Are Exclusive MDU Access Agreements on Thin Regulatory Ice?

Good arguments can be made for and against exclusive, perpetual access

By Carl E. Kandutsch ■ *Ph.D., J.D.*

At the recent Broadband Summit in Dallas, one topic in particular seemed to be on the minds of private cable operators (PCOs) and property managers: Will the use of exclusive access agreements between owners of multi-dwelling unit (MDU) properties and communications providers be banned or restricted in the foreseeable future?

The concern over the future of exclusive right-of-entry (ROE) agreements is timely because in July 2006, Verizon filed comments in the FCC's Franchise Reform proceeding urging the Commission to prospectively ban exclusive MDU contracts for video services and to rule that existing exclusive contracts are unenforceable.

This article sketches out some of the issues surrounding the debate over exclusive MDU contracts, in the hope that policy-makers involved in the debate will at least take into account what is at stake.

By "exclusive contracts," we mean right-of-entry (ROE) agreements that give a single provider exclusive rights – including access, service provision, and/or marketing rights – with respect to the delivery of video and other services to tenants of an MDU owner's property over a period of time. In general, the policy debate over whether such contracts should be encouraged, tolerated or banned involves the following viewpoints:

On the one hand, proponents of the "level playing field" assert that the use of exclusive MDU contracts obviously constitutes a barrier to competitive entry because no provider other than the incumbent can compete for subscribers in a property that is subject to an exclusive ROE agreement. The government should intervene, they say, and prohibit the use of such exclusive contracts – in the name of "deregulation."

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On the other hand, PCOs can justifiably respond that government intervention in the MDU marketplace with regard to exclusive ROE agreements would be both unnecessary and harmful. Smaller providers, lacking the economies of scale available to large cable incumbents, depend on exclusive contracts for their survival. Banning exclusive agreements would cripple an entire class of competitive entrants and therefore undermine competition generally.

Finally, MDU owners can point out that there is nothing "deregulatory" at all about proposals to prohibit or restrict the use of exclusive building access agreements. In fact, restrictions on the kind of contracts owners can make amount to restrictions on the uses they can make of their private property: Property ownership means nothing if it doesn't imply the right to exclude others, and the formation of an exclusive access agreement is a pretty unambiguous exercise of that right.

Some History: The Cable Inside Wiring Proceeding

The FCC first considered the question of exclusive MDU contracts during its ongoing *Inside Wiring* proceeding, initiated in 1996. The issue of exclusivity was one of several matters necessarily confronted in any attempt to introduce cable television competition into MDU markets: How could one propose a procedure by which a competitive provider might use the existing cable wiring in an MDU building as long as the incumbent provider maintained exclusive monopoly control over that wiring by virtue of a long-term exclusive ROE agreement? The issue of exclusivity was bound to arise when the FCC considered the question of when, if ever, its new rules for the disposition of inside wiring would apply in the first instance.

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sidered whether to prohibit or pre-empt so-called "perpetual" MDU contracts, and whether to pre-empt state mandatory access laws, for the same reasons. Perpetual ROE agreements do not specify any finite term; rather, the term of the contract is linked to the term of the incumbent's cable franchise agreement, including any extensions and renewals of the franchise. Because cable franchises are almost always renewed or extended as a matter of course, these ROE agreements, in effect, endure in perpetuity.[1] An MDU owner locked into a perpetual ROE agreement may not use the inside wiring rules because the incumbent retains perpetual monopoly control over the existing wiring.

Likewise, state mandatory access laws tend to preclude application of the inside wiring rules. Such laws generally prohibit an MDU owner from blocking a tenant's access to the services offered by the local franchised cable operator.[2] Mandatory access is usually interpreted to imply that the incumbent cable company retains control over any existing inside wiring used to provide cable service to residents of an MDU building. Thus, MDU owners in mandatory access states are unable to use the federal building-by-building inside wiring rules.

