ANALYSIS OF PROPOSED
CONSENT ORDER TO AID PUBLIC COMMENT

I. Introduction

The Federal Trade Commission has accepted for public comment from Time Warner Inc. ("Time Warner"), Turner Broadcasting System, Inc. ("Turner"), Tele-Communications, Inc. ("TCI"), and Liberty Media Corporation ("LMC") (collectively "the proposed respondents") an Agreement Containing Consent Order ("the proposed consent order"). The Commission has also entered into an Interim Agreement that requires the proposed respondents to take specific action during the public comment period.

The proposed consent order is designed to remedy likely antitrust effects arising from Time Warner's acquisition of Turner as well as related transactions, including TCI's proposed ownership interest in Time Warner and long-term cable television programming service agreements between Time Warner and TCI for post-acquisition carriage by TCI of Turner programming.

II. Description of the Parties, the Acquisition and Related Transactions

Time Warner is a leading provider of cable networks and a leading distributor of cable television. Time Warner Entertainment ("TWE"), a partnership in which Time Warner holds the majority interest, owns HBO and Cinemax, two premium cable networks. Time Warner and Time Warner Cable, a subsidiary of TWE, are collectively the nation's second largest distributor of cable television and serve approximately 11.5 million cable subscribers or approximately 17 percent of U.S. cable television households.

Turner is a leading provider of cable networks. Turner owns the following “marquee” or “crown jewel” cable networks: Cable News Network ("CNN"), Turner Network Television ("TNT"), and TBS SuperStation (referred to as "WTBS"). Turner also owns Headline News (“HLN”), Cartoon Network, Turner Classic Movies, CNN International USA and CNN Financial Network.

TCI is the nation's largest operator of cable television systems, serving approximately 27 percent of all U.S. cable television households. LMC, a subsidiary of TCI, is a leading provider of cable programming. TCI also owns interests in a large number of cable networks.

In September 1995, Time Warner and Turner entered into an agreement for Time Warner to acquire the approximately 80 percent of the outstanding shares in Turner that it does not already own. TCI and LMC have an approximately 24 percent existing interest in Turner. By trading their interest in Turner for an interest in Time Warner, TCI and LMC would acquire approximately a 7.5 percent interest in the fully diluted equity of Time Warner as well as the right of first refusal on the approximately 7.4 percent interest in Time Warner that R. E. Turner, III, chairman of Turner, would receive as a result of this acquisition. Although Time Warner has a 'poison pill' that would prevent TCI from acquiring more than a certain amount of stock without triggering adverse consequences, that poison pill would still allow TCI to acquire approximately 15 percent of the Fully Diluted Equity, and if the poison pill were to be altered or waived, TCI could acquire more than 15 percent of the fully diluted equity of Time Warner. Also in September 1995, Time Warner entered into two long-term mandatory carriage agreements referred to as the Programming Service Agreements (PSAs). Under the terms of these PSAs, TCI would be required, on virtually all of its cable television

systems, to carry CNN, HLN, TNT and WTBS for a twenty-year period.

III. The Complaint

The draft complaint accompanying the proposed consent order and the Interim Agreement alleges that the acquisition, along with related transactions, would allow Time Warner unilaterally to raise the prices of cable television programming and would limit the ability of cable television systems that buy such programming to take responsive action to avoid such price increases. It would do so, according to the draft complaint, both through horizontal combination in the market for cable programming (in which Time Warner, after the acquisition, would control about 40% of the market) and through higher entry barriers into that market as a result of the vertical integration (by merger and contract) between Turner's programming interests and Time Warner's and TCI's cable distribution interests. The complaint alleges that TCI and Time Warner, respectively, operate the first and second largest cable television systems in the United States, reaching nearly half of all cable households; that Time Warner would gain the power to raise prices on its own and on Turner's programming unilaterally; that TCI's ownership interest in Time Warner and concurrent long term contractual obligations to carry Turner programming would undermine TCI's incentive to sign up better or less expensive non-Time Warner programming, preventing rivals to the combined Time Warner and Turner from achieving sufficient distribution to realize economies of scale and thereby to erode Time Warner's market power; that barriers to entry into programming and into downstream retail distribution markets would be raised; and that substantial increases in wholesale programming costs for both cable systems and alternative service providers—including direct broadcast satellite service and other forms of non-cable distribution—would lead to higher service prices and fewer entertainment and information sources for consumers.

