, or 42 per year. This pace amounts to entry into just under thirteen one-hundredths of one percent (0.0013) of US cable communities annually.

Data on the technology deployed in communities with overbuilders presented later in Table 3 shows that a higher percentage of the 42 communities for which date of overbuilder entry was not provided are served by overbuild systems utilizing last generation technology with no advanced features than is indicated for the pre-1995 communities in the built-out sample. If we assume instead that entry in all of these communities occurred from 1997 through 2002, total entry during the period would have been 294, the average annual rate of entry would have been 49, and the average fraction of cable communities entered annually would have been fifteen one-hundredths of one percent (0.0015).

These figures on the pace of overbuilder entry may be interpreted in either of two ways. If, counter to the evidence developed in Section III, overbuilders are assumed viable in all of the communities they serve, the failure of the overbuild strategy to catch on elsewhere suggests that potential investors in overbuild systems have serious doubts that they can be profitable in other cable communities. That is, the capital market response to the experience with overbuild operations accumulated in the US to date suggests that there is little confidence a second cable system can be viable in a typical cable community.

The second interpretation of the data on entry presented above is more consistent with the evidence on overbuilder viability presented in Section III.B. That is that the capital market has seen overbuild operations fail repeatedly and has concluded that in general overbuild systems are not good business opportunities. By both interpretations of the entry data, it seems clear that investors have concluded that in general competitive markets that include two satellite services will not support a second cable provider of multichannel video services, at least with the technologies currently available.

If there are exceptions to this general conclusion, the best bets would seem to be overbuilds operated by telephone companies and co-operatives in small rural communities. Of the 382 communities in the sample with built out systems, a total of 244 survived the various elimination criteria to be included in CS1, for a survival rate of 64 percent.[16] Yet of the 89 communities with built out systems currently operated by telephone companies, 86 are in CS1. These communities are predominantly small and rural. Community population is available for 76 of the 86 communities in CS1 served by telco-owned systems. Nearly 59 percent have fewer than 15,000 residents, 47 percent are communities with fewer than 10,000 residents, and approximately 36 percent are communities with fewer than 5,000 residents. Over six percent of these telco-served communities have fewer than 1,500 residents. All ten built-out communities served by

[16] The 39 former Ameritech New Media systems not included in the larger sample would not have been in CS1 in any case because Ameritech New Media sold its systems to WideOpenWest for substantially less than the cost of building them.

cable co-operatives are in CS1.[17] Nine of these communities had fewer than 10,000 residents, six had fewer than 5,000. (Population was not listed for one of the co-op communities.)

It is not clear why rural telephone companies and co-operatives may be more successful than other types of owners as operators of overbuild systems. One possibility is that closer relationships with customers in smaller communities make it easier for rural telephone companies to sell new services, and perhaps the co-operative organizational form may have advantages in small, close-knit communities. It may also be the case that with convergence the natural long-run market structure in small communities is one with a single wireline provider of video, high speed data and voice services and what we are witnessing is a necessary step toward that future if the local telephone company is to be the surviving wireline competitor. Whatever the reason, the character of these rural settings likely is not replicable in the more typical urban cable communities.

A closer look at the data collected in the Kagan study suggests that most of the more recent overbuild experiments were inspired by the capabilities of relatively recent technological advances that make it possible to use cable plant to provide telephony and high speed Internet service in addition to more traditional video services. Table 3 adds to the entry data reported in Table 2 numbers and percentages of entrants offering the combination of video, high-speed Internet and telephony (the three bundled services) and the numbers of entrants offering either the three bundled services or the two services of video plus high speed Internet service.

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[17] Systems serving two of the overbuild communities operated by telephone co-operatives were counted as co-op operated rather than telephone company operated.

Table 3
New Technology and Overbuild Entry Decisions
(built-out commercial systems)

	Pre-1995	1995-1996	1997-1998	1999-2000	2001-2002	2003-2004	No Entry Date
Number of Communities	33	46	66	77	70	17	42
# 3 Bundled Services	7	15	30	61	38	14	3
% 3 Bundled Services	21.2%	32.6%	45.5%	79.2%	54.3%	82.4%	7.1%
# HSD or 3 Bundled Services	23	40	61	70	63	15	12
% HSD or 3 Bundled Services	69.7%	87.0%	92.4%	90.9%	90.0%	88.2%	28.6%

Table 3 shows a heavy reliance on high-speed data or high-speed data and telephony technology strategies by overbuilders, including those who entered prior to the Telecom Act, and that reliance on multi-service platforms has in general been increasing over time. Notable is the growing percentage of overbuilders offering video services, high speed Internet service, and telephony, which has averaged well over 50 percent from 1999 on.

As was discussed in Section II, new entrants into established markets are often inspired by the potential they perceive in new technologies. It is also frequently the case that pre-entry optimism is shown unwarranted by the post-entry market responses to the entrants' products and services. At least at this point, capital markets appear to have concluded that the overbuilder strategy is not one that can profitably be applied in most cable markets, even when it is supported by advanced distribution technology and triple play service offerings. However, even if this were not the case and we restricted our attention to overbuilders with the most technologically advanced systems, it would still be inappropriate to assume that prices observed in overbuild communities are the prices that should prevail in communities without overbuild systems. If the future is one in which all wireline competitors offer multi-service bundles, we are still early in the transition to that future. Because the new technologies imply different cost structures and, with multi-service offerings, new strategies for exploiting demand, there is no way to know how competitive prices with the new technologies will compare to competitive prices with the old technologies, or how prices might move during a period of transition.