Notwithstanding their unambiguously anti-competitive effects, considerations of federalism persuaded the FCC in 1997 not to pre-empt either perpetual MDU contracts or state mandatory access laws. Regarding mandatory access laws, the Commission expressed "concern" that such laws unfairly skew competition in favor of large cable incumbents, and "encouraged" the states to consider repealing mandatory access laws to the extent they are discriminatory.[3]

Regarding perpetual MDU contracts, the Commission conceded that such contracts undermine competition, but concluded, based on a survey conducted by the Real Access Alliance, that "perpetual contracts are not prevalent and, in fact, are no longer being widely negotiated.[4]

The most likely explanation for the FCC's inaction, however, is that the Commission feared the political and legal imbroglio that would inevitably follow Federal intervention in areas traditionally relegated to local legislative and judicial functions, on issues of importance to the politically powerful cable industry.

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Throughout the *Inside Wiring* proceeding, telephone companies and some cable operators have argued that the FCC should ban or impose a cap on the duration of exclusive MDU contracts. On the other hand, the real estate industry and private cable operators have strongly advocated the competitive benefits of exclusive access agreements, so long as they are not of perpetual duration. Thus, the private cable industry's trade association (the Independent Multi-Family Communications Council or IMCC[5]) proposed a "fresh look" policy whereby MDU owners bound by long-term or perpetual exclusive access agreements would have a federally mandated window of six months in which they could choose to terminate or renegotiate those agreements without risking liability for breach of contract.

Recognizing that the record was inconclusive with respect to the effect of exclusive contracts on competition in MDU markets, the FCC's 1997 *Second Further Notice of Proposed Rulemaking* sought comment on three options:

(1) Imposing a cap on the duration of exclusive contracts;
(2) Limiting the power of providers with market power to enter into exclusive contracts; or
(3) Adopting a "fresh look" policy for perpetual agreements.[6]

The following years saw a vigor-

ous debate on the merits of exclusive contracts, with the IMCC urging the Commission to preserve exclusive contracts, but to ban perpetual agreements and to preempt state mandatory access laws. Ultimately, in 2003 the FCC again decided to leave exclusive agreements alone:

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In sum, we find that the record does not support a prohibition on exclusive contracts for video services in MDUs, nor a time limit, in the nature of a cap, for such contracts. The parties have identified both pro-competitive and anti-competitive aspects of exclusive contracts. We cannot state, based on the record, that exclusive contracts are predominantly anti-competitive…. We note that competition in the MDU market is improving, even with the existence of exclusive contracts. Accordingly, we decline to intervene.[7]

Nonetheless, the FCC's *Inside Wiring* docket remains open, and in theory the Commission could re-open the issue of exclusive MDU contracts at any time.

More History: The Competitive Networks Proceeding

In the late 1990s, the FCC responded to complaints by several wireless data providers that they were unable to effectively exercise their interconnection rights as CLECs in multi-tenant (referred to as MTE) commercial buildings, with a rulemaking action known as the *Competitive Networks* proceeding.[8]

The CLECs argued that access to commercial tenants in MTE buildings was impeded due to, among other things, the existence of long-term exclusive agreements between building owners and incumbent local exchange carriers (ILECs). The Commission agreed with the CLECs and banned exclusive access agreements between telecommunications providers and owners of commercial MTE properties.[9]

Obviously, this action appeared to contradict the Cable Bureau's nearly simultaneous decision not to interfere with exclusive MDU contracts involving video providers.

Fending off the charge of inconsistency, the FCC emphasized several key differences between competitive conditions in commercial MTE and residential MDU markets, including the following: Commercial leases tend to be much longer than residential leases, making it that much more difficult for a commercial tenant to relocate if the tenant is dissatisfied with the building's exclusive telecommunications provider. Moreover, a provider's revenue stream from a business customer is much stronger than that from the average residential customer, allowing a provider to recover its investment in the building more rapidly than a PCO could recover its investment in a residential building. Accordingly, there is less economic justification for exclusivity in commercial buildings than in residential properties.