The Commission has reason to believe that the acquisition and related transactions, if successful, may have anticompetitive effects and be in violation of Section 7 of the Clayton Act and Section 5 of the Federal Trade Commission Act.

IV. Terms of the Proposed Consent Order

The proposed consent order would resolve the alleged antitrust concerns by breaking down the entry barriers that would otherwise be erected by the transaction. It would do so by: (1) requiring TCI to divest all of its ownership interests in Time Warner or, in the alternative, capping TCI's ownership of Time Warner stock and denying TCI and its controlling shareholders the right to vote any such Time Warner stock; (2) canceling the PSAs; (3) prohibiting Time Warner from bundling Time Warner's HBO with any Turner networks and prohibiting the bundling of Turner's CNN, TNT, and WTBS with any Time Warner networks; (4) prohibiting Time Warner from discriminating against rival Multichannel Video Programming Distributors ("MVPDs") in the provision of Turner programming; (5) prohibiting Time Warner from foreclosing rival programmers from access to Time Warner's distribution; and (6) requiring Time Warner to carry a 24-hour all news channel that would compete with Turner's CNN. The following sections discuss the primary provisions of the proposed consent order in more detail.

A. TCI Will Divest Its Interest in Time Warner or Accept a Capped Nonvoting Interest

The divestiture provision of the proposed consent order (Paragraph II) requires TCI and LMC to divest their collective ownership of approximately 7.5 percent of the fully diluted

shares in Time Warner—the amount they will obtain from Time Warner in exchange for their 24 percent ownership interest in Turner—to a different company ("The Separate Company") that will be spun off by TCI and LMC. The stock of The Separate Company would be distributed to all of the shareholders of TCI's LMC subsidiary. Because that stock would be freely tradeable on an exchange, the ownership of The Separate Company would diverge over time from the ownership of the Liberty Media Tracking Stock (and would, at the outset, be different from the ownership of TCI). TCI would therefore breach its fiduciary duty to its shareholders if it forestalled programming entry that could benefit TCI as a cable system operator in order to benefit Time Warner's interests as a programmer.

In addition to the divestiture provisions ensuring that TCI will have no incentive to forgo its own best interests in order to favor those of Time Warner, the proposed consent order contains provisions to ensure that the transaction will not leave TCI or its management in a position to influence Time Warner to alter its own conduct in order to benefit TCI's interests. Absent restrictions in the consent order, the TCI Control Shareholders (John C. Malone, Bob Magness, and Kearns-Tribune Corporation) would have a controlling share of the voting power of The Separate Company. To prevent those shareholders from having significant influence over Time Warner's conduct, the proposed consent order contains the

following provisions that will wall off the TCI Control Shareholders from influencing the officers, directors, and employees of The Separate Company and its day-to-day operations:

- The Commission must approve the initial board of directors of The Separate Company;
- Within six months of the distribution of The Separate Company's stock, the stockholders (excluding the TCI Control Shareholders) of The Separate Company must elect new directors;
- Members of the board of directors of The Separate Company are prohibited from serving as officers, directors, or employees of TCI or LMC, or holding or controlling greater than one-tenth of one percent (0.1%) of the ownership in or voting power of TCI or LMC;
- Officers, directors or employees of TCI or LMC are prohibited from concurrently serving as officers, directors, or employees of The Separate Company, with a narrow exception so that TCI or LMC employees may provide limited operational services to The Separate Company;
- The TCI Control Shareholders are prohibited from voting (other than a *de minimis* voting share necessary for tax purposes) any stock of The Separate Company to elect the board of directors or on other matters. There are limited exceptions for voting on major issues such as a proposed merger or sale of The Separate Company, the disposition of all or substantially all of The Separate Company's assets, the dissolution of The Separate Company, or proposed changes in the corporate charter or bylaw of The Separate Company. However, no vote on any of these excepted issues would be successful unless a majority of shareholders other than the TCI Control Shareholders vote in favor of such proposal;
- The TCI Control Shareholders are prohibited from seeking to influence, or attempting to control by proxy or otherwise, any other person’s vote of The Separate Company’s stock;
- Officers, directors, and employees of TCI or LMC, or any of the TCI Control Shareholders are prohibited from communicating with any officer, director, or employee of The Separate Company except on the limited matters on which they are permitted to vote. Further restrictions require that, in order for a TCI Control Shareholder to seek to initiate action on an issue on which they are entitled to vote, they must do so in writing;