V. Conclusions

A close look at overbuilders and the communities they serve shows that it would be imprudent to use prices in these communities as benchmarks for evaluating prices in other cable communities. The competitive price standard employed for policy analysis assumes competition among firms able to cover their investment and operating costs from the revenues they generate. The evidence reviewed in this report suggests that this likely is not the case for many, and perhaps most, of the overbuilders operating in the United States today. To the contrary, the evidence for a high rate of financial failure is compelling and it would be analytically inappropriate to view the effects on price of systems that can't recover their own investment costs as evidence of how competitive multichannel video markets should behave.

The fact that only a tiny fraction of a percent of cable communities attract overbuilder entry in any given year in itself suggests that most knowledgeable potential investors see little prospects for profit in the overbuilder strategy. Empirical studies of the price effects of overbuild competition have not controlled for overbuilder viability or for the possibility that new overbuilders may be charging low introductory prices to rapidly build market share. For this reason, these studies shed no light on what competitive cable service prices might be. Even if this was not the case, the failure of capital markets to support a broad rollout of overbuild systems suggests that the conditions under which overbuild operations can thrive are quite different from those in the typical cable community.

TESTIMONY OF MICHAEL WILLNER
PRESIDENT AND CHIEF EXECUTIVE OFFICER
INSIGHT COMMUNICATIONS

on

COMPETITION AND OVERBUILDS IN THE VIDEO MARKET

before the

SUBCOMMITTEE ON ANTITRUST,
COMPETITION POLICY AND CONSUMER RIGHTS
COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE
WASHINGTON, D.C.

FEBRUARY 11, 2004

I. INTRODUCTION

Mr. Chairman, Senator Kohl, members of the subcommittee, my name is Michael Willner. I am President and CEO of Insight Communications (Insight), the nation's ninth largest cable operator. My company owns and manages cable systems serving 1.4 million customers in Illinois, Indiana, Kentucky, and Ohio. I am also a Director of the National Cable & Telecommunications Association (NCTA) and serve on its Executive Committee. Thank you for inviting me to testify about the state of competition in the multichannel video market and how Insight is responding to competitive challenges posed by DBS and other competitors.

Many industry watchers do not realize the extent of competition in the multichannel video marketplace. Indeed, today's television market looks nothing like the one 10 years ago, when cable companies were the only multichannel video providers except for large backyard dishes and local broadcast stations. Back then, cable offered a one-way analog video service averaging 30-53 channels of local and national programming.[1] Today, as the FCC recently noted in its Tenth Annual Report to Congress, most consumers have a choice of at least three providers (Dish, DirecTV, and cable) offering hundreds of channels of television and digital services.[2] Some consumers enjoy even more options provided by alternative broadband service providers (BSPs), microwave/MMDS companies; and private SMATV systems serving apartment buildings and condominiums.

1 *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*. FCC 04-5, MB Docket No. 03-172, released January 28, 2004, paragraph 18. (Hereinafter cited as the "Tenth Annual Report.")

2 Ibid, paragraph 5.

Direct Broadcast Satellite in particular has flourished as a competitor to cable since its launch in 1993, garnering more than 21% of the video market and driving cable's market share down from 95% in 1994 to 75% in 2004.[3] Along with increased consumer choice between competing providers has come a wide array of new entertainment and data services, including digital video, HDTV, high-speed access to the Internet, and cable telephony. The FCC's Tenth Annual Report notes that: "Cable television has, in fact, greatly evolved since the first report, providing [consumers with] more choice, greater flexibility, and more control."[4]

Insight is a leader in providing consumers with both video and non-video communications services and is one of many cable companies delivering on the promises of the 1996 Telecommunications Act. We are competing across the board in a wide range of services – and let me assure you that it is a fiercely competitive and aggressive marketplace.

II. INSIGHT COMMUNICATIONS

Insight Communications operates in dozens of mid-sized communities throughout Illinois, Indiana, Kentucky, and Ohio. Founded in 1985, Insight and its 3,200 employees offer 1.4 million customers a wide array of advanced cable services – including digital video, pay-per-view, high-speed Internet access, high-definition television (HDTV), digital video recorders (DVR), and digital telephony. As of September 2003, Insight passed 2,313,500 homes and provided basic cable service to 1,400,000 customers. Insight also has 383,700 digital cable customers, 208,500 high-speed Internet subscribers, and 49,300 telephone customers.

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3 C-band satellite, MMDS, SMATV, and BSPs account for the remaining 4%. See MVPD chart on page 3.

4 Ibid, paragraph 12.

III. THE VIDEO MARKET IS FULLY COMPETITIVE

Today, consumers can choose from a variety of multichannel video providers, including DBS, alternative broadband providers like RCN/Starpower, local telephone companies, and utilities. As a result of this competition, 24.9 million consumers (1 out of 4 video subscribers) now obtain multichannel video programming from someone other than their local cable operator.

Subscribers to Multichannel Video Program Distributors (MVPD), November 2003

	Subscribers (in Millions)	Percent of Total MVPD Subscribers
DBS	21.60	22.50%
C-Band	0.50	0.52%
MMDS	0.20	0.21%
SMATV	1.20	1.25%
Broadband Service Providers	1.40	1.46%
Non-Cable MVPD	24.90	25.94%
Cable	71.10	74.06%
Total MVPD	96.00	100.00%

Source: Kagan World Media, Kagan Media Money, December 16, 2003, p. 6; SkyTRENDS, www.skyreport.com; Nielsen Media Research.

DBS is a particularly effective competitor in the multichannel video market. It is available in all 50 states and offers hundreds of channels that include almost all the most popular and widely carried national cable networks, as well as some programming (such as DirecTV's exclusive NFL sports package) that is not carried by local cable systems. With the passage of the Satellite Home Viewer Improvement Act (SHVIA) in November 1999, DBS companies can now retransmit local broadcast signals into their market of origin ("local-into-local") – and they do so in the vast majority of markets.