Finally, the Commission did not rule out a future prohibition on exclusive telecommunications contracts for residential buildings. Rather, the 2000 *Order* invites comments on whether the ban should be extended to all multi-tenant properties regardless of use.

In summary, exclusive access agreements are currently acceptable for video providers in residential MDU markets, but are banned for telecommunications providers in commercial MTE markets. Self-evidently, this disparate regulatory framework is based on several fragile distinctions:

- First, the distinction between residential and commercial multi-tenant buildings is tenuous at best; and
- Second, the distinction between telecommunications and video providers is rapidly disappearing for all practical purposes.

It is in this context that Verizon's effort to ban exclusive MDU access agreements for video must be understood.

Verizon's Comments

Despite the fact that the FCC's *Inside Wiring* and *Competitive Networks* proceedings remain open, the issue of exclusive MDU contracts remained dormant until last summer, when Verizon filed comments in the Commission's *Cable Franchise Reform* proceeding[10], urging the Commission to prospectively ban exclusive agreements and to preempt the enforcement of existing exclusive agreements.

Verizon's argument is based on the common sense notion that tenants in an MDU building that is subject to an exclusive access agreement with one video provider are thereby deprived of the option of choosing a competing video provider. Thus, Verizon asserts that it has been unable to sell its FiOS video service to MDU residents where the building owner has signed an exclusive agreement with the incumbent cable operator.

Stated in this way, there is no doubt that Verizon's argument is valid: Of

course, there is no competition in any MDU building served by a single provider with exclusive access rights. But the self-evident fact that exclusive contracts foreclose competition in particular MDU buildings does not necessarily imply that such contracts undermine competition in MDU markets generally. Competition policy is concerned with the latter question, and not the former.

Verizon sidesteps this crucial distinction because its argument is framed solely in terms of a duopoly involving large incumbent cable MSOs and the newly entrant telephone companies. It ignores an entire category of competitive entrants, *i.e.,* PCOs, either standing alone, or in joint ventures with DBS (direct broadcast satellite) providers DirecTV and Dish Network.

For example, in its July 6, 2006 Comments, Verizon asserts:

As a result of such [exclusive] arrangements, consumers have been deprived of the opportunity to choose their cable provider simply because the incumbent cable company obtained exclusive access arrangement with their landlord. In many cases, the landlords themselves would prefer to have the opportunity to give their tenants greater access to a variety of cable choices but are unable to do so because they signed such an agreement – sometimes years in the past when there was no meaningful competition among cable providers …. Given that many of these arrangements were negotiated at a time when cable providers enjoyed near monopolies, they tend to be one-sided agreements that provide little or no benefit to the property owner or the customer. In most cases, they serve merely to benefit entrenched cable providers at the expense of new entrants seeking to give consumers more choices at lower costs.…It was previously argued that exclusive access arrangements were necessary to permit fledgling cable providers to establish footholds in certain areas. Yet experience has shown that the opposite is true – exclusive access arrangements are used almost exclusively by dominant cable providers as a means of keeping out newer competition.

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The picture presented by this quotation suggests a competitive landscape dominated by a few large cable operators that in the relatively distant past (that is, before the advent of competition in video markets due to the availability of DBS services in the mid-1990s) locked up significant portions of the MDU market by signing exclusive access agreements with property owners that continue to undermine competition today.

This is not an accurate picture, however. First, most of the exclusive ROE agreements executed prior to the advent of competition have expired by now, or are due to expire soon. Few of those agreements specify terms in excess of ten to twelve years. The exceptions, of course, are *perpetual* exclusive contracts, which, by their nature, are of indefinite term. But if perpetual ROE agreements undermine competition, then policymakers' focus should be on perpetual agreements specifically, and not on exclusive agreements as such.

