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Open Video Systems: Too Much Regulation Too Late?

Michael Botein*

There are lessons to be learned from the nonstarters in regulatory history. A good example in the 1996 Telecommunications Act (“1996 Act”)¹ was Section 653’s creation of open video systems (“OVS”).² OVS was an attempt to create a quasi-carrier platform, more available to third parties than cable but with enough potential profit to encourage investment. At least in theory, OVS operators would be subject to less regulation than either cable systems or common carriers. OVS turned out to be a flop, however, in terms of market share. Five years after passage of the 1996 Act, OVS had a total of 60,000 subscribers and the number appeared to be declining.³

The experience with OVS is particularly relevant today with the potential entry of “fiber to the home” (“FTTH”) from incumbent local exchange carriers (“ILECs”), such as Verizon and AT&T. Both companies are in the process of rolling out FTTH systems under rubrics such as FiOS (Verizon) or Lightspeed (AT&T), promising high-bandwidth digital video and other applications.⁴ At present, these developments’ legal status is less

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1. Pub. L. No. 104-104, 110 Stat. 56 (codified in scattered sections of 47 U.S.C.).

2. *Id.* § 653 (codified at 47 U.S.C. § 573 (2000)).

3. Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, *Seventh Annual Report*, 16 F.C.C.R. 6005, para. 14 (2001) [hereinafter *Video Programming Report*].

4. Dionne Searcey, *Dethroned by AT&T, Verizon Pushes Ultrafast Internet Lines*, WALL ST. J., Mar. 8, 2006, at A1; Karen Brown, *AT&T: Lightspeed Could Dim Cable*, MULTICHANNEL NEWS, Jan. 31, 2006, available at <http://www.multichannel.com/article/CA6303693.html?display=Breaking+News>; Verizon, About FiOS, <http://www22.verizon>

than clear since debate exists as to whether FTTH could or should be regulated as cable television under the 1996 Act.⁵ OVS status would be a logical approach to regulatory classification, but the ILECs apparently are not interested in it—probably for the same reasons which have dissuaded past entrepreneurs.⁶

The background of OVS is less than clear and little in the 1996 Act's sparse legislative history sheds much light. The primary impetus seems to have been cleaning up after a prior Federal Communications Commission ("FCC") regulatory experiment—video dialtone ("VDT"). This was an attempt to allow the ILECs to market video programming to the home through separate subsidiaries.⁷ As with OVS, the goal was to bring new competition into the multichannel video market, which then was dominated by the cable industry. Video dialtone ultimately proved too cumbersome to be workable; however, and Congress as well as the Commission went in search of a less restrictive regulatory framework, ultimately settling on OVS. Section 653 of the 1996 Act thus explicitly invalidated the FCC's VDT rules and substituted OVS for them.⁸

Although Section 653's intent clearly was to provide regulatory relief, its language is not well crafted. As one observer noted, "[t]his is a bizarre statute . . ."⁹ The law begins by providing that "[a] local exchange carrier may provide cable service . . . through an open video system . . .," but then adds that ". . . an operator of a cable system or any other person . . ." may apply for a certificate to operate an OVS system.¹⁰

The statute then goes on to impose or relieve regulatory obligations by a series of cross-references. The basic requirements are that an OVS

.com/FiOSForHome/channels/FiOS/root/about_FiOS.asp (last visited Mar. 3, 2006).

5. Much of the confusion stems from the definition of "cable system" within 47 U.S.C. § 522(7) (2000), which excludes "a facility of a common carrier . . . to the extent such facility is used in the transmission of video programming directly to subscribers, unless the extent of such use is solely to provide interactive on-demand services . . ."

6. See *infra* notes 22–23 and accompanying text.

7. Implementation of Section 302 of the Telecommunications Act of 1996 Open Video Systems, *Second Report and Order*, 11 F.C.C.R. 18223 (1996) [hereinafter *Open Video Systems*].

8. Telecommunications Act, § 653, 110 Stat. 124 provides:

The Commission's regulations and policies with respect to video dialtone requirements . . . shall cease to be effective on the date of enactment of this Act. This paragraph shall not be construed to require the termination of any video-dialtone system that the Commission has approved before the date of enactment of this Act.