- The Separate Company is prohibited from acquiring more than 14.99% of the fully diluted equity shares of Time Warner, with exceptions in the event that the TCI Control Shareholders sell their stock in The Separate Company or in TCI and LMC; and

- The Separate Company is prohibited from voting its shares (other than a *de minimis* voting share necessary for tax purposes) in Time Warner, except that such shares can become voting if The Separate Company sells them to an Independent Third Party or in the event that the TCI Control Shareholders sell their stock in The Separate Company or in TCI and LMC.

The Commission has reason to believe that the divestiture of TCI's and LMC's interest in Time Warner to The Separate Company is in the public interest. The required divestiture of the Time Warner stock by TCI and LMC and the ancillary restrictions outlined above are beneficial to consumers because (1) they would restore TCI's otherwise diminished incentives to carry cable programming that would compete with Time Warner's cable programming; and (2) they would eliminate TCI's and LMC's ability to influence the operations of Time Warner.

The proposed consent order also requires TCI and LMC to apply to the Internal Revenue Service ("IRS") for a ruling that the divestiture of TCI's and LMC's interest in Time Warner to The Separate Company would be generally tax-free. Upon receipt of the IRS Ruling, TCI and LMC has thirty days to transfer its Time Warner stock to The Separate Company. After TCI and LMC divest this interest in Time Warner to The Separate Company, TCI, LMC, Magness and Malone are prohibited from acquiring any stock in Time Warner, above a collective *de minimis* nonvoting amount, without the prior approval of the Commission.

Pending the ruling by the IRS, or in the event that the TCI and LMC are unable to obtain such an IRS ruling, (1) TCI, LMC, John C. Malone and Bob Magness, collectively and individually, are capped at level no more than the lesser of 9.2 percent of the fully diluted equity of Time Warner or 12.4% of the actual issued and outstanding common stock of Time

Warner, as determined by generally accepted accounting principles; and (2) TCI, LMC and the TCI Control Shareholders' interest in Time Warner must be nonvoting (other than a *de minimis* voting share necessary for tax purposes), unless the interest is sold to an Independent Third Party. This nonvoting cap is designed to restore TCI's otherwise diminished incentives to carry cable programming that would compete with Time Warner's cable programming as well as to prevent TCI from seeking to influence Time Warner's competitive behavior.

B. TCI's Long-Term Carriage Agreement with Turner Is Canceled

As part of the transaction, Time Warner and TCI entered into PSAs that required TCI to carry Turner programming for the next twenty years, at a price set at the lesser of 85% of the industry average price or the lowest price given to any distributor. According to the complaint, the PSAs would tend to prevent Time Warner's rivals from achieving sufficient distribution to threaten Time Warner's market power by locking up scarce TCI channel space for an extended period of time. By negotiating this arrangement as part of the Turner acquisition, and not at arm's length, Time Warner was able to compensate TCI for helping to achieve this result. Under the Interim Agreement, TCI and Time Warner are obligated to cancel the PSAs. Following cancellation of the PSAs, there would be a six month "cooling off" period during which Time Warner and TCI could not enter into new mandatory carriage requirements on an analog tier for Turner programming.[1] This cooling off period will ensure

[1] Analog technology is currently used for cable programming distribution and places

that such agreements are negotiated at arm's length. Thereafter, the parties cannot enter into any agreement that would secure Time Warner guaranteed mandatory carriage rights on TCI analog channel capacity for more than five-year periods. This restriction would not prevent TCI from having renewal options to extend for additional five-year periods, but would prohibit Time Warner from obligating TCI to carry a Time Warner channel for more than five years. The only exceptions to the cooling off period for Time Warner/TCI carriage agreements would relate to WTBS and HLN on which there are no existing contracts. Any such carriage agreements for those services would also be limited to five years.

In requiring the cancellation of the PSAs and prescribing shorter renewal option periods, the Commission has not concluded that any such long-term programming agreements are anticompetitive in and of themselves or would violate the antitrust laws standing alone. Rather, the Commission has concluded that the PSAs are anticompetitive in the context of the entire transaction arising from the merger and ownership of Time Warner stock by TCI and in light of those two companies' significant market shares in both programming and cable service. The divestiture and rescission requirements would therefore sever complementary ownership and long-term contractual links between TCI and Time Warner. This would restore incentives for TCI, a cable operator serving nearly a third of the nation's cable households, to place non-Time Warner programming on its cable systems, in effect disciplining any market power resulting from a combination of Time Warner and Turner programming.