Second, it is highly misleading to say "exclusive access arrangements are used almost exclusively by dominant cable providers as a means of keeping out newer competition." On the one hand, this statement ignores the use of exclusive access arrangements by PCOs. MSOs, not PCOs, are the "dominant" cable providers in any market. In fact, the core business model upon which the PCO industry fundamentally relies involves the use of exclusive access agreements.

And, on the other hand, it is not true that PCOs use exclusive agreements in order to suppress competition (although that might conceivably be a byproduct). Rather, for PCOs, exclusive access agreements are the best available mechanism by which a small provider can be assured that its initial investment in wiring an MDU building will be recovered over time. Rich Baxter of Consolidated Smart Systems commented: "A regulatory ban on exclusive MDU contracts would profoundly disrupt the PCO business paradigm," and fundamentally alter the way in which his company proposes its business case to prospective investors.

The empirical evidence suggests that both the national markets for MDU housing and for video services in MDU buildings are extremely competitive. This, at any rate, is the FCC's conclusion in each of its annual *Competition Reports* in recent years.

This suggests that MDU owners are forced by the marketplace to act as representatives (or proxies) for their tenants. If an MDU owner can increase the value of being a tenant in its building (for instance, by making available a sophisticated and cutting-edge array of communications services), the owner can capture that value through higher rents.

The fact that MDU owners continue to enter into exclusive access agreements with a wide array of providers in competitive housing markets implies that such exclusive agreements do not in general deprive tenants of value otherwise available. It suggests, rather, that exclusive provider arrangements can and do maximize value to residents, for example, by allowing the provider the financial resources to contractually commit to technology and service upgrades in order to remain competitive with similarly situated providers in the local area.

Furthermore, while it may be true that Verizon has been unable to gain access to some MDU properties, Verizon has not provided evidence showing that it would have invested in those properties in the absence of an exclusive agreement with the incumbent.

Does Verizon's business model for deploying FiOS include overbuilding MDU buildings in order to compete with incumbents and other entrants on a unit-by-unit basis within the building? Verizon doesn't say. But if Verizon is not inclined to overbuild FiOS in MDU buildings, then the competitive problem stems not from exclusive ROE agreements, but from something else – namely, the need to achieve *de facto* dominance, if not exclusivity, in order to justify the costs of wiring an MDU building for FiOS at all.

While the existence of a significant portion of exclusive agreements in a particular neighborhood might affect a cable MSO's decision to invest in that neighborhood, it would not affect a PCO's investment decisions, because a PCO's costs to provide service are largely incurred on a building-by-building (rather than a city-wide or regional) basis.

Assuming that MDU owners have a real incentive to represent their residents, in order to demonstrate that exclusive MDU access agreements undermine competition, Verizon would have to show that when an owner signs an exclusive agreement for any particular MDU building, this materially reduces the competitive choices for other MDU owners in the market. However, while the existence of a significant portion of exclusive agreements in a particular neighborhood might affect a cable MSO's decision to invest in that neighborhood, it would not affect a PCO's investment decisions, because a PCO's costs to provide service are largely incurred on a building-by-building (rather than a city-wide or regional) basis. In other words, it is highly unlikely that a PCO could use exclusive access agreements to undermine MDU competition even if this were its goal.

Conclusion

Exclusive access agreements provide an easy target for over-zealous regulators because from a superficial perspective, exclusivity has an aura of anti-competitiveness about it: By definition, there is no competition within any MDU property that is subject to an exclusive provider contract. But MDU markets are not defined by individual buildings and therefore the anti-competitive aura surrounding exclusive access agreements can be misleading.

The fact is that an entire class of competitors, namely, PCOs, depends on exclusive access agreements in order to assure themselves of a revenue stream sufficient to invest in the facilities needed to offer MDU residents the uniquely tailored, cutting-edge communications services that allow PCOs to differentiate themselves from cable incumbents.

If the FCC or Congress were to ban exclusive agreements in the name of competition, they would risk killing off a significant and important class of competitors, and obviously, without competitors, there is no possibility of competition.