9. Monroe Price, Professor of Law at Benjamin N. Cardozo School of Law, Remarks at the Open Video Systems and the Media Marketplace Seminar, pt. 1 (May 23, 1996), available at <http://www.citi.columbia.edu/ovstran.htm>, (last visited Mar. 3, 2006) [hereinafter *OVS Seminar*].

10. 47 U.S.C. § 573(a)(1) (2000).

operator offer a form of leased access to third parties on “just and reasonable” “rates, terms, and conditions.”¹¹ This looks very much like a form of common carriage under the old *Midwest Video II* case.¹² The Supreme Court held that the FCC’s original public access channels were a form of common carriage since they required cable operators to deal with any qualified third party;¹³ OVS leased access channel requirements are substantially similar. Although the Court has never formally overruled *Midwest Video II*, it also has not invoked it in recent years.¹⁴

The mirror image of the leased access requirement is that if there is demand for two-thirds or more of an OVS system’s channels, the operator may control no more than one-third of them.¹⁵ This obviously gives an OVS operator substantially less content control than a cable system, which is subject only to requirements of must-carry and public access channels—a relatively limited number, except in major urban areas.¹⁶ The statute also requires the Commission to adopt requirements of public, educational, and governmental (“PEG”) access channels and mandatory carriage of local television broadcast stations.¹⁷ It also mandates a series of traditional cable rules, such as network nonduplication and syndicated exclusivity (now repealed).¹⁸

On the other hand, the statute appeared to relieve OVS operators from local regulatory requirements. It allows a city to charge an OVS system fees no greater than franchise fees paid by a cable system.¹⁹ The inference naturally was that OVS operators were not subject to local franchising—long a complaint of the cable industry. The Commission supported this interpretation, reasoning that Congress had meant to repeal prior legislation requiring a cable system to have a local franchise.²⁰

The Fifth Circuit, however, quickly changed this result. *Dallas v. FCC*²¹ held that although the 1996 Act had repealed the federal requirement that cable systems obtain a local franchise, “it does not eviscerate the *ability* of local authorities to impose franchise requirements

11. *Id.* at § 573(b)(1)(A).

12. *FCC v. Midwest Video Corp.*, 440 U.S. 689 (1979).

13. *Id.* at 695–96.

14. *See, e.g., Denver Area Educ. Telecomm. Consortium, Inc. v. FCC*, 518 U.S. 727, 734 (1996) (emphasizing the long history and acceptance of cable access channels).

15. *See* 47 U.S.C. § 573(b)(1)(B).

16. *See infra* discussion following note 26.

17. 47 U.S.C. § 573(c)(1)(B).

18. *Id.* § 573(b)(1)(D). The FCC repealed the syndicated exclusivity rules in 1981. *See Malrite T.V. of N.Y. v. FCC*, 652 F.2d 1140 (2d Cir. 1981) (upholding the repeal).

19. § 573(c)(2)(B).

20. *See Open Video Systems, supra* note 7, paras. 211–14.

21. 165 F.3d 341 (5th Cir. 1999).

...”²² Since most large cities try to control any entity using their streets, the end result is that OVS—like cable—ended up being subject to both franchising and franchise fees. One possible difference between the two media is that ILECs already hold franchises for their telephone businesses, and thus a FTTH offering might be covered by these. Most large cities have rejected this argument on the ground that telephone and video services are completely different. However, one state court decision gives at least some support.²³

Thus, Section 653 was intended to be a “cable light” form of regulation, to encourage entry of new firms and creation of new competition in the multichannel media industry. Its terms as well as subsequent interpretation, however, resulted in authorizing a new medium on roughly the same regulatory terms as traditional cable television.

Combined with this lack of real deregulation, market forces may have doomed OVS from the beginning. Regardless of the regulatory environment, OVS started out with three significant handicaps.

First, events largely outpaced OVS development. By the end of 1996, more than three quarters of U.S. households already had cable, direct broadcast satellites, or some other form of multichannel media.²⁴ As a result, in most substantial geographic markets OVS was in the position of a second entrant, or “overbuilder.” This is a historically disfavored position in the cable and local telephone exchange markets. To the extent that economies of scale exist, the incumbent already has almost all of them. In addition, by definition the first entrant also has access to prime subscribers as well as programmers. And programming may be the most important factor in marketing a multichannel medium since by definition subscribers want more interesting content than traditional broadcasting in the first place. Although programmers are legally free as well as required to sell to new entrants,²⁵ most are not anxious to because of their existing relations and established billing procedures with cable and other multichannel distributors. A second provider thus invariably finds it difficult to secure good programming—and hence subscribers. Even today, of course, some communities do not have even one multichannel video provider. Almost by definition, however, these are relatively small and rural; as a result, the infrastructure costs per subscriber often are prohibitive in light of potential revenues.