In the face of competition from DBS, cable's market share has dropped from 95% ten years ago to under 75% today. In 2003, the number of DBS subscribers jumped from 19.4 million to 21.1 million – an 8.8% increase. DirecTV alone has more subscribers (12 million) than all cable companies except Comcast and is the second largest multichannel video provider in the United States. EchoStar, the second-largest DBS provider, has more customers than all but two cable companies – Comcast and Time Warner. With DBS and other video providers, consumers today have real choices in the video market – and they are exercising those choices.

The FCC remarked upon this phenomenon in its Tenth Annual Report to Congress:

> Ten years ago, cable operators served almost 100% of the nation's MVPD subscribers. Today, most consumers have the additional choice of two national DBS providers, and cable's share of the MVPD market has fallen to approximately 75% of all MVPD subscribers. Competition in the MVPD market has been accompanied by technological innovation and the introduction of new products and services. In 1994, most cable operators offered 30 to 53 analog video channels. Today, after investing tens of billions of dollars to rebuild and upgrade cable systems, cable operators offer, on average, 70 analog video channels, 120 digital channels, high-definition television programming, video-on-demand, and non-video services, such as high-speed Internet access service, and telephone service.[5]

DBS's residential subscriber penetration on a state-by-state basis reveals the breadth of DirecTV and EchoStar's competitive strength. As of July 2003, direct-to-home penetration exceeded 30% in four states, 20% in 29 states, and 15% in 40 states.

[5] Ibid, paragraph 18.

States with Direct-To-Home (DTH) Dish Penetration
Of Fifteen Percent or More (July 2003)

State	Penetration Rate	State	Penetration Rate
Vermont	35.78%	**Texas**	22.25%
Montana	33.96%	**South Carolina**	21.70%
Wyoming	31.36%	**Virginia**	21.34%
Idaho	30.91%	**Arizona**	21.18%
Utah	29.99%	**Oregon**	20.93%
Mississippi	28.12%	**South Dakota**	20.71%
Missouri	27.25%	**Wisconsin**	20.53%
Arkansas	26.78%	**Minnesota**	20.39%
New Mexico	25.66%	**Maine**	20.23%
Georgia	24.93%	**California**	19.91%
Colorado	24.49%	**Nebraska**	19.61%
Oklahoma	23.77%	**Kansas**	18.91%
Indiana	23.08%	**Washington**	18.62%
Kentucky	22.97%	**Alaska**	18.46%
North Carolina	22.97%	**Michigan**	18.32%
West Virginia	22.91%	**Florida**	17.66%
Alabama	22.74%	**Illinois**	17.61%
North Dakota	22.49%	**Nevada**	16.55%
Iowa	22.35%	**Louisiana**	15.61%
Tennessee	22.28%	**Ohio**	15.35%

Source: SkyTRENDS SkyMAP, July 2003; www.skyreport.com; TV Household data from A.C. Nielsen.

DBS companies are not only big and getting bigger, they are now vertically integrated. For example, on December 19, 2003, the FCC approved transfer of DirecTV's DBS and other licenses (including PanAmSat) from General Motors/Hughes to News Corporation (NewsCorp). DirecTV offers more than 825 channels of programming, including local broadcast channels in 64 markets. NewsCorp, the global media corporation, operates the Fox broadcast network, 35 TV stations, 10 national cable networks, 12 regional networks, and other program rights and interests. The DirecTV-NewsCorp deal is valued at $6.6 billion.

Because "the proposed transaction is likely to result in anticompetitive harms" in some areas, the FCC conditioned the merger in four ways: (1) NewsCorp is barred from withholding any satellite-delivered cable network under its control from any cable operator or satellite carrier until at least October 2007; (2) NewsCorp must submit disputes over regional sports programming contracts to a single commercial arbitrator; (3) for systems with fewer than 5,000 subscribers, the FCC basically requires NewsCorp to elect must carry for its stations – it may not seek cash or carriage of other than its broadcast signal; and (4) DirecTV must provide local channel services in an additional 30 DMAs beyond what had been previously funded, projected, or planned by Hughes/DirecTV.

In addition, telephone companies are reentering the video market in partnerships with DBS. The RBOCs in particular – with over 90 million customers – are engaging in an intense battle with cable operators by announcing several joint marketing partnerships: (1) SBC Communications and EchoStar; (2) Qwest Communications and both EchoStar and DirecTV; (3) BellSouth and DirecTV, and (4) Verizon and DirecTV. In the last partnership, announced on January 29, 2004, customers can order all Verizon and DirecTV services by making a single call to Verizon. Discounts are available to new DirecTV subscribers and to Verizon customers who buy packages of local, long distance, and data services. DirecTV will install its services and provide follow-up customer care for its customers acquired through Verizon.

IV. OVERBUILDS

Only 433 of the 33,485 cable communities nationwide have two competing franchised wireline providers. Indeed, in its October 2003 Report, GAO reported that "wire-based" competition to cable is limited to about two percent of US markets. However, many of these franchised overbuilders have never deployed their services or are trying to avoid bankruptcy. Several more are already out of business. Despite the expectation in 1996 that telephone companies and other wireline overbuilders would become the main competitors to cable, the GAO found that "in recent years, DBS has become the primary competitor to cable operators in the subscription video industry."[6]

Insight faces ubiquitous competition from Dish/EchoStar and DirecTV/NewsCorp in all of its markets. Insight also faces wireline overbuilders in two of our cable systems: Evansville, Indiana, and Columbus, Ohio. In those systems, some areas are overbuilt and others are not. However, where the services are similar, so is the pricing. For example, in Evansville, Insight charges $35.95 for basic/expanded basic compared to $32.99 for TotalLink SIGECOM. In Ohio, WideOpenWest, which purchased overbuild systems from Ameritech (americast®), charges $38.50 while Insight charges $34.40.