Bill Burhop, the Executive Director of IMCC, offered this comment on the issue: "PCOs have encountered and surmounted many obstacles in the past, and will continue to do so in the future. Exclusive service contracts have been a fundamental economic factor that has allowed PCOs to provide competition to franchised cable. MDUs have supported exclusives because they see them as helping PCOs compete with the MSOs.

"The FCC studied these contract provisions for several years and determined that they do benefit the consumer. Next year the FCC may begin a new inquiry. We believe the FCC and Congress should encourage any competition to the huge franchised companies, particularly by PCOs in joint ventures with the DBS platforms.

"Washington should not tilt the playing field so as to favor one service provider industry over another. Let the market decide if exclusive service contracts are beneficial for MDU residents or not. If exclusive contracts are challenged we assume the FCC will also reexamine the anti-competitive force of perpetual contract provisions and state mandatory access statutes.

"Regardless, PCOs will find ways to compete using marketing agreements, bulk contracts and other techniques to help MDU/REIT owners better serve residents."[11]

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kets, the Commission should focus not on exclusive access agreements, but on two different practices that have no competitive justification: Perpetual MDU access agreements, and state mandatory access laws. These practices, rather than exclusive agreements *per se*, are truly a remnant of a pre-competitive age, and serve only to impede competitive entry rivals to franchised cable in the multihousing environment. **BBP**

About the Author

The author is a former attorney in the FCC's Cable Bureau, and is currently in private practice assisting PCOs and multihousing professionals nationwide. He invites readers with comments, questions or consulting inquiries to contact him at ckandutsch@adelphia.net, or by telephone at (207) 659-6247.

References

[1] Looming on the horizon is the question of whether perpetual MDU contracts will be enforceable when a state or Congress enacts statewide video franchise legislation. Presumably, a cable company holding a statewide or national certificate is no longer operating under the same cable franchise that existed when the ROE agreement was executed, and therefore, the agreement would terminate.

[2] The IMCC website provides a list of state mandatory access laws at http://www.imcc-online.org/ISSUES/RESOURCE%20Info/Mandatory%20Access/states.htm.

[3] *Report and Order and Second Further Notice of Proposed Rulemaking*, In the Matter of Telecommunications Services Inside Wiring, CS Docket No. 95-184 (rel. Oct. 17, 1997), ¶ 190.

[4] *First Order on Reconsideration and Second Report and Order*, In the Matter of Telecommunications Services Inside Wiring, CS Docket No. 95-184 (rel. Jan. 29, 2003), ¶ 76. The RAA survey indicated that only between 3.8 and 4.8 percent of the total properties surveyed are subject to perpetual contracts. Based on this author's experience as a practitioner, the RAA results vastly underestimate the portion of MDU properties bound up by perpetual MDU access agreements.

[5] IMCC was formerly known as the Independent Cable Television Association or ICTA.

[6] *Report and Order and Second Further Notice of Proposed Rulemaking*, In the Matter of Telecommunications Services Inside Wiring, CS Docket No. 95-184 (rel. Oct. 17, 1997), ¶ 203.

[7] *First Order on Reconsideration and Second Report and Order*, In the Matter of Telecommunications Services Inside Wiring, CS Docket No. 95-184 (rel. Jan. 29, 2003), ¶ 71.

[8] *First Report and Order and Further Notice of Proposed Rulemaking*, In the Matter of Promotion of Competitive Networks in Local Telecommunications Markets, WT Docket No. 99-217 (rel. Oct. 2000).

[9] *Id.*, at ¶¶ 27-40.

[10] *Notice of Proposed Rulemaking*, In the Matter of Implementation of Section 621(a)(1) of the Cable Communications Policy Act of 1984 as amended by the Cable Television Consumer Protection and Competition Act of 1992, MB Docket No. 05-311 (rel. Nov. 18, 2005). Verizon's *ex parte* Comments on exclusive MDU contracts were filed on July 6, 2006 and on August 9, 2006.

[11] Received via email by the author.

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