22. *Id.* at 347 (emphasis original).

23. *WH Link, LLC v. Otsego*, 664 N.W.2d 390 (Minn. Ct. App. 2003).

24. *Video Programming Report*, *supra* note 3, paras. 5–15.

25. 47 U.S.C. § 548(c)(2)(C) (2000) (prohibiting exclusive dealing arrangements between programmers and multichannel video distributors).

Second, OVS' very structure invites programmers to provide content on a leased rather than licensed basis. Assuming that an OVS operator honored Section 653's requirement of just and reasonable rates to third parties,²⁶ it would not be able to extract much profit from a leased channel transaction. Cable operators traditionally have fought leased access tooth and nail, precisely because licensing is more profitable than leasing—particularly with pay channels. In addition, a licensing arrangement creates opportunities for a system to secure local advertising time on national satellite channels, which has turned into twenty percent of the cable industry's revenue stream.

Third, Section 653's set-aside of up to two-thirds of all channels to third parties reduces an OVS operator's opportunity to maximize channels and thus revenues. This requirement would apply, of course, only if there were demand by third parties for two-thirds or more of the channels since today about 250 satellite networks are chasing half that number of cable channels. However, eighty channels might fill up very quickly.

Early OVS observers assumed that the medium would develop quickly as a broadband digital system. For example, in 1996, former FCC Cable Service Bureau Chief Meredith Jones noted that “[w]hat we hear . . . is that if you have a switched digital system, your capacity is virtually infinite.”²⁷ This may be true in the future. But at present, the cost of implementing fiber-optic cable as well as video switching is high.²⁸

At least for the moment, state-of-the-art technology in the cable industry still is “hybrid fiber-coax,” which uses a fiber backbone and coaxial cable to offer a mixture of 125 or more analog and digital channels.²⁹ Even this is not inexpensive, with costs running about \$1,000–\$1,500 per household.³⁰

With this amount of capacity under the two-thirds set-aside, OVS is at a significant disadvantage to traditional cable.³¹ In a major urban market, a cable system would have to assign about twenty channels to must-carry signals and five to PEG access; it would retain 100 or more channels for its own use. By comparison, an OVS operator would be under a similar requirement, but would control only about forty channels as a result of the set-aside—thus leaving it with perhaps fifteen to twenty channels to

26. See *supra* discussion accompanying note 11.

27. OVS Seminar, *supra* note 9, at Part II.

28. See Matt Stump, *Video's the Rage at Supercomm Confab*, MULTICHANNEL NEWS, June 13, 2005, at 8, available at <http://www.multichannel.com/article/CA607888.html>.

29. Michael Botein, *The Demise of the Information Superhighway*, 11 MEDIA L. & POL'Y 85, 87–88 (2003).

30. *Id.* at 92.

31. See *supra* note 15 and accompanying text.

program on its own after meeting its must carry and PEG obligations. This is not exactly a recipe for profitability. In a 500 channel digital universe, of course, the results would be quite different; an OVS operator would retain more than 100 channels after satisfying its must carry and PEG obligations. However, this still appears to be fairly far off.

An OVS system thus begins with a significant liability as the second entrant, which only exacerbates its problems in acquiring attractive programming and hence subscribers. This situation is aggravated by the two-thirds set-aside, reducing its available channels.

OVS' nonstarter status thus is less than surprising. The reasons for Section 653's counterproductive provision also are relatively clear in hindsight. The drafters simply made a number of wrong assumptions about the state of the industries with which they were dealing: they underestimated cable's entrenchment and overestimated OVS' ability to develop a completely new digital technology in a few years. The ILECs' avoidance of OVS thus made a lot of sense.

This leaves the intriguing question of where things go from here, particularly in relation to the ILECs' FTTH proposals—a traditional common carrier approach washed out with video dialtone. The ILECs had no interest in OVS hybrid status, and they clearly do not want to be regulated as cable operators. Perhaps there is another, fresh, innovative approach, but it does not seem to have surfaced so far.