V. CABLE OPERATORS HAVE INVESTED ALMOST $85 BILLION IN THEIR SYSTEMS AND UPGRADED THEIR SERVICE OFFERINGS IN ORDER TO COMPETE WITH DBS AND OTHER VIDEO PROVIDERS

With the emergence of DBS in 1994, cable operators embarked on a massive rebuild of their systems, adding digital technology and replacing hundreds of thousands of miles of coaxial cable with fiber optics. Helped by passage of the Telecommunications Act of 1996 and the prospect of deregulation in March 1999, cable operators were able to attract investors and raise billions of dollars in private risk capital. Since 1996, cable operators have invested almost $85 billion in system upgrades – more than $1,200 for every cable customer.

6 *Issues Related to Competition and Subscriber Rates in the Cable Television Industry*. United States General Accounting Office, October 2003. GAO-04-8: page 9. Hereinafter, "October 2003 Report.".

The difference between the cable industry's investment in infrastructure before and after the 1996 Act speaks for itself. From 1992 to 1995, annual investment in plant and facilities averaged $3.6 billion. Since 1996, annual capital spending has more than tripled, averaging $10.9 billion a year.

Cable operators like Insight now provide consumers with a broad array of interactive digital video services, high-speed Internet access, and – in an increasing number of communities – competitive local telephone service. For example, over 21.5 million cable customers purchase optional "digital tiers" which include up to 260 additional channels of video programming and CD-quality music. Cable operators also use digital capacity to offer high-definition programming created by cable networks and broadcast stations. As of December 1, 2003, cable operators offering HDTV passed 70 million TV households, reaching 96 of the top 100 television markets and 143 of all 210 DMAs. We expect these numbers to grow in 2004.

Insight already offers HDTV service in communities serving over 95% of our subscribers. Insight offers between 4 and 15 HD signals in each community, including local digital broadcast signals and/or satellite-delivered HDTV program networks.

Cable operators have also used their new digital capacity to become the leading providers of an entirely new service – high-speed broadband Internet access. As of September 30, 2003, 15 million U.S. households had cable modems. Moreover, high-speed cable modem service is today available to more than 85% of the nation. In response to cable modems, local telephone companies introduced residential DSL – their own high-speed Internet service. Cable modem service and DSL now compete vigorously in most markets.

In addition, cable operators are fulfilling their promise to give consumers a full-scale, facilities-based alternative to their local telephone company. Over upgraded broadband facilities, cable operators currently provide phone service to approximately 2.5 million residential customers; Insight provides residential telephone service to about 50,000 customers. Many companies are now launching Internet-based "Voice over IP" (VoIP) service, like Time Warner Cable in Portland, Maine; Cablevision in Long Island, New York; and Charter in Wausau, Wisconsin. These offerings feature unlimited local and long distance service, plus other calling features, for about $40 a month. Cable's phone services are further spurring incumbent telephone companies to offer competitive pricing plans and deploy VoIP.

But competition is not the only benefit flowing from cable's $85 billion capital investment in new facilities and technology. As Chairman Powell noted on January 28, 2004:[7]

> ... it may be that the greatest benefits stemming from these investments of DBS and cable operators over then last ten years has been the expanding diversity of programming, ideas and opinions that come across our television screens on a daily basis. Increased infrastructure investment has meant increased channel capacity and with it more diversity. The thirty channel systems of a decade ago are today cable and satellite systems offering literally hundreds of channels. It is unquestioned that this increased channel capacity has allowed the biggest of our nation's media companies to get bigger, but it is equally undeniable that it has also provided opportunities for new, independent cable networks and programmers – sparking intense competition in the video programming market as well.

Indeed, the FCC's Tenth Annual Report notes that there are 61 new networks planned in addition to the 339 national cable program networks already in existence (Appendix C).

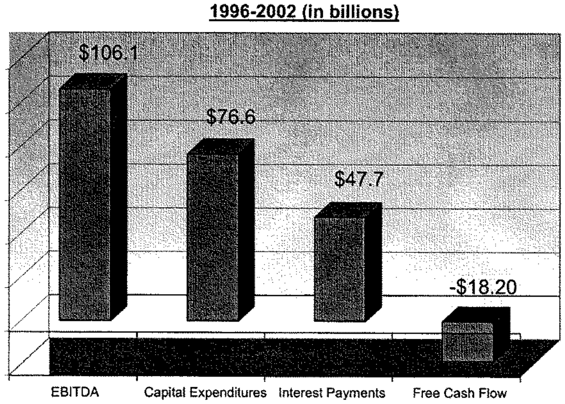
[7] FCC-04-5, *Separate Statement of Michael K. Powell*, paragraph 4, emphasis added.

VI. PRICES

A. Cable Reinvests in Upgraded Equipment and Service

From 1996 – 2002, total cable operating expenses, capital expenditures, and interest exceeded total cable industry revenues by more than $18 billion. As documented in a July 2003 analysis by the Bortz Media and Sports Group Inc., the cable industry during those six years spent nearly 75 cents of every dollar of cash flow[8] on upgrading infrastructure to offer new and improved services. When interest obligations are also taken into account, the cable industry's "free cash-flow" (i.e., funds available for distribution to investors and/or debt reduction) was actually negative from 1996 – 2002 (see following chart).

Cable Industry Capital Re-investment, 1996-2002 (in billions)



Source: Bortz Media estimate based on Kagan World Media, Broadband Cable Financial Databook 2000 and 2002, and company reports.

[8] Earnings before interest, taxes, depreciation and amortization (EBITDA).

As the Bortz study concluded, "the immediate result of this massive re-investment has been the expansion of system bandwidth, with this added capacity then enabling cable operators to very quickly make available new services such as digital video and high-speed Internet access to the vast majority of cable customers."[9]

B. Price Increases Reflect Cost Increases, Which Exceed Inflation

The principal reason that cable's prices are rising faster than inflation is that its costs are increasing at a rate far greater than inflation – but so have the quality and value of the services cable provides. Despite this fact, some still suggest that increasing cable prices indicate a lack of competition in the video marketplace. There is no economic basis for this contention:

> It is not true ... that firms with higher market power would be expected to demonstrate a higher growth rate of prices over time than would firms with lesser market power, all else equal. The latter proposition, though often asserted or implied in the popular press and similar venues, is not supported by economic logic. Similarly, one would not expect firms with high market power necessarily to demonstrate higher growth rate of prices over time than the rate of inflation, nor, conversely, can one expect that a firm with price growth faster than the rate of inflation has an above-average level of market power.[10]

One does not need an economist to discredit the notion that rising prices for cable service indicate a lack of competition in the video marketplace. As the facts demonstrate, cable operators face vigorous competition from the two national DBS companies as well as from other video service providers. Indeed, it is precisely because cable operators are facing growing

9 *Reinvesting in America: An Analysis of the Cable Industry's Impact on the U.S. Economy*. Bortz Media and Sports Group, Inc., July 2003: page 16. (Hereinafter cited as the "Bortz Study.")

10 Statement of Dr. Debra J. Aron, Director, LECG and Professor, Communications Systems, Northwestern University, attached to NCTA Comments to the Federal Communications Commission in MB Docket No. 02-145 (July 29, 2002).

competition from DBS that they make the costly investments in facilities and service (which cause their prices to rise). And it is precisely because of this competition that cable operators have little choice but to pay – and pass through – programming cost increases in order to secure the content demanded by their customers.

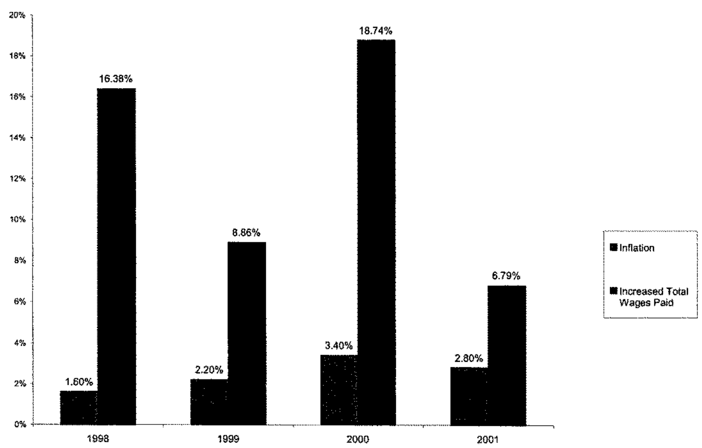
In short, the best explanation for cable price increases is the most mundane – prices are a function of costs. Cable operators' costs have increased sharply over time – in many cases, as the result of efforts by cable operators to bring more value to consumers, but sometimes for reasons beyond the operators' control.

C. Cable's Labor Costs Have Sharply Increased

As noted by the GAO in its October 2003 Report on competition and cable rates,[11] another factor that explains cable price increases is the investment by cable operators in labor and customer service. As cable operators have improved the size, proficiency, and training of their workforce to implement system upgrades, introduce new services, and offer 24/7 customer service, cable's labor costs have consistently risen faster than inflation. As the chart below demonstrates, from 1997 to 2001, total wages paid by "cable and other pay TV services" rose, according to the Bureau of Labor Statistics, by 60.6% – more than 15% per year. This is roughly five times the rate of inflation.

[11] GAO-04-8: page 26.

Increase in Annual Wages versus Inflation

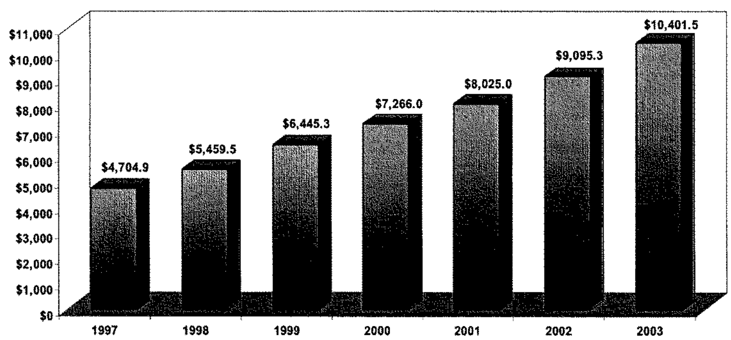


Source: Bureau of Labor Statistics; Total Wages Paid for SIC 484 (Cable and Other Pay TV Services), 1997-2001, and CPI-U for All Items, 1997-2001

D. Increased Expenditures by Cable Networks Have Substantially Enhanced the Value of Cable Programming

Although the number of channels of programming on expanded basic tiers is no longer increasing significantly, costs associated with many existing channels of programming are increasing faster than inflation. Simply put, the underlying costs of creating programming are increasing at a rate greater than inflation.