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significant limitations on the addition of new channels. Digital technology, which is still in its infancy and not currently a competitive factor in video distribution, has the potential to expand capacity sixfold, thereby substantially alleviating capacity constraints on the digital tier.

C. Time Warner is Barred From Bundling HBO with any Turner Programming and CNN, TNT and WTBS with Time Warner Programming

Paragraph V bars Time Warner from bundling HBO with Turner channels—that is, making HBO available, or available on more favorable terms, only if the purchaser agrees to take the Turner channels. Time Warner is also barred from bundling CNN, TNT, or WTBS with Time Warner channels. This provision applies to new programming as well as existing programming. This provision is designed to address concerns that the easiest way the combined firm could exert substantially greater negotiating leverage over cable operators is by combining all or some of such "marquee" services and offering them as a package or offering them along with unwanted programming. Because the focus of the provision is on seeking to prevent the additional market power arising from this combination of programming, this provision does not prevent bundling engaged in pre-merger—that is, Turner channels with Turner channels and pre-merger Time Warner channels with Time Warner channels. Rather, it is narrowly targeted at Time Warner's use of its newly-acquired stable of "marquee" channels to raise prices by bundling.

The Commission emphasizes that, in general, bundling often benefits customers by giving firms an incentive to increase output and serve buyers who would otherwise not obtain the product or service. The Commission, however, believes that, in the context of this transaction, the limited bar on bundling is a prudent measure that will prevent actions by Time Warner that are likely to harm competition.

D. Time Warner is Barred from Price Discrimination Against Rival MVPDs

Paragraph VI is designed to prevent Time Warner from using its larger stable of programming interests to disadvantage new entrants into the distribution of cable programs such as Direct Broadcast Services, wireless systems, and systems created by telephone companies. The complaint alleges that, as a programmer that does not own its own distribution, Turner pre-merger had no incentive to and did not generally charge significantly higher prices to new MVPD entrants compared to the prices offered to established MVPDs. Under the terms of Paragraph VI, the preacquisition range of pricing offered by Turner is used as a benchmark to prevent Time Warner from discriminating against the rival distributors of programming in its service areas, and Time Warner may not increase the range of pricing on Turner programming services between established MVPDs and new entrants any more than Turner had pre-merger. Because Time Warner's incentive to discriminate against MVPDs stems from an incentive to protect its own cable company from those in or entering its downstream distribution areas, this provision only covers competitors in Time Warner's distribution areas. Because the price charged by Time Warner as a programmer to Time Warner's cable systems is, to some extent, an internal transfer price, the proposed consent order uses as a benchmark the price charged to the three largest cable system operators nationwide rather than the price charged to Time Warner. This provision, therefore, compares the price charged to Time Warner's competitors in the overlap areas with the price charged to the three largest cable system operators, and asks whether the spread between the two is any greater than the pre-merger spread between a similarly situated MVPD and the three largest cable system operators. It thus focuses on the greater possibility for price discrimination against new MVPD entrants arising directly as a result of this merger. It both ensures that Time Warner's additional market power as a result of this merger does not result

in higher prices to new MVPD entrants, while it narrowly protects only those new entrants that Time Warner may have an incentive to harm.

E. Conduct and Reporting Requirements Designed to Ensure that Time Warner Cable Does Not Discriminatorily Deny Carriage to Unaffiliated Programmers

The order has two main provisions designed to address concerns that this combination increases Time Warner's incentives to disadvantage unaffiliated programmers in making carriage decisions for its own cable company. Paragraph VII, drawn from statutory provisions in the 1992 Cable Act, is designed to prevent Time Warner from discriminating in its carriage decisions so as to exclude or substantially impair the ability of an unaffiliated national video programmer to enter into or to compete in the video programming market. The Commission views these provisions as working in tandem with the collection and reporting requirements contained in Paragraph VIII. Under that paragraph, Time Warner is required to collect and maintain information about programming offers received and the disposition of those offers as well as information comparing Time Warner cable systems' carriage rates to carriage rates on other MVPDs for national video programming services. Such information would be reported on a quarterly basis to the management committee of TWE. TWE's management committee includes representatives of U S West since U S West is a minority partner in TWE. TWE owns or operates all of Time Warner's cable systems. Because U S West's incentives would be to maximize return to TWE's cable systems rather than to Time Warner's wholly owned programming interests, it would have strong incentives to alert the Commission to actions by Time Warner that favored Time Warner's wholly owned programming interests at the expense of Time Warner cable systems' profitability. Such information would also be available for inspection independently by the Commission. Furthermore, Time Warner's General Counsel responsible for cable systems is required to certify annually to the Commission its compliance