<u>Basic Cable Network Expenditures 1997 – 2003</u>
<u>For Original Programming and Program Acquisition (in Millions)</u>

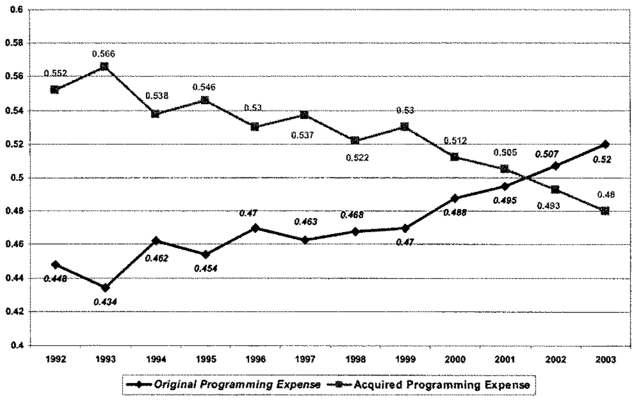


Source: Kagan World Media, *Economics of Basic Cable Networks*, 2004

Between 1997 and 2003, expenditures by basic cable networks for original programming and program acquisition increased by 121% – <u>an average of 20% per year</u> – from $4.7 billion to $10.4 billion. As part of their expanded investment in programming, cable networks have also increased their commitment to original programming. Between 1992 and 2003, spending on new content grew from $913 million to $5.4 billion. Original programming expenditures now represent 52% of cable networks' total programming investment and 70% of the programming aired by cable networks is made specifically for cable.[12]

12 Cabletelevision Advertising Bureau (CAB).

Percentage of Programming Expenditures
Original versus Acquired, 1992 – 2003



Source: Kagan World Media, *Cable Program Investor*, September 12, 2003, pp. 12-14.

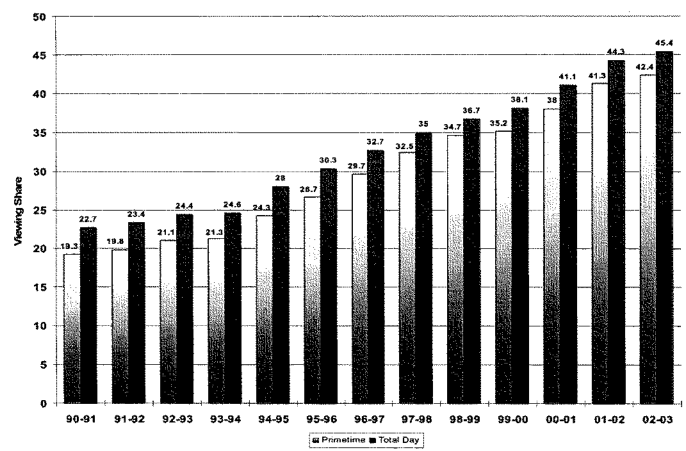
The cable networks' increased programming investments have resulted in original, compelling, and high-quality content that is attracting more viewers than ever before. Over the past ten years, the cable networks' viewing shares have increased steadily in both primetime and daytime. During the full 2001/2002 television season,[13] more people watched ad-supported cable during primetime than the seven national broadcast networks combined.[14] Cable repeated this achievement in the 2002/2003 TV season, with ad-supported cable networks finishing the

[13] The 2001/2002 full TV season ran from September 24, 2001 to September 22, 2002.

[14] "A TV First: Ad-Supported Cable Wins Primetime Viewership Race for Entire 2001/2002 Season," CAB Press Release, September 24, 2002.

season with a 49.6 share, up about 4% from the previous season. By comparison, the seven broadcast networks continued their decline, finishing the 2002/2003 season with a 45 share, down almost 4%.

Basic Cable Network Viewing Shares
Primetime and Total Day
1990/91 – 2002/03



Source: CAB analysis of Nielsen data in Total Television Households (October – September).

Moreover, cable networks continue to win a record number of industry awards. Ten cable networks took home a total of 39 Primetime Emmy awards presented by the Academy of Television Arts & Sciences in 2003. HBO topped all other networks with 18 awards; TNT collected six; Comedy Central took home three; A&E, Cartoon Network, Discovery Channel, SCI FI and USA each won two; and Bravo and Showtime each received one. In April 2003, cable networks won nine George Foster Peabody Awards out of 31 awards granted. Similarly, in

January 2004, cable networks took home a record nine Golden Globe Awards, up from eight in 2003.

In its October 2003 Report, GAO confirmed that higher programming costs contribute significantly to cable price increases. GAO found that of the 79 cable networks it analyzed, "expenditures by these networks to produce programming increased from $6.47 billion in 1999 to $8.90 billion in 2002, or by about 38 percent."[15] In many cases, increases in cable program costs reflect decisions of cable networks to upgrade the quality of their programming. Just as cable operators have incurred significant expenses to improve their facilities, many cable program networks have sought to enhance the value of their programming to cable operators and consumers by producing or purchasing more attractive – and more expensive – programming.

As GAO pointed out, "competition among networks to produce and show content that will attract viewers has become more intense."[16] This competition has bid up the cost of key inputs (such as writers and producers) and has spurred investment in programming. GAO highlighted increased original content and improved quality of programming as a major factor in increasing programming costs. It found that costs for program networks have gone up due to the increased costs of sports rights and greater competition among networks for the broadcast rights of existing programming.[17] Since both the quantity and quality of cable services are continually expanding, cable's value to subscribers is increasing in measurable ways.

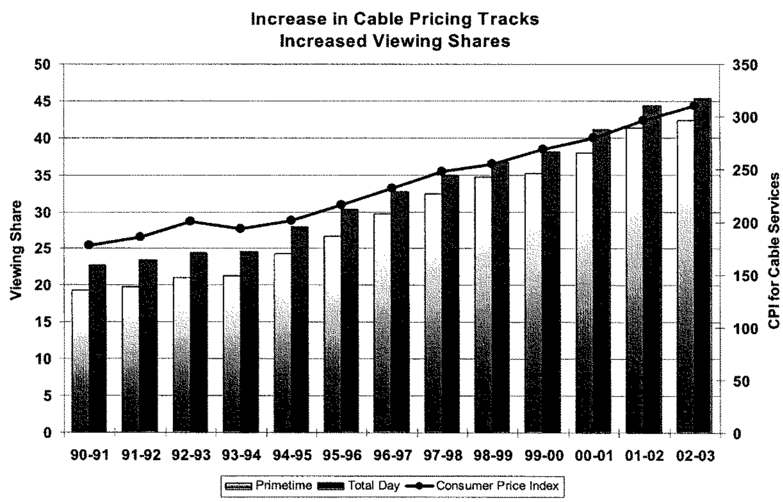
[15] GAO-04-8: page 24, citing data from Kagan World Media.

[16] Ibid: 23.

[17] Ibid (based on interviews with cable network executives).

A 2003 study by Michigan State University Professor Steven Wildman shows that a useful measure of value is the price paid by cable customers on a usage basis: [18]

> the amount of time the average cable household spent watching the ad-supported cable networks that predominate in cable systems' expanded basic packages increased by 43 percent – from 24 hours and 22 minutes per week to 34 hours and 44 minutes per week. Even more so than the increases in cable viewing shares that are more commonly cited, this increase in time spent watching cable programming is direct evidence of an increase in the value of basic cable programming to cable subscribers.



Source: CAB, Cable TV Facts 2002, US Department of Labor, Bureau of Labor Statistics, Consumer Price Index Chart. Reported viewing shares are for advertising supported cable, Oct-Sept each year and CPI is for September of each year.

[18] Steve Wildman, "Assessing Quality-Adjusted Changes in the Real Price of Cable Service," September 10, 2003, page 13.

Specifically, Professor Wildman established a price per viewing hour (PPVH), which is the price cable subscribers pay for service divided by the number of hours spent watching programs on basic cable networks. When the price of basic cable service is adjusted for inflation, Professor Wildman concludes that the real price paid for an hour of cable viewing has fallen by 15.2%."[19] Cable service costs more, in part, because of increased programming costs, but consumption of the product has increased despite the higher price – a clear indication that the marketplace is working to increase and maximize consumer welfare.

VII. CABLE CONTRIBUTES SIGNIFICANTLY TO THE NATIONAL ECONOMY

In scrutinizing competition and pricing, one should remember that the cable industry is more than a key provider of entertainment and information to the American consumer – it has a significant and rapidly growing impact on the U.S. economy. Through the aggressive re-investment of capital over the past eight years, the cable industry has put in place a broadband infrastructure that supports a wide range of services provided to the American consumer. In the process of making this infrastructure investment to provide what the American public wants, the industry has exerted a substantial, positive economic impact.

As of 2002, the cable industry (directly and indirectly) accounted for more than 1.1 million U.S. jobs representing over $42 billion in personal income.[20] Gross economic output attributable to the industry amounts to more than $173 billion. Other measures of the industry's positive economic impact include:

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[19] Ibid.

[20] Bortz Study, page 10.

- Cable operator revenues in 2002 totaled more than $48 billion, providing direct employment to 176,000 people. Annual compensation to cable industry employees totaled $8.9 billion.

- These cable industry employees can be found in all 50 states, reflecting the overwhelmingly local character of an industry comprised of close to 10,000 local cable systems.

- Cable industry suppliers provide another 131,000 cable-related jobs, representing personal income of $7.3 billion annually.

- Since 1990, direct and indirect employment attributable to the cable industry has more than doubled, increasing by more than 570,000 jobs. <u>This growth amounts to nearly three percent of all net new jobs created by the U.S. economy over this 12-year period</u>.

- Cable's economic impacts are spread throughout all major sectors of the U.S. economy. The largest impacts are in the information and manufacturing sectors, each of which is critical to both the growth and the overall health of the economy.

VIII. CONCLUSION

The video market is now fully competitive. Multiple video providers vie for customer loyalty, each trying to provide unique new products while trying to outdo those provided by their competitors. As a result of this competition, a wide new array of services – both video and non-video – is available to consumers over alternative broadband platforms. This is exactly what Congress intended when it passed the Telecommunications Act of 1996.

Eight years ago, some expected wireline overbuilds to become the main competitor to incumbent cable operators. Instead, satellite distribution succeeded in that role – but that does not mean that consumers don't have a meaningful choice in the multichannel video marketplace. As it turned out, satellite technology developed very quickly in the mid-1990s and its cost infrastructure became far more efficient than overbuilding entire communities with a second cable system. Even though wireline overbuilds are not widespread, I still wake up each and every morning thinking about my highly competitive business in every single market. There is no difference in how we compete whether we have two competitors or three.

The cable industry's massive, nationwide investment in upgraded facilities, new services, and higher quality programming has caused prices to rise faster than the rate of inflation. But it has also brought consumers greatly enhanced value. This is the inescapable conclusion of both the October 2003 GAO Report and the FCC's Tenth Annual Report to Congress on the status of competition in the video programming market. As FCC Chairman Michael Powell noted:

> Over this past decade Americans have responded and taken advantage of the increased competition, investment, innovation and diversity in the pay-television and programming markets. More Americans pay for television today than they did a decade ago. Today, 85% of television households (94.1 million households) pay for television, as compared to 63% of TV households (60.3 million households) in 1993. As more diverse and higher quality programming has emerged on cable and satellite systems, more people are watching. For the second year in a row (and only the second time in history), cable programming networks collectively brought more viewers to their channels throughout the day than did the seven broadcast networks and in primetime, cable networks brought in a viewing share of over 50% of all television viewers (vs. 44.7% of the seven networks). The shift in viewing should come as no surprise as the quality of cable programming has also been recognized as award nominations and wins continue to reach new heights for cable programming.[21]

Both the GAO and the FCC have confirmed the existence of a highly competitive multichannel video market. It is an environment where consumers enjoy an increasing choice of providers, programming, and services. It is also a market where cable has been investing heavily since 1996 and where regulation would deter new investment while depriving consumers of next-generation services.

Thank you for the opportunity to present my views. I would be glad to answer any questions you might have.

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[21] FCC 04-05, *Separate Statement of Michael K. Powell*, paragraph 7.

BEFORE THE
UNITED STATES SENATE
COMMITTEE ON THE JUDICIARY
SUBCOMMITTEE ON ANTITRUST, COMPETITION
AND BUSINESS AND CONSUMER RIGHTS

HEARING ON

"CABLE COMPETITION – INCREASING PRICE; INCREASING VALUE?"

FEBRUARY 11, 2004

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TESTIMONY OF

THE
NATIONAL ASSOCIATION OF TELECOMMUNICATIONS
OFFICERS AND ADVISORS

BY

CORALIE WILSON

PRESIDENT, NATOA BOARD OF DIRECTORS

THE NATIONAL ASSOCIATION OF TELECOMMUNICATIONS OFFICERS AND ADVISORS

TESTIMONY OF CORALIE WILSON

PRESIDENT, BOARD OF DIRECTORS

OF THE

NATIONAL ASSOCIATION OF TELECOMMUNICATIONS OFFICERS AND ADVISORS

"CABLE COMPETITION – INCREASING PRICE; INCREASING VALUE?"

FEBRUARY 11, 2004

Chairman DeWine and Members of this Committee:

I am Coralie Wilson, President of the Board of Directors of the National Association of Telecommunications Officers and Advisors. NATOA is a national organization that represents the cable, telecommunications and related interests of local governments across the United States. We are grateful for the opportunity to share our views and suggestions on the important issues before you today.

The FCC has repeatedly found that head-to-head competition between terrestrial facilities-based providers of video programming results in significantly lower rates, more channels and better service for consumers. The General Accounting Office recently estimated that the rate differential is approximately 15 percent nationwide. Local governments therefore have a strong interest in promoting robust cable competition

In the late 1990s, competition began to emerge in many communities across the United States. In many cases, however, incumbents sought to thwart local governments from awarding competitive franchises, and in others we began to see incumbents engaging in a variety of anticompetitive practices.

By 2002, the number of overbuilds declined dramatically. Although the economy was clearly a factor, the feedback that NATOA was receiving from its members suggested that the anticompetitive activities of incumbents were also contributing to this phenomenon. As a result, NATOA commissioned a study of the kinds of anticompetitive practices that were occurring and the steps that may be necessary to deal with this problem.

In March 2003, the Baller Herbst Law Group submitted its extensive report and recommendations to NATOA, a copy of which is attached, with privileged attorney-client material removed. As you will see, it contained dozens of examples of anticompetitive behavior. The report cautioned that, given the nature of the data-collection process, some of the information presented might not be completely accurate or current and that it had not been subjected to detailed analysis. The report concluded, however, that the sheer volume of the information available indicated that anticompetitive practices by incumbent cable operators warranted further investigation. In presenting the report to you, we underscore its reservations and add a further qualification that the facts and cases cited are now nearly a year old.

Recent FCC decisions and orders have reflected increasing concern about anticompetitive practices by the major incumbent cable operators, but the agency believes that it lacks statutory authority to do anything about this problem. To this end we believe that two statutory changes, while not the entire solution, would be very helpful.

First, several major incumbent cable operators are practicing targeted rate discrimination through what they call "win-back" programs. A common and critical feature is that the incumbent does not offer its own subscribers the same special deals that it offers to subscribers who have transferred, or are threatening to transfer, their business to an overbuilder.

It was precisely for this reason that Congress enacted in 1992 a uniform rate requirement in Section 623(d) of the Communications Act. As Congress stated, the purpose of Section 623(d) was "to prevent cable operators from dropping the rates in one portion of a franchise area to undercut a competitor temporarily."

In the Telecommunications Act of 1996, believing that true competition in the cable industry was imminent, Congress subjected the uniform rate requirement to an important qualification – it would no longer be applicable if there was "effective competition" in the relevant market. At times, incumbent operators have successfully defeated a claim of anticompetitive practices simply by filing a claim for effective competition with the FCC. Since claims of effective competition based on direct broadcast satellite offerings are based on data not generally available to the local government and requires a response in 20 days, they are very difficult to defeat Hence, the use of effective competition claims to defeat allegations of anticompetitive practices is very effective. Congress should recognize this and delete the "effective competition" exception from Section 623(d).

Second, Sections 628(c)(2)(C) and (D) of the Communications Act prohibit vertically integrated cable operators and programming vendors from entering into, or renewing, exclusive contracts under most circumstances. Unfortunately, the FCC has repeatedly found that these provisions apply only to video programming delivered by satellites, and not to programming delivered terrestrially through fiber optic cable. As the FCC has itself recognized, this construction of the law adversely affects the ability of overbuilders to obtain critical programming, especially regional sports programming, and it gives incumbents the incentive to shift programming from satellite to terrestrial delivery as horizontal growth and "clustering" in the cable industry enhances the ability of incumbents to deliver video programming terrestrially among adjoining cable systems. NATOA recommends that Congress eliminate the terrestrial delivery loophole. Furthermore, given the efforts of major cable incumbents to tie up content of all kinds, not merely video programming, in exclusive contracts, Congress may also want to extend the ban on exclusive contracts to include content of all kinds.

We appreciate this opportunity to testify and would be glad to answer any questions or provide any further information that the Committee or its staff may desire.

Thank you.