with the substantive prohibitions in Paragraph VII.

F. Time Warner Cable Agrees to Carry CNN Rival

Of the types of programming in which the post-merger Time Warner will have a leading position, the one with the fewest existing close substitutes is the all-news segment, in which CNN is by far the most significant player. There are actual or potential entrants that could in the future erode CNN's market power, but their ability to do so is partly dependent on their ability to secure widespread distribution. Without access to Time Warner's extensive cable holdings, such new entry may not be successful. Time Warner's acquisition of CNN gives it both the ability and incentive to make entry of competing news services more difficult, by denying them access to its extensive distribution system. To remedy this potential anticompetitive effect, Time Warner would be required to place a news channel on certain of its cable systems under Paragraph IX of the proposed agreement. The rate of roll-out and the final penetration rate is set at levels so as not to interfere with Time Warner's carriage of other programming. It is set at such a level that Time Warner may continue carrying any channel that it is now carrying, may add any channel that it is contractually committed to carry in the future, and may continue any plans it has to carry unaffiliated programming in the future. It limits only Time Warner's ability to give effect to its incentive to deny access even to a news channel that does not interfere with such commitments or plans. Time Warner has committed to achieve penetration of 50% of total basic subscribers by July 30, 1999, if it seeks to fulfill this provision by increasing carriage for an existing channel, or to achieve penetration of 50% of total basic subscribers by July 30, 2001, if it seeks to fulfill this provision by carrying a channel not currently carried by Time Warner. This shorter period is possible in the former case because, to the extent that Time Warner is already committed to carry the channel on a portion of Time Warner's systems, less additional capacity would need to be

found in order to achieve the required penetration. On the other hand, the longer period if a new news service is selected assures that an existing news service or other service need not be displaced to make room for the new service.

This provision was crafted so as to give Time Warner flexibility in choosing a new news channel, without undermining the Commission's competitive concern that the chosen service have the opportunity to become a strong competitor to CNN. To ensure that the competing news channel is competitively significant, the order obligates Time Warner to choose a news service that will have contractual commitments with unaffiliated cable operators to reach 10 million subscribers by February 1, 1997. Together with Time Warner's commitments required by the proposed order, such a service would have commitments for a total of approximately 15 million subscribers. In the alternative, Time Warner could take a service with a smaller unaffiliated subscriber base, if it places the service on more of its own systems in order to assure that the service's total subscribers would reach 15 million. In order to attract advertisers and become a competitive force, a news service must have a critical mass of subscribers. The thresholds contained in this order give Time Warner flexibility while ensuring that the service selected has enough subscribers to have a credible opportunity to become an effective competitor. The

February 1, 1997, date was selected so as to give competitive news services an opportunity to achieve the required number of subscribers.

Accordingly, this provision should not interfere with Time Warner's plans to carry programming of its choosing or unduly involve the Commission in Time Warner's choice of a new service. It is analogous to divestiture of one channel on some cable systems and is thus far less burdensome to Time Warner than the typical antitrust remedy which would require that Time Warner divest some or all of cable systems in their entirety. The Commission, however, recognizes that this provision is unusual and invites public comment on the appropriateness of such a requirement.

V. Opportunity for Public Comment

The proposed consent order has been placed on the public record for 60 days for reception of comments from interested persons. Comments received during this period will become part of the public record. After 60 days, the Commission will again review the agreement and comments received, and will decide whether it should withdraw from the agreement or make final the order contained in the agreement.

By accepting the consent order subject to final approval, the Commission anticipates that the competitive problems alleged in the complaint will be resolved. The purpose of this analysis is to invite and facilitate public comment concerning the consent order. It is not intended to constitute an official interpretation of the agreement and proposed order or in any way to modify their